TREASURY DEPARTMENT REPORT ON INNOCENT SPOUSE RELIEF

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

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CONTENTS

TREASURY DEPARTMENT REPORT ON INNOCENT SPOUSE RELIEF

TUESDAY, FEBRUARY 24, 1998

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:07 p.m., in room B–318, Rayburn House Office Building, Honorable Nancy L. Johnson [Chairman of the Subcommittee] presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
February 19, 1998
No. OV-12

CONTACT: (202) 225-7601

Johnson Announces Hearing on Treasury Department Report on Innocent Spouse Relief

Congresswoman Nancy L. Johnson (R-CT), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the Report to Congress of the Treasury Department on Joint Liability and Innocent Spouse Issues. **The hearing will take place on Tuesday, February 24, 1998, in room B-318 Rayburn House Office Building, beginning at 2:00 p.m.**

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include individuals testifying on behalf of the Department of Treasury and the U.S. General Accounting Office (GAO). However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Under the Internal Revenue 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 the tax attributable to his or her spouse's return. However, the decision to file separately generally will result in a higher combined tax liability. By contrast, taxpayers who file a joint return are held jointly and severally liable for the full, correct amount of tax for both spouses for the year in question. Historically, even married couples with only one wage earner often file joint returns in order to benefit from the lower tax rates which may result.

If one spouse has concealed income and failed to report it on a joint return, then it may be unfair to collect the resulting tax liability from the other spouse, if the "innocent" spouse did not know of or benefit from the income. Congress sought to address such instances of unfairness beginning in 1971 by enacting the "innocent-spouse" provisions of the tax law, Section 6013(e). In order to qualify for relief under the current innocent spouse provision, a taxpayer must demonstrate four separate requirements: (1) that a joint return was filed; (2) that the joint return contained 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 unfair to hold the taxpayer liable for the deficiency in income tax attributable to the substantial understatement.

On November 5, 1997, Congress acted again to strengthen the innocent-spouse provision of the tax law when the House passed H.R. 2676, the "Internal Revenue Service (IRS) Restructuring and Reform Act of 1997." H.R. 2676 would improve the operation of the innocent-spouse provision by repealing various statutory dollar thresholds which limit eligibility for relief; by allowing relief for simply erroneous items (rather than limiting relief to "grossly" erroneous items under the current law); and by allowing innocent-spouse relief to be provided on a pro-rata basis (instead of on an 'all or nothing' basis).

In announcing the hearing, Chairman Johnson stated: "The plight of many 'innocent spouses' under current law is nothing less than a disgrace. The House passed IRS Restructuring and Reform Act would mark a big improvement in the innocent-spouse law. We need to review the report of the Treasury Department, which was released after the House acted, to see if it can give us some ideas on how to do more to protect innocent-spouses."

(MORE)

FOCUS OF THE HEARING:

On July 30, 1996, the President signed into law the Taxpayer Bill of Rights 2, (P.L. 104-168). Section 401 of P.L. 104-168 directed the GAO and the Department of the Treasury to study the innocent spouse issue and report back to Congress within six months. Specifically Treasury was instructed to report on: (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, and (4) 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. The report of the Treasury Department was submitted to Congress on February 10, 1998. A report of the GAO was submitted on March 12, 1997. The Subcommittee will review these reports to determine what legislative action may be appropriate in order to provide meaningful innocent-spouse relief to injured taxpayers. The results may be helpful in guiding Congress to improve H.R. 2676 as it proceeds through the remainder of the legislative process.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should *submit at least six (6) single-space legal-size copies of their statement, along with an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format only, with their name, address, and hearing date noted on a label*, by the close of business, Tuesday, March 10, 1998, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at http://www.house.gov/ways_means/"

(MORE)

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

*****

Chairman JOHNSON of Connecticut. Good morning. The hearing will come to order.

As the Congress develops legislation to restructure and reform the Internal Revenue Service, we have learned of a number of disturbing cases in which taxpayers have been grossly mistreated by the IRS. Out of all the horror stories that have surfaced in recent months, none have been more heartbreaking than those involving innocent spouses—taxpayers who in many cases have been left to rear children as single parents, often without child support, only to find that their former spouses have saddled them with a crushing debt. Many of these horror stories have been going on for years without the IRS helping the spouses who are seeking relief from mounting tax liabilities, interest, and penalties. I have seen dozens of letters from innocent spouses who find themselves in this sort of jam—and I really do mean dozens.

I also want to just stray from my written statement to share with you one of those letters. It says, "I was so thrilled to see an article in USA Today regarding your organization. I started to feel like the Lone Ranger. It's good to know that I'm not alone, and that others are outraged by the treatment of innocent spouses, and attempting to effect a change in the system." This comes from a woman from California. "I'm a single mother with one daughter at NYU on scholarship, a daughter who's graduating from high school this year, and a 6-year-old son. I get very little child support and struggle to make ends meet every month. My ex-husband was self-employed during several years of our marriage and did not pay his taxes because he was a cocaine addict. He accrued a debt of $14,000 to the IRS and $8,000 to the Franchise Tax Board during the years that we were married.

"I, on the other hand, worked diligently, and had the usual taxes taken out of my pay. In addition, I put money into a 401(k) at work for our children's college education, so that he could not touch it and blow it all up his nose.

"Since our divorce, he has cleaned up his act. We had a meeting with the IRS together, and he told them that he was a cocaine addict, and that he was the one that did not pay his taxes, and wanted to take full responsibility for the entire debt. They agreed and had me fill out some forms.

"One of the questions on the form asked if I had a thrift savings plan. When the IRS agent saw that I had one, her eyes lit up like a Christmas tree. She indicated that they were going to levy all of my 401(k) and take the money out. I started crying hysterically, and just after destroying my life, the agent said, 'Sweetheart, Jesus will see you through this.'

"She retired and there was a new agent that took her place. I was crying on the phone when discussing the case with her, and she said, 'Miss Smith, it's not that big a deal. I refuse to talk to you if you're going to cry.'"

She goes on with some other things, and in the end, she was forced to file bankruptcy, to stop the levy on her 401(k) and the garnishment of the Franchise Tax Board, and so on. I mean, this is unconscionable, and I know there is no one in the Congress and no one in the IRS that would defend it, but when you get as many letters as this committee has gotten on this issue, and as many let-

ters, and have seen as many cases as individual Members have seen, you know that this is one of those horrendous problems that simply must be solved.

As Elizabeth Cockrell, who started an organization called Women for IRS Finance Equity, testified before the Senate Finance Committee recently, "All they"—that is, many of these women—"are guilty of is trusting their husbands and signing a joint tax return with him."

I had hoped we could address this problem when the subcommittee began developing recommendations for the Taxpayer Bill of Rights 2 nearly three years ago, but I was persuaded that the issues associated with joint and several liability were so complex that we should not act in haste. We, therefore, asked the Treasury Department and the General Accounting Office to help us better understand these issues.

On July 30, 1996, the President signed the Taxpayer Bill of Rights Act 2 into law. The law directed both the GAO and Treasury to study the innocent spouse issue and report back to us within six months; that is, by January 30 of 1997, more than a year ago. The GAO's report was issued on March 12 of 1997, and Treasury's report was on my desk February 9 of 1998, over a year late.

During that year, the National Commission on Restructuring the IRS issued a report; the Subcommittee on Oversight developed TBOR 3 recommendations; the Committee on Ways and Means has reported the IRS Restructuring and Reform Act, and the Clinton administration has supported that reform and approved and sent H.R. 2676, the IRS restructuring bill, to the Senate—all without the benefit of the Treasury's guidance on the innocent spouse issue.

You'll remember that we have made a little progress on the innocent spouse issue in these bills by working together, but it has been minimal. I have been very disappointed that the Treasury couldn't have come forward with their report on time. I truly believe that the kinds of cases, the kinds of families that have been affected by the innocent spouse provisions represent some of the Americans that are simply most abused by the greatest free nation in the world. It is saddening; it is embarrassing; it is intolerable, and we have to change it.

I welcome the Treasury here today to share with us their report and their recommendations. Overdue as they may be, they, nonetheless, are welcome. We do intend to work with you. We hope that we can do this in such a way that it could still be part of the IRS reform as it moves through. I know that the Senate had earlier hearings, that they could try to get it into their form of the IRS restructuring bill. And while you are a day late, I hope you're not a dollar short in the quality of your recommendations.

Thank you very much for being here, Mr. Lubick, and before you proceed, let me recognize Bill Coyne, my ranking member of the Oversight Subcommittee of Ways and Means. Bill?

Mr. COYNE. Thank you, Madam Chairwoman.

Today the Ways and Means Subcommittee on Oversight will discuss two excellent reports recently issued by the Department of Treasury and the U.S. General Accounting Office. I look forward to receiving the experts' views on "joint liability" issues raised by

married individuals filing joint returns and innocent spouse issues raised under current law and in proposals for reform.

I am particularly pleased to note that the innocent spouse legislative recommendations discussed in the reports are included in our House-passed "Taxpayer Bill of Rights 3" legislation pending before the Senate. To summarize, the bill expands the availability of innocent spouse relief by, No. 1, eliminating the various dollar thresholds; No. 2, broadening the definition of eligible tax understatements, and three, providing partial innocent spouse relief in certain situations, and No. 4, providing tax court jurisdiction over denials of innocent spouse relief.

In addition, I want to mention that the President's Fiscal Year 1999 budget contains an additional proposal to expand innocent spouse relief, which should be enacted into law. The proposal would suspend collection actions, in a joint liability case while one spouse is contesting the tax liability in Tax Court.

Finally, IRS Commissioner Rossotti announced last month that the IRS is developing a special form and administrative process to facilitate claims for innocent spouse relief.

Our bipartisan efforts to initiate, and follow up on, pro-taxpayer legislative reforms have been successful, and must continue.

Thank you.

Chairman JOHNSON of Connecticut. Ms. Thurman, do you have an opening comment?

Ms. THURMAN. No.

Chairman JOHNSON of Connecticut. OK. Mr. Lubick.

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF TREASURY

Mr. LUBICK. Thank you, Madam Chairman, Mr. Coyne, Mrs. Thurman. I am pleased, finally, to be here to discuss our report on innocent spouse issues. As my written statement, submitted for the record, indicates in quoting Secretary Rubin, it is imperative that we protect taxpayers whose spouses violate the tax laws without their knowledge, and we assure you that both Treasury and IRS are committed to taking steps to achieve this goal and to working with the Congress to find a solution.

I apologize for the lateness of this report. In point of fact, the essence of it was in my hands last April, and I think I mentioned this to you several times. We continued to search and explore every possible way to make the relief as meaningful and as broad as possible. And, indeed, the matters that were included in your markup of the restructuring bill were matters which we, indeed, with you, had recommended. But we promise you now that we will work with the greatest speed and diligence to complete the job.

The report I believe you have. In its detail it speaks for itself. I do wish to take some time this morning to summarize the principal issues raised by the report and its conclusion.

We start with the basic notion that the general rule under present law, and one which we think is appropriate, is that married couples ought to be able to file a joint return with all of their income and deductions as one, and we recognize that to make that effective, the general principle ought to be joint and several liability for the taxpayers filing that return.

There are a number of reasons for this. One is that we think it's essential to preserve the simplicity of a married couple as an economy unit filing one return instead of two returns, or perhaps even three. We want to avoid the complexity that be required if we had to make specific allocations of items of deduction and credit, in particular, and we want to encourage the allowance of the offset of items of deduction and credits against the income and tax liabilities of the combined unit.

We want also to reduce the administrative demands on the Internal Revenue Service. In 1996, there were 49 million joint returns filed by married couples. If we were to abandon the principle of joint filing, under some circumstances it might require the IRS to deal with separate returns, much closer to 100 million returns, and that, of course, would make obvious difficulties for the administration of the tax law.

The principle of filing a joint return was first enacted in 1948, and it accomplished its purpose of achieving equality between the common-law States, which are most of the States of the United States, and those community-property States, where married taxpayers, before the 1948 act, had the advantage of splitting their income and achieving a much lower rate of taxation than those in the common-law States.

We believe that joint and several liability in the case of taxpayers filing a return is necessary to prevent manipulation. In the collection area, if we did not have that, it would be very possible for interspousal transfers to occur, which can be done currently without any gift or estate tax consequences, in order to avoid collection. If the tax liability is separated from the assets, that would jeopardize the revenue.

The signers of a tax return should assume the liability on the tax return because they receive all of the various benefits of filing jointly—the ones I've outlined of common pooling of income and deductions, the benefits of split income, which in the case of most married couples provides a bonus of tax liability.

Then, too, I think it is important in the administration of the tax laws that the return have legal significance and that taxpayers attest to its veracity and be encouraged to be aware of what is in the return.

In addition, separating liability could, indeed, as we will see as I go through some of the other alternatives, have the result of not particularly benefiting one spouse or the other, but rather in the collection area of benefiting other creditors of the marital community, at the expense of the IRS, and I think it's inappropriate, the IRS being an involuntary creditor.

And, finally, we would certainly preserve the option of present law to permit married couples to file separately. So if there is, indeed, a particular situation, even though it may involve the loss of some particular benefits, the privilege of filing separately would remain as it has since 1948.

That brings us to the innocent spouse situation, and that rule has developed as an equitable rule. I recall, incidentally, when this issue first came before the Treasury Department by a lawyer in New York, Lillian Vernon, who came to our office in 1963 to press

for a change in the code. We didn't make it while I was here, but in 1971 the origins of the present law did come into the statute.

We believe that where it is inequitable to hold a victimized spouse liable for a tax liability caused by his or her—and usually her—spouse who has deluded or defrauded both her and the Government, we should afford relief, carefully-targeted relief, although we would, in general, preserve the rule of joint and several liability.

Now let me review what some of the alternatives are, which are discussed in the report, and let me see how they test up against this general standard.

One possibility, of course, is to go back to the situation before 1948 by having every taxpayer file as an individual and have separate filing. This could be done either through individual separate returns or, as some States do, having two or three columns on the return in which each of the spouses lists his or her separate income, and then there is a column for the aggregate.

The obvious problem with that is that it might require close to 49 million persons to prepare a second return. It would mean that the IRS would have to process close to 49 million additional returns. The IRS would have to set up close to 49 million separate accounts, and would have to send notices out separately, perhaps up to another 49 million taxpayers. And, most importantly, it might mean the loss of the benefits of the joint return unless the substantive tax law were changed accordingly. So we ruled out in the report the notion of going back to separate return filing.

That led us to dealing with the possibility of the filing of a joint return, but making the liability proportionate. In other words, husband and wife could file a joint return, but their liability would be separate, based upon some proportion of the income attributable to each one.

There are two ways in which proportionate liability can be determined. One is what we call front-end proportionate liability. It is determined at the time of the filing of the return. The difficulty with that is that, for the vast majority of cases, fortunately, the issue of liability would never arise. But, nevertheless, if it's to be determined at the front end, that increases the paperwork burden, the complexity of double returns, and that seems to us to be extremely undesirable, both for the taxpayers and the Internal Revenue Service.

Indeed, a separate liability also would in the run-of-the-mill case simply result in perhaps a preference to creditors other than the IRS, to private creditors, and we think that is inappropriate.

The allocation in preparation of these returns of deductions between the husband and the wife is a very complicated issue. Unless one of the married couple earned or received all of the income, one would have to allocate the deductions in order to determine the proportionate income of each member of the community.

The most damning principle, however, that we discovered, when we studied front-end, proportionate liability, is that you would still need to have the system under the law today of equitable relief for an innocent spouse, because suppose we have a situation where a return was filed and the return was inaccurate because of the concealment of income or the claiming of an erroneous deduction by

one of the spouses, and then the additional liability is discovered. That means that the total income of the marital community is increased, and if that's so, when you apply the ratio of income of the two spouses, even if the additional income is attributable solely to the one spouse that was concealing the income, it would result in an increase for the innocent spouse because her proportionate percentage, applied to a larger amount, would increase her liability.

So the result would be that you would have gone through all of this effort of additional recordkeeping, difficulty of allocations, complications in the tax law, and while there may be a lesser amount of innocent spouse relief that would be necessary, nevertheless, there still would be a need to go into all of these questions again of protecting the innocent spouse.

So then we turn next to the notion of what we call the back-end proportionate liability, along the lines of the bill which was worked out by a committee of the American Bar Association. In that situation, nothing would be done at the time of filing a return other than what is done today. A joint return would be filed. Both members of the marital community would sign it. When the situation arose that there was an audit by the Internal Revenue Service, then a determination would be made as to what the proportionate liability of the two members of the community would be, based upon the relative proportions of their income.

Again, the rules for allocating income and deductions, particularly those that are generated by joint assets or obligations, would be quite complex and potentially difficult to administer. The fact is that most married couples share their economic attributes without tracing it, and to have to go to tracing means either the maintenance of records and paperwork from the beginning—and most couples at the beginning probably would assume that they weren't going to get into this situation, and so it would be a difficult problem to determine the allocation.

Additional assessments could still be made against the innocent spouse, as I described in the case of a front-end determination, because, again, if the Internal Revenue Service discovered that one spouse had made an omission from gross income or taken an erroneous deduction, and there was a significant increase in the total tax liability of the community, the problem is still there. The proportion of the income attributable to the innocent spouse is still going to be larger than what it was in the case applied to the original return.

On top of that, in many cases refunds would have been issued, and there are tremendous complications if a refund check was issued to the couple as to who gets credit for the refund and in what proportion. We come to the situation that some kind of innocent spouse relief would still be needed. So even in the back-end proportionate liability, even though the problem isn't quite as serious as the front-end proportionate liability, you're still going to need an innocent spouse relief provision. Given that, that you would still need to have targeted equitable relief, it seems very unwise to introduce all the complexity to the system that would be involved in calculating the pro rata liability.

Another type of proportionate liability relief that's been proposed was one allowing the taxpayers to allocate the liability between

themselves, either at the time of the filing of the return or at the time a dispute arises. The latter is the American Institute of Certified Public Accountants' proposal, that you allocate at the time the dispute arises. And, indeed, some have proposed that you follow the terms of a divorce decree or a divorce settlement in allocating it.

The problem here, again, is that you're introducing a situation that is complex, but more than complex, it's manipulable. It would permit in many situations taxpayers to divorce their income tax liability from the underlying assets that should be used to satisfy them, because, again, assets can be transferred between spouses without any economic detriment.

And, again, we have found that in the situation, once an allocation is made, there's still the need for equitable relief, if an adjustment is made later on, when the original allocation was made at a time that the actual liability was unknown to the innocent spouse at least. So, again, you're in a situation where we would need the equitable relief, and therefore, it's very questionable that we want to upset the system, a system that works for almost everyone, simply to target those cases that cry for equity, when we can devise some relief for those limited number of cases.

A final one, which I will mention only briefly, and it's also referred to in the GAO report on this subject, is to permit allocation by the terms of the divorce decree, and that—we share the view of the GAO that this should be discarded because it means the IRS becoming a party to protect its interests in about every divorce proceeding that occurs in the country. It seems to us fairly clear that that is not appropriate.

Now that brings us to what can be done to improve the situation to avoid cases such as you, Madam Chairman, have described to us in the letter, such as the ones that were brought to light in a recent hearing of the Finance Committee, and probably the situations that are referred to in the sheaf of letters which you held up.

And we think there are two approaches here. One is to take steps administratively, and we have undertaken to do much of that as far as we can, in cooperation with the Service, and I can assure you that the Commissioner is very anxious to move this. We are expediting the issuance of a new form to assist taxpayers in preparing their claims for relief under the innocent spouse provisions. They're going to be processed in one central location to ensure we get technical expertise of the IRS examiner, and that we get consistent treatment for all taxpayers; we don't have some rogue agents or collection officers going off on their own with particularly harsh and stringent application.

We are reviewing all of our current training materials to ensure that they stress the responsibility of our employees in the IRS to identify situations where the innocent spouse provisions might apply, even if the taxpayer is not aware of the process. So where appropriate, the IRS will provide these taxpayers with assistance with a new form and help them prepare it.

Telephone assisters will be trained in the innocent spouse provisions, will be available to answer questions through the IRS toll-free telephone system. There will be special training courses on the innocent spouse provisions to be given to both the collection and ex-

amination personnel in both their basic training as well as annual, continuing professional education and training.

We intend to alert couples who file joint returns of the legal consequences of joint filing in the instructions in their tax packages, and we're going to revise our publications to make innocent spouses aware of the relief provisions available to them.

And, finally, we're going to reach out at 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.

Now, in addition to that, we are recommending to Congress certain statutory changes to both the innocent spouse rules themselves, and I think most importantly, to the procedures in which they may be invoked. We recommend legislation, some of which you have already incorporated in the IRS restructuring bill. The first one is the elimination of dollar thresholds that bar innocent spouse relief in some meritorious cases. We're going to give relief to innocent spouses regardless of the amount.

We propose to liberalize the treatment of erroneous items of deduction and credit, to treat them the same way as omissions from gross income. Heretofore, there's been a more stringent test for deductions. It has to be established that they were grossly erroneous, and we're now putting that on the same basis as omissions from income. If there's simply an erroneous deduction and the other tests for equitable relief are met, we'd propose, and you have adopted in the IRS Restructuring Act, to give relief.

Some others are not in the legislation. We've developed them since, and we would hope to get them added in the Senate proceedings, and I do not believe we are too late. We would extend the relief provisions applicable to taxpayers in the community property States. We want to make them comparable with those applicable in the common-law property States. Heretofore, because of the peculiar rules of community property, they have not been available on the same basis as in the common-law States.

As I indicated, what I think is most important are two procedural proposals. We would significantly expand the taxpayers' procedural opportunities to claim substantive relief by making access to the Tax Court routinely available, and that, indeed, would suspend collection activity. I think most of the horror cases have come from Internal Revenue Service collection officers pressing for collection and hounding innocent taxpayers before they ever had a chance to present the factual situation. This access to the Tax Court, of course, would mean that there would have to be access to the higher levels of the Internal Revenue Service, and we will have available Internal Revenue Service personnel who are thoroughly versed and, indeed, will take an appropriate attitude toward providing relief through the application of the statutory provisions as they were intended to be applied. And as Mr. Coyne mentioned, we would recommend prohibiting collection of the joint liability from one spouse while the other spouse is contesting that in the Tax Court.

I think one of the most important things we can do here is to make sure that the administration of these provisions by the IRS is fair, is appropriate, and doesn't take place in an atmosphere of

pressure without a fair hearing and fair recognition of the situation of the innocent spouse. So we believe that this will prevent many, if not most, of the cases of abuse by collection officers that have so disturbed you as well as us.

This is the program that we would like to move forward with expeditiously, working with you and with the members of the other body, and we would hope that we would see rapidly these changes enacted. The ones that we have talked about, incidentally, are not systemic changes. You all know that the Internal Revenue Service is in a very difficult situation today in trying to convert its systems to deal with the year 2000 problem. The proposals which we are making will not affect the systems, but will make available this equitable relief, and it could be put into effect immediately.

So I'd be very pleased to deal with any questions that any of you may have.

[The prepared statement follows:]

EMBARGOED UNTIL 2 P.M. EST
Testimony as Prepared for Delivery
February 24, 1998

TREASURY ASSISTANT SECRETARY (TAX POLICY) DONALD C. LUBICK
HOUSE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

Chairman Johnson and Members of the Subcommittee:

I am pleased to appear before you today in response to your request to discuss the Department of the Treasury's recently-released Report to the Congress on Joint Liability and Innocent Spouse Issues ("Report"). As we indicated in the Report and in the President's budget proposals, we share with many in Congress the concern that the existing statutory framework on these issues sometimes works imperfectly for taxpayers, particularly those who are divorced or separated from a former spouse. I welcome the opportunity to discuss these provisions and various possible solutions with you today.

As Secretary Rubin has stated, "it is imperative that we protect taxpayers whose spouses violate the tax laws without their knowledge." Treasury and the Internal Revenue Service ("IRS") are taking steps to achieve this goal, and we are also committed to working with Congress to find a solution.

Let me first remind the Subcommittee of the genesis of our Report and explain the procedure we followed. In the years following the enactment of the first Omnibus Taxpayer Bill of Rights in 1988 and leading up to the enactment of the Taxpayer Bill of Rights 2 ("TBOR 2") in 1996, Congress heard complaints from many taxpayers and their representatives about the tax rules applicable to married taxpayers who file joint returns, particularly those who later divorce or separate. Concern has focused especially on the Internal Revenue Code's standard of "joint and several liability" for joint filers and the so-called "innocent spouse" provisions that provide relief from joint and several liability in certain situations. Rather than abruptly changing these rules, however, Congress in TBOR 2 prudently directed Treasury and the IRS, as well as the General Accounting Office, to conduct studies of these issues, and in particular to analyze four

specific 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, the IRS may collect such liability only in accordance with the decree;
(3) Whether the innocent spouse provisions of the Internal Revenue Code provide meaningful relief in all cases where such relief is appropriate; and
(4) The effect of providing that community income, which (in accordance with the rules contained in I.R.C. § 879(a)) may currently be treated as the income of one spouse, is exempt from a levy for failure to pay any tax by the other spouse for a taxable year ending before their marriage.

The legislative history accompanying TBOR 2 further directed us to examine the effects of legislatively reversing a 1930 Supreme Court case, Poe v. Seaborn, for income tax purposes in community property states, and finally to consider "the tax policy implications, the equity implications, and operational changes which would face the IRS" if any of these rules were changed by statute.

As part of the Administration's own initiatives to enhance taxpayer's rights, Treasury and the IRS had begun studying these issues even before TBOR 2 was finally enacted. In 1996, we requested public input on the topics identified by Congress, and we received a great number of thoughtful comments and reform proposals. These generated extensive discussions, both internally among members of our working group and publicly with interested tax practitioner groups, such as the American Bar Association ("ABA") and the American Institute of Certified Public Accountants ("AICPA").

As you know, Madam Chairman, the Report of our study was delivered to Congress nearly a full year late. I sincerely apologize for that tardiness, but I want to assure you and the other members of the Subcommittee that the delay was caused substantially by our desire to analyze all of these issues thoroughly and in as complete and even-handed a manner as we could. We hope you will agree with us that eventually we did evaluate all of the proposals fully, fairly, and in considerable depth, and that ultimately what we provided in our Report meets the Congress's request for an inquiry into these problems.

Let me turn now to the results of our study. As you can see, the organization of our Report varies slightly from the enumeration of questions in the TBOR 2 statute and legislative history. There are several reasons for this. First, our research convinced us that it is important to consider the narrow topics Congress asked us to analyze within a much broader context. Joint return filing, joint and several liability, the interplay of the Federal income tax law with State common law or community property law, and the innocent spouse relief provisions have evolved over many decades. Reviewing this history convinced us that the current rules on these issues are the end result of a series of considered tax policy decisions by Congress. They are also

integrally related to a number of more fundamental tax considerations, such as the existence of different filing statuses for individual income taxpayers and the many factors that go into determining the amount of tax, including marginal rates, phase-outs, other deduction and credit limitations, and so forth. Finally, the IRS has in many respects structured its administration of the income tax system around the current joint filing and liability rules, and significant changes to those rules would have major effects on return processing, account servicing, examination and collection, and dispute resolution. It is important to recall that the IRS receives over 51 million returns from married taxpayers each year, and that according to the General Accounting Office the universe of potential innocent spouse cases may be as few as 35,000 annually.[1/] In short, reform proposals cannot and should not be considered in isolation.

Our study also persuaded us that the current system has many basic features that are worth preserving. These include, in particular, the joint filing option for married couples, the principle of joint and several liability for the tax due in most joint filing situations, and the allowance for equitable relief, currently in the form of the innocent spouse provisions, as the exception rather than the rule. Let me discuss each of these for a moment.

First, there are sound policy reasons for permitting married couples to file joint income tax returns and thereby treating them as a single economic unit for tax purposes. This permits spouses to offset each other's income and losses with great ease and simplicity, provides that couples in similar economic situations pay the same amount of tax, and permits married taxpayers in common law property jurisdictions the same income-splitting effect that is available to taxpayers by operation of law in community property jurisdictions. There are also practical reasons for joint filing, in particular to simplify filing obligations for the roughly 49 million married couples who do file jointly, and to reduce by up to half the resources that the IRS must devote to handling the annual income tax returns of married individuals.

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, each spouse voluntarily undertakes the responsibility for the correct total joint liability, just as other taxpayers undertake responsibility for their correct tax liability upon the filing of a return. Taxpayers who wish to avoid the rule of joint and several liability, and in effect to obtain proportional liability, already may elect to file separate returns using married filing separate status, although we recognize that there are frequently drawbacks to doing so. Undeniably, however, taxpayers should be made more fully aware of their filing status options and the legal consequences of each filing status.

We acknowledge that joint and several liability can lead to inequitable results in some

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1/ General Accounting Office, Information on the Joint and Several liability Standard, No. GAO/GGD-97-34 (March, 1997) at 4.

factual situations, for instance where one spouse withholds information or intentionally deceives the other. The innocent spouse provisions are intended to rectify such situations, and they do so in many cases but, we realize, may also work imperfectly in some other cases. Eventually we concluded, however, that some of the reform proposals, such as shifting to a mandatory separate return system or a proportionate liability system at the "front-end" (return filing) stage of the tax process, would have significant drawbacks affecting millions of taxpayers, in an effort to address these relatively infrequent situations. Such a dramatic change would impose large compliance and paperwork burdens on taxpayers and the IRS, yet they would provide very little compensating benefits to the overall operation of the tax system. In certain egregious situations, moreover, they would still require some kind of equitable relief provisions, like the current innocent spouse rules.

More limited "back-end" proposals, which would apply only in the event of a controversy over the amount or collection of a tax liability, do have some distinct advantages when compared to current law, but they also suffer from potentially serious defects of their own. We discuss two of these proposals -- the ABA's proportionate liability recommendation and the AICPA's allocated liability concept -- at some length in our Report, because they were the two proposals that were presented to us in the most complete and thorough form. On the positive side, back-end reform proposals would as a general rule not be nearly as disruptive to the processing of income tax returns as front-end approaches, and they would potentially limit the ultimate tax exposure of a spouse for whom the current standard of joint and several liability for the full joint tax amount may be perceived as unfair. Each proposal also bears distinct disadvantages, however. There are many technical or "mechanical" problems with each proposal, which could create significant difficulties in tax administration and collection for taxpayers and the IRS. 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, and these proposals, in which taxpayers would bear the burden of demonstrating the proper treatment of a challenged item, would not resolve such difficulties. Moreover, some kinds of equitable relief (like the current innocent spouse rules) still would be needed in certain situations in which the liability-limiting rules would leave results that may still be considered unfair. Thus, while these approaches possibly would reduce the number of cases in which innocent spouse relief is needed, they would not eliminate it entirely.

Some other reform proposals that we considered would depart fairly dramatically from appropriate and well-established tax policy and have serious defects that become readily apparent upon close review. These include, for instance, the proposals to reverse Poe v. Seaborn or to limit the amount of community property that is subject to collection for federal tax debts. Both proposals would create significant anomalies between community property and common law jurisdictions, depart from traditional deference to State law regarding what constitutes property or rights to property, and unilaterally impair collection of Federal taxes vis-a-vis other creditors who would continue to follow and be bound by State property law.

We concluded in our study that the best option for reform in this area is to devise

strategies that will preserve the many advantages of the current system and yet will modify the system to afford innocent spouse relief in more cases where such relief is appropriate. Our plan will affect taxpayer contacts with the IRS at all stages of the process, from initial filings through a new ultimate remedy in the Tax Court.

Treasury and the IRS have already undertaken several administrative actions to improve the operation of the innocent spouse provisions, and we are considering other changes in the regulations, forms, and publications concerning joint and several liability and innocent spouse issues. These 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 all 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 process. When appropriate, the IRS will provide these taxpayer 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's 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 and 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.

- Reaching out at 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.

We have also recommended to Congress certain statutory changes to both the innocent spouse rules themselves and the procedures in which they may be invoked. In particular, we recommend legislation that would:

- totally eliminate dollar thresholds that bar innocent spouse relief in some meritorious cases;

- liberalize the treatment of erroneous items of deduction and credit to treat them the same

way as income items in applying the innocent spouse rules;

- extend the relief provisions applicable to taxpayers in community property states to make them comparable to those applicable in non-community property states;

- significantly expand taxpayers' procedural opportunities to claim substantive relief under the innocent spouse provisions, by making access to Tax Court routinely available; and

- prohibit collection of a joint liability from one spouse when the other spouse is contesting the amount of liability in the Tax Court.

The new procedures we are recommending will prevent many of the cases of abuse by collection officers that have so disturbed you and us. We do not, however, recommend elimination of the joint and several liability standard or the current "knowledge" standard in the innocent spouse rules, because we believe that they are critical to maintaining the legal significance of an income tax return and, ultimately, to the successful operation of our voluntary self-assessment system. Eliminating them would greatly complicate the administration of this system without benefiting the vast majority of taxpayers who are never involved in a potential innocent spouse situation.

Our Report discusses our conclusions in some depth, and as you know the President's FY 1999 budget proposal incorporated our legislative recommendations. Several of our proposed changes have been incorporated in the IRS restructuring bill (H.R. 2676) passed by the House of Representatives last fall. We hope to add our other new proposals to H.R. 2676 as that legislation is considered in the Senate this year. Treasury and the IRS look forward to working with the tax-writing committees of Congress to enact these important reforms.

This concludes my prepared remarks. I would be happy to answer your questions at this time.

-30-

Chairman JOHNSON of Connecticut. Thank you, Mr. Lubick. I appreciate the additional recommendations that you have made to the Senate, and I think they are helpful, but I am extremely disappointed in your testimony in regard to divorce decrees, especially when within the decree there is clearly an equitable allocation of responsibility, and the decree addresses specifically tax liability and allocates it to one partner, I absolutely don't see how the Government has the right to ignore that.

Now I don't think it's too hard to look back at a decree and see if it was grossly manipulated. I think you're—what's the term I'm looking for?—you're just moving from the particular to the absurd to say that the Federal Government would have to become a party to every divorce action.

Mr. LUBICK. No, it couldn't.

Chairman JOHNSON of Connecticut. It couldn't. Of course it couldn't.

And in many divorce situations there really aren't tax liability issues, but where that has been clearly specified in divorce decree, it seems to be not a hardship on the IRS at this point in terms of the changes that confront it, and I, too, don't want to complicate its life until we get through the year 2000 changes. But it does not seem to me a hardship, and where a decision has been made and a judge has ruled this as fair, a fair distribution of responsibility among the partners, it positively defies logic that the IRS should then come in and say, "I don't care what the judge says; I don't care what responsibilities either partner took on. We're going after both of you equally for the tax liability."

Where is the IRS's common sense in this opposition?

Mr. LUBICK. It seems to me, Madam Chairman, with all due respect, that to allow State courts to allocate tax liability which has otherwise arisen, and is not an innocent spouse situation—if it's an innocent spouse situation, I don't have any problem with that, where the one spouse was not aware of an omission that was concealed by the other spouse, but I think the present statute would cover that. But to say that liability that's already been established, and there are marital assets for it, the court could as well say, well, we will take these marital assets and have them paid in satisfaction of that liability. But if the court—and it seems to me the burden ought to be on the court to make sure, if there are assets there, that they are satisfied. I don't see how the IRS as a creditors—other creditors are protected in that situation. The court cannot change the——

Chairman JOHNSON of Connecticut. Well, presumably, the IRS can go after the spouse who is liable. We're not saying that the IRS can't go after a taxpayer to make good on a liability to the public——

Mr. LUBICK. But, but——

Chairman JOHNSON of Connecticut. All we're saying is that if in the allocation of the liabilities and assets, for instance, in a marriage situation it is agreed that the tax liability must be shouldered by one spouse, why wouldn't the public accept that? Why wouldn't it be in our public interest to accept that?

Mr. LUBICK. In every other situation, Madam Chairman—the Visa card liability, suppose there's a joint liability. The court—and

usually in a divorce decree you have the parties negotiating a settlement, and then it routinely goes before the court, and if it's not contested——

Chairman JOHNSON of Connecticut. Right, and the goal of the settlement—that's a perfectly good example of that, credit card liabilities—the goal of the settlement is to allocate in some fair manner both the assets and the liabilities. So if I am allocated the responsibility to repay $5,000 in credit card debt at 18 percent, and my spouse is allocated the responsibility to repay $5,000 in taxes, why later on should the Government be able to come at me for his $5,000, which he didn't repay, when I repaid my $5,000, and that was the deal? I paid this debt; he paid that debt. At a certain point people need to be able to settle their lives, and if they make that decision, and the court affirms that it's equitable, then the IRS's responsibility is to make sure that he who is liable for the $5,000 pays the $5,000, and you can attach wages; you can attach assets; you can do all kinds of things, but why should you have the right to come after the other spouse who paid their share of the joint liabilities?

Mr. LUBICK. Well, the bank in that situation, if it had the joint liability, if the bank were not paid, could go after both of them, too.

Chairman JOHNSON of Connecticut. Okay, take another example. You split the liabilities down the middle. I have to pay half the credit card debt and half the taxpayer debt; I pay my halves, and my former spouse doesn't pay his half of the credit card, but I take my name off it, so I can control that. The legal document says he has to pay you the other half. At a certain point we have to provide closure to people going through divorce, and if their responsibilities are allocated, you can't always leave them exposed then to another set of laws that comes back and says, "We don't care what the allocation was or how fair it was or who paid what. You're going to pay for this."

Now, for instance, according to what you're saying, these women—there's no way she could get out from under her savings—when, clearly, she paid the taxes on her salary; she saved from that salary. Her husband acknowledges he didn't pay his taxes, that he used it for cocaine instead, wants to assume the debt. And under all the changes that you have made, there is no way an IRS person, no matter how much sensitivity training they have received, could allocate that burden entirely to the husband, with savings sitting there that was set aside specifically so kids could go to college.

We have to be able under the law to look at responsible behavior and irresponsible behavior, and one of the things I liked about that letter was that it was so clear, and there was acknowledgement.

Now is there anything you have told me that would allow the IRS in that situation to say, fine, you've acknowledged it; now you're liable, and we're going to let your wife alone, and we're going to let her 401(k) alone?

Mr. LUBICK. Well, obviously, if the IRS came into it right then——

Chairman JOHNSON of Connecticut. I'm talking about right then. They came into the taxpayer advocate; he acknowledged—everybody said this is fine; he's going to take the debt, and then they saw her 401(k) savings.

Mr. LUBICK. If the IRS is a party to it, I would see no problem whatsoever, and I think there are procedures before the Internal Revenue Service that would permit agreements like this. Collection officers make agreements all the time, and if you involve the IRS, and the IRS is willing to——

Chairman JOHNSON of Connecticut. So could the collection officer at that point have made the decision, I mean legally——

Mr. LUBICK. Yes, yes.

Chairman JOHNSON of Connecticut [continuing]. That the IRS funds were off-limits——

Mr. LUBICK. Sure.

Chairman JOHNSON of Connecticut [continuing]. And that the husband had the liability.

Mr. LUBICK. The IRS can do that.

Chairman JOHNSON of Connecticut. How do we give better guidance to the IRS officer that that's what they are to do?

Mr. LUBICK. Well, I'm sure we could find a way because I have had these situations——

Chairman JOHNSON of Connecticut. Because really this person was forced into bankruptcy because of the right of the IRS officer, and nothing you're doing would change that IRS officer's, in a sense, burden of responsibility to act in a way that was fair and equitable.

Mr. LUBICK. But if at the point that you're arriving at the agreement, and both parties recognize we have a liability to the IRS and we have a certain amount of assets, you can work that out with the Internal Revenue Service, and——

Chairman JOHNSON of Connecticut. I don't see any way, though, that anything that you're recommending that would change the IRS's view that two divorced people, one of whom was a cocaine addict, have this liability, and so I'm going to allocate it all to you because you, lady, the good guy who worked hard and paid your taxes and saved for your kids' education, clearly were doing the right thing. I don't think under the current law the IRS officer could in good faith make such a one-sided decision, and you think they could?

Mr. LUBICK. I think, if I understand you correctly, what you're talking about is the situation where you have a——

Chairman JOHNSON of Connecticut. You have a clear excuse——

Mr. LUBICK. You have a letter.

Chairman JOHNSON of Connecticut [continuing]. Clear recognition on the other side.

Mr. LUBICK. You have a creditor who has a liability that's recognized, and it's a liability of both parties. The parties are going to divorce. They're going to——

Chairman JOHNSON of Connecticut. But this letter was served after the fact, as I gathered.

Mr. LUBICK. Well, that's the problem. It doesn't seem to me, under the law in the United States, with respect to any creditor, whether it's the IRS or a bank or any other creditor, as to whom there is liability of both parties, that a court, in the absence of that party, can change that liability.

Chairman JOHNSON of Connecticut. Switching from the court for a minute, because I think that is a different issue, and I think we

have a right to give guidance to the IRS on that issue. But severing that for a moment, my question to you was: Can you foresee under any circumstances—first of all, there is no change that you're recommending that would free the IRS agent, in light of those 401(k) savings, to completely, in a sense, free the woman from this case, and have the settlement entirely with the husband at maybe $100 a month for 10 years?

Mr. LUBICK. Well, if the IRS participates in a settlement arrangement like that, the IRS can do that; the collection officers have that authority. They can——

Chairman JOHNSON of Connecticut. So the collection officers could agree to such a settlement?

Mr. LUBICK. Yes.

Chairman JOHNSON of Connecticut. Okay. One last question, and then let me go on, because I know other people have questions. The taxpayer advocates, when they were testifying before us and talking with us, they recommended that taxpayers who filed a joint return be allowed to subsequently change their filing status to married, filing separately, in cases where one spouse would be unfairly saddled with a joint tax liability. Now if you—this seems to me very logical, because while I understand what you're saying about paperwork and allocation and all that stuff, there are other situations in which you can go back and view your tax obligations retroactively differently. And if you allowed a certain period of time when married, filing jointly, could be changed to married, filing separately, it's a relatively narrow window, and the allocation issues, while serious, are not impossible and they're not a lot different than goes on in the settlement process anyway. Why couldn't we use that mechanism suggested by the taxpayer advocate of allowing retroactive married, filing separately, as a way of resolving this between the two people and the IRS?

Mr. LUBICK. I think the problem is that allowing the parties subsequently to change their returns would allow them—would open the door to very collusive transactions. As I said, assets could be transferred freely between spouses, and——

Chairman JOHNSON of Connecticut. I understand that.

Mr. LUBICK. If in the interim the assets get separated from the tax liability, you have a situation where the only party losing is the Government. It's a way of avoiding taxes. The parties simply shift the tax liability through the separate returns non compos tunc ex post facto.

Chairman JOHNSON of Connecticut. I'll leave it to other people now, but, you know, I hear what you're saying about that, about manipulation. On the other hand, there are cases—and that letter kind of gave one, I mean, assuming it's as simple as that letter, and I understand that behind it could be very complicated. But where one person acted responsibly and actually paid taxes on all her wages, and if they have the right to file jointly, she would go back, record her income, record her taxes paid, and so on. And he would have to do the same. Now, presumably, there is some recollection and some record of his income, and, clearly, a record of no taxes withheld.

So it just seems to me that there are ways to simplify this, and we've got to do better than the recommendations that you've proposed. That's where my thinking is now.

Mr. LUBICK. Well, we would provide that innocent spouse relief extends not only to understatement on the return, but also to underpayments. I don't know whether in the case you're talking about it would be—that she wouldn't know that he hadn't paid the taxes that——

Chairman JOHNSON of Connecticut. Well, that was the implication; we don't know that, right?

Mr. LUBICK. Yes. Yes, I think so. So, therefore, I think what we had proposed for the innocent spouse relief would include understatements. I don't know exactly on all of the facts, but I think there's a possibility that our proposal might cover that situation.

Chairman JOHNSON of Connecticut. Thank you. Sometimes it's a blessing not to be a tax lawyer. [Laughter.]

Although, on the other hand, you can make some mistakes, and I appreciate that.

Mr. LUBICK. It's quite normally a blessing not to be one, I can assure you.

Chairman JOHNSON of Connecticut. Mr. Coyne?

Mr. COYNE. I have no questions.

Chairman JOHNSON of Connecticut. Mr. Portman?

Mr. PORTMAN. Thank you, Madam Chair, and for bringing this issue to the attention of the Congress a couple of years ago, I'm glad we finally got the report from Treasury, a little late in terms of the train leaving the station here in the House, but we are lucky that it takes 30 days to make instant coffee in the Senate. [Laughter.]

Because it's still hanging out over there, and hopefully, we can make some of these changes. I think Chairman Johnson has made a couple of good points that we ought to look at again.

I just want to review the bidding a little bit. Bill Coyne and I look at this in terms of the Commission, and this subcommittee added some things to it. We actually ended up with five or six pretty good provisions, I think, and I want to just go over those quickly to make sure you support them all.

As a starting point, eliminating the understatement thresholds, I think you just said that's fine.

Mr. LUBICK. Yes, sir.

Mr. PORTMAN. And GAO has told us that's going to add about 40,000 additional spouses a year, roughly. Do you agree with that, more or less? So it will more than double the number of innocent spouse cases probably?

Mr. LUBICK. Eliminating the threshold—I'm not sure. Do you have the numbers [speaking with staff]?

Mr. PORTMAN. GAO has that in its report. I saw it. I would guess you agree with that number?

Mr. LUBICK. These are potentials, not necessarily actual cases, I believe.

Mr. PORTMAN. Okay. That's your projection, though; is that correct? We'll talk to GAO later.

The grossly erroneous standard, that was something that we took out and made that merely "erroneous," and it sounds like you agree with that.

Mr. LUBICK. Yes. We do. We do. We agree with you.

Mr. PORTMAN. Okay.

The Tax Court jurisdiction, it sounds like you agree with that.

Mr. LUBICK. We do.

Mr. PORTMAN. Right now you have to pay the deficiency, and you have to go file a case in the district court, I guess, and get back your money you've already paid. And we're saying the Tax Court has jurisdiction. That's in the legislation. You agree with that?

Mr. LUBICK. Right.

Mr. PORTMAN. Could you expand on that a little bit?

Mr. LUBICK. It's not a deficiency, Mr. Portman; it's the liability, and then you sue for a refund of it——

Mr. PORTMAN. A refund of what——

Mr. LUBICK. We would stay the collection action and allow you to——

Mr. PORTMAN. Okay. So you're saying you agree we should have accessibility to the Tax Court.

Mr. LUBICK. Full accessibility——

Mr. PORTMAN. And during that time period there should be a suspension?

Mr. LUBICK. A suspension, yes, sir, unless there's some jeopardy or somebody's about to run off to South America with large assets.

Mr. PORTMAN. Canada would be okay, but——

Mr. LUBICK. Pardon me?

Mr. PORTMAN. No, no. I could see us legislating on this.

Suspending collection actions can mean a lot of different things. Are you suggesting that we authorize the Advocate, as we do with some of the other cases to be able to make that decision or how would you do the suspensions? With injured spouse or other hardship cases, we authorize the Advocate to suspend collection actions. Is that how you would contemplate doing it?

Mr. LUBICK. I understand it's automatic upon the application.

Mr. PORTMAN. So long as the innocent spouse criteria are met, it's automatic?

Mr. LUBICK. No. That would defeat the whole situation. The purpose is to determine——

Mr. PORTMAN. So as long as someone has applied——

Mr. LUBICK. As long as the innocent——

Mr. PORTMAN [continuing]. For the relief, that person would be——

Mr. LUBICK. As long as the claimed innocent spouse applied for the relief——

Mr. PORTMAN. Okay.

Mr. LUBICK [continuing]. Then that triggers it until it can be determined.

Mr. PORTMAN. Okay, it can be determined by the Tax Court?

Mr. LUBICK. Correct.

Mr. PORTMAN. Okay. So that's a little different, I think, than our legislation, and we would need to, as I understand it, change the legislation slightly in that regard, but it's the same idea.

The things the IRS is already doing I think are very helpful—the separate form; that's in our legislation. I think the IRS has the authority to do that, and they're moving ahead with it, as I understand it.

Mr. LUBICK. Yes, we are.

Mr. PORTMAN. Additional information is being provided. I understand instructions are being provided.

Mr. LUBICK. Yes, sir.

Mr. PORTMAN. That's in the legislation. That's being done. It sounds like that's already not only agreed to by Treasury, but you're moving ahead with that at the IRS.

There are two final ones. One would be the community-property States issue, and I don't know if we looked at that before, but that seems to me something that makes a lot of sense that we would want to add.

The final one gets into something where I think you have expressed different views on it in the past. I want to make sure that we're on the same page, and that's this notion of relief being provided an apportioned or pro rata basis. Right now, if you are an innocent spouse and you're responsible for some of—let's say 5 percent—of the so-called omission, under the current standard you can't get relief, or at least it's not clear that you can get relief. We need to clarify that standard. So we've codified that in our legislation.

That codification would say that, indeed, you can get pro rata relief. If you're responsible for 5 percent of it, then you, would be on the hook for that 5 percent, but not for the additional 95 percent. Do you agree with that?

Mr. LUBICK. We think that's a proper interpretation of present law actually because the statute now gives you relief with respect to omissions from gross income as to which you didn't have knowledge, and it would be inequitable to hold the innocent spouse liable, and the same as to deductions. It seems to me the relief is given on an item-by-item basis, if the criteria are met. So we don't have any problem with that. We think there was a court decision to that effect which was correctly decided, and we think——

Mr. PORTMAN. Okay, that's not in your Treasury report? That's not in the President's budget? It's not there because you think it's unnecessary to codify it?

Mr. LUBICK. I think that's correct.

Mr. PORTMAN. Okay.

Mr. LUBICK. But we have no objection to it.

Mr. PORTMAN. Okay. I wondered if there was some disagreement there. The Chair has raised a couple of other issues. Let me raise just one other, and that's this notion of not eliminating the current knowledge standard, but doing something to clarify the standard. It sounds like, from what you've said today, you're not in favor of eliminating the standard, but I think it was AICPA in a hearing recently came up with some suggestions, where there might be some factors that either could be codified or IRS could lay out through administrative action and regulations, to determine what knowledge means. Do you have a view on that?

Mr. LUBICK. I haven't thought much about it, but to whatever extent we can make clear what the criteria are, we certainly are in favor of doing that. There certainly can't be any objection to——

Mr. PORTMAN. To trying to codify something?

Mr. LUBICK [continuing]. Indicating situations that would be illustrative of justifying relief.

Mr. PORTMAN. Okay. I think that's about it in terms of additions. I see my time is up. I have some other questions. Maybe we'll get back to them later. Thank you, Madam Chair.

Chairman JOHNSON of Connecticut. Mrs. Thurman?

Mrs. THURMAN. Mr. Lubick, I want to go back to some of the questions that the chairman was talking about. I really can appreciate this marriage issue or at least the divorce decree. In listening to the responses, I can see where the liability—thank God I'm not going through a divorce; I think I've learned a few things here today. But I guess the issue here is, for some of these folks—because when they do go through a divorce, they break up their assets or their liabilities, and they try to—some will come to agreement, and then, all of a sudden, the woman or the man, depending on who gets this liability, ends up in the situation of saying, whoa, wait a minute. And I can appreciate what you're saying, though. I have to tell you that there is a liability, and reading through the report, both the GAO and yourselves have mentioned how difficult this could be, and the 1.2 million divorces, and being involved in all of that.

But I guess it's the same issue that we go back to over and over again, and that's kind of the friendliness of this. I certainly think that if I had to go talk to the ABA or to my Florida lawyers, I would suggest to them, or to the accountants or whoever, you guys need to make this very clear that this liability is not washed just because of this decree. I think that is a part of their education responsibility to their profession.

But on the other side, if you do have a situation—and I'll use this because it most of the time goes this way: The wife gets the house, and this might be where she goes then, because interest rates are low, and things are wonderful; goes in, refinances it, gets the money, puts it in the bank to get a college education because she can't count on the husband or the father to take care of those situations, and then, all of a sudden, she gets hit with this.

What can we do—maybe it doesn't have to be done legislatively as much as it has to be just within our system. How do we make sure that we have gone to the fullest extent of making the other person who in this decree is liable for these liabilities? Is there something we can do?

Mr. LUBICK. I would suggest that, if I were a judge or if I were a party who knew I had a secondary liability on this obligation, I would try to set up some third-party arrangement, a trust arrangement, or an agency arrangement, or an escrow arrangement. If we're talking about the assets that the parties have and they're carving them up, and the assets have to meet the obligations, it seems to me a procedure can easily be set up to make sure that those liabilities are discharged. There are all kinds of security arrangements that the spouse who assumes the obligation can give in the remaining properties, particularly if it's real property, to se-

cure the performance of those obligations. There are legal techniques that can be done.

Now, obviously, every person going to divorce court doesn't have a lawyer necessarily who's aware of all this, but the judges ought to know it, for crying outloud——

Mrs. THURMAN. Okay, well, then maybe there's a question for you. Are we doing something from the IRS? We've talked an awful lot about giving information out to the taxpayers and to businesses and to different organizations and groups, so that they feel friendlier toward the IRS. Are we doing an educational system with those that would be in this situation or potentially are making these decisions?

Mr. LUBICK. I think the problem here, at least in the case that engendered this discussion, was that the divorce occurred prior to the IRS coming into the picture, which makes it a little difficult for the——

Mrs. THURMAN. However, though, if—not really, because——

Mr. LUBICK. But you're right.

Mrs. THURMAN. Personally, you're not involved with it, but if the judge is making a determination on liabilities in that divorce, then they are; the judge is involved. What I'm wondering is—is this a situation that we should go to our State courts or divorce attorneys, or is it continuing education? There has got to be a way for them to get into this.

Mr. LUBICK. I think there's some good points there. First of all, we indicated that we are going to expand the materials, the educational materials, that are furnished to taxpayers, so that at the time of making out the returns—I don't know if the innocent spouse is going to read the instructions——

Mrs. THURMAN. Right.

Mr. LUBICK [continuing]. To the form. That may not be realistic.

Mrs. THURMAN. Sure.

Mr. LUBICK. But we are certainly focusing—as we indicated, one of our proposals administratively is to focus outreach on both the national and local levels to community organizations that served abused or battered spouses, and we——

Mrs. THURMAN. Don't agree to it. I mean, it would be real easy; just don't agree to it.

Mr. LUBICK. Well, I think that's right. You are in a consensual situation between two parties, and you're trying to modify the rights of a third party who wasn't a party to the proceeding. That's where I got stuck with Ms. Johnson——

Mrs. THURMAN. Before my time runs out, though, let me ask you this: Knowing that this decree is in effect, and when you have a situation like this come up, what can the IRS do, or what are they doing, or do you think they're doing, to try to fulfill that decree? I mean, to make sure that the liability is placed on the person that it's supposed to be.

Mr. LUBICK. I think you've put your finger on what I think is the most disturbing part of this whole problem, which is that—and I think it's produced the most dramatic of the examples; that there have been some particular agents who are hard-nosed and unsympathetic and——

Mrs. THURMAN. And done nothing to go after the other person?

Mr. LUBICK. Right, and there are illustrations of that. I think that is precisely the situation that the Commissioner has undertaken to turn around, because his theme, as you have heard, is customer service and training the IRS agents to be sensitive to people and to provide taxpayer advocate assistance in all of these cases. A lot of it is personal relations, interpersonal relations, and how you handle it. There is no question but what, if we didn't have a lot of these examples where you have insensitive officers pursuing collection, the situation would not have been so exacerbated. And I think while revenue agents aren't normally repositories of the milk of human kindness in superabundance—[Laughter]—I think there has to be—there are ways of doing things and other ways of doing things, and the training of the tax administrators to respect taxpayer rights, which has been emphasized so much from this committee and others in the Congress. And the appointment of Commissioner Rossotti I think is going to lead to a kinder, gentler Internal Revenue Service, if you will.

Mrs. THURMAN. Well, I know I can only speak for myself, but, hopefully, that we think there is a way to do this right.

Chairman JOHNSON of Connecticut. Mr. Weller.

Mr. WELLER. Thank you, Madam Chairman. And Mr. Secretary, good to see you today.

Mr. LUBICK. Good to see you, sir.

Mr. WELLER. I want to again thank the Chair for her leadership on this issue and for continuing to focus attention on an issue which is pretty meaningful back home with the folks that I represent. I often think, in terms of innocent spouses, of victims who have contacted my congressional office seeking help; usually about half a dozen a year have contacted our office. In talking with colleagues, maybe multiply that, it starts adding up of those who have been victims. The unfortunate thing is they've gone through the tragedy of breakup of a marriage and a divorce, and in many cases the innocent spouse is not only the victim, or haven't experienced that tragedy, but their former husband may be—usually is a deadbeat dad, if he's a deadbeat taxpayer, and the IRS, the tax collector, shows up at her door because they can find her, but they can't find him.

One of the most obvious problems I find in just looking at the issue in general is that the IRS looks for the most available spouse. I'm just trying to get a better understanding of what the IRS—what Treasury is proposing to do to address that particular problem of just going after the first available spouse that they can find and sticking her with the bill.

Mr. LUBICK. Well, that's a question of tax administration, and I think you're right; generally, the tendency of a collector, a bill collector, is to find some assets that he can seize. It seems to me, again, through our instructions to agents and our basic training of agents, which we have indicated we are sensitizing them to the problems of innocent spouses, and I'm hopeful that this training will take and that they will have regard for the image of the organization they represent, the Internal Revenue Service. They should be proud to be officers of the Internal Revenue Service, and it should conduct itself in a very honorable fashion.

If we have eliminated, as the Commissioner has promised, the notion of just quotas, getting in as many dollars as you can, without regard to the sensitivities of the human beings you're dealing with, if that has gone by the boards, as I believe it has, then I think you're going to see a change in attitude and a change in culture that, while it's something intangible, I think it will result in better treatment. There are always going to be cases where people will differ as to what should be done, but I think in the cases where the chairman has indicated, the liability is essentially that of one of the contracting parties, every effort should clearly be made to follow that——

Mr. WELLER. But, Secretary Lubick, I think what I'm—one of the points or, actually, issues I'd like to see is, in the case, before you go out and find the first person you can find in the couple, usually the unlucky mom who has the kids and is struggling to make ends meet, and her husband is not paying child support, and now the tax collector's at the door—what efforts are you taking to review the case before you put this poor, innocent spouse through the mental anguish of an additional—you know, the tax collector being at the door? She's already gone through the case. Usually, in many cases, at least those I've experienced, where child support's not being collected, and she's already gone through the tragedy of a divorce, and then the tax collector shows up at the door and puts her through the mental anguish of saying he also wants a lot of money in back taxes. What precautions is the agency making to ensure that this particular innocent spouse is actually liable——

Mr. LUBICK. That's something——

Mr. WELLER [continuing]. For the tax burden?

Mr. LUBICK. I don't have personal knowledge of what the Commissioner has attempted to do in that area, but I will assure you of this: I will suggest to the Commissioner—I will take back the statement that you've made and the question that you've made and say that they ought to, if they're going after one member of a marital community, understand what the situation is between the two of them, and clearly suggest that their primary effort ought to be directed to the appropriate party, determined after a review of the entire matrimonial situation.

Mr. WELLER. Because my experience is this is very—I mean, the tax collector at the door is a pretty traumatic experience for anyone, let alone someone who's struggling with other issues. I was just wondering—some have suggested proportional liability as one of the solutions. I was wondering, can you make some sort of preliminary determination, which you're referring to, but also in the notification of this particular outstanding—or person, this innocent spouse, who's being contacted by the IRS; can you somehow outline what the liability is in the case of her former husband owing taxes?

Mr. LUBICK. Well, we have already introduced a number of educational and administrative remedies to make sure that, if you're really dealing with the innocent spouse, using the technical term that we've been referring to in these hearings, one that's entitled to relief, to make sure that that person knows what her or his results are, to make sure that that potential innocent spouse is advised of her or his rights, and to make sure that action is not taken. We are trying to review the training materials to ensure

that the agents have responsibility to identify situations where the innocent spouse provisions might apply, even where the taxpayer doesn't know about the process. So in those situations, we are taking as strong measures as we possibly can to get our officers in the field alerting the taxpayers and making sure that we try to uncover these cases before the axe falls on their neck.

Mr. WELLER. Well, I look forward to hearing the Commissioner's response to that request. Because, like I say, in the cases I've experienced with contacts with my office, the emotional trauma that this innocent spouse is going through is pretty demanding on her situation, and I think it's very important that the IRS, before they contact her, second-guess themselves, and also ensure that she actually is liable before they put her through the emotional trauma of trying to defend herself for someone else's tax liability.

So thank you, Madam Chair. I see my time has expired.

Chairman JOHNSON of Connecticut. Thank you, Mr. Weller.

Mr. Lubick, in answer to my earlier question, you said that the IRS could let the woman who had worked hard and saved off the hook; the IRS had the power to do that. Would that decision be contingent on the other party paying off the tax liability?

Mr. LUBICK. It's a bargaining situation. It's a contractual situation. I've been in those situations myself, representing people, involving several parties, and where agreements were——

Chairman JOHNSON of Connecticut. But, practically, is it ever so that an IRS agent will let one party with assets completely off the hook and hold the other party liable, and would free that person from any obligation before the other party had actually paid their liability?

Mr. LUBICK. I think when the officers consider these agreements, they get financial statements of both parties. If the primary party, primarily responsible party, has the assets, then that, I think, could very well be part of the settlement. Now if you're talking about the situation where——

Chairman JOHNSON of Connecticut. But if the primarily responsible party doesn't have the assets——

Mr. LUBICK. You're talking about where the primarily responsible——

Chairman JOHNSON of Connecticut [continuing]. And has to pay over a long period of time, it's very unlikely the IRS is going to free the not responsible party who has assets?

Mr. LUBICK. I think it depends on the comparative financial situation, but, again, as I indicate, there are also security arrangements that can be made——

Chairman JOHNSON of Connecticut. I very much appreciate not only Mr. Rossotti's attitude, but the IRS's effort over the last two years, which has been substantial, to change its attitude, to think more straight, to be more direct with the Congress and the American taxpayer, to recognize problems that have happened in the past. But I don't think we make any progress when we don't provide a structure of law that is concerned with justice as well as collection, and the problem has been that the IRS's primary concern is collection. There's a point at which justice matters. That is throughout our law.

I have to tell you that I am very concerned with the fact that we have no protection, in a sense, for a just settlement with the responsible spouse. I don't see any problem with the ABA's proposal that the allocation of tax items and the separation of a tax liability or assessment would occur only in two instances: upon an election by one spouse following an assessment of unpaid tax or upon the assertion of deficiency of tax. You could even narrow this more to focus only on situations of divorce.

But, you know, you look at how they're going to deal with allocations, and the spouse seeking to separate the liability would have to provide the information needed; the other party could challenge it. In most of these cases, these people are not at a point in life where they have a very complex tax return, and the kinds of recommendations the ABA is making is that failure to report earned income, deficiencies would be based upon failure to report income. That income would be assessed solely against the party that earned the income. That doesn't take a rocket scientist to see that that's fair.

Now maybe the other party, in this case, this woman who clearly paid taxes on her wages, had the withholding and the medicare and the social security, and then her husband, who wasn't reporting his income, why is it so hard for the Government to say, "You're right; that's his income. He has now reported it. He is liable for the taxes, and you, Lady, are legally free to go, and we will deal with him."?

It just seems to me that the IRS's obsession with collection, which I respect—after all, we all depend on the taxes getting collected to pay for the roads and bridges and the children in their schools, but at a certain point justice matters, and that's what we're talking about here. None of the procedural recommendations that you've made, as important as they are—and they're nice—none of them go to the heart of this matter that says, where one spouse has fulfilled their full obligations as a wage-earning, taxpaying American, they can get complete relief, and we, the rest of the public, will struggle with their nonperforming spouse, and if the nonperforming spouse in the end doesn't pay all their taxes, we will attach him; we'll keep that 10-year liability in case he wins the lottery, but we're not going to penalize the person who did right, worked hard, and paid their taxes. You're not reaching that bottom line, I have to tell you.

When the taxpayer advocates make this recommendation, it's because they're negotiating these kinds of agreements. They're the guys out in the front line in your kinder and gentler IRS, and I'm convinced we're going to have a kinder and gentler IRS, but the kinder and gentler tax advocates have to have some structure of law that allows them to accept what they perceived as a just settlement, not only the maximum collectible settlement. And now they only have maximum collectibles.

I really think you've got to work with us in the next few weeks over a far more aggressive approach as to how we deal with the legally-divided liabilities in divorce decrees, and under what circumstances do we allow a retroactive separation of tax liability? How do we allow ourselves the right of a certain time, when we can see things have gone afoul, to go back and file separately? And give

the taxpayers the primary responsibility to justify all that and to allocate all that. As I say, I can't believe in many of these cases these are terribly complicated tax returns. I mean, they're not usually that really big money, but, anyway, there certainly would be some that were very good money.

Mr. LUBICK. Well, you know, we're going to work with you as much as we can. I——

Chairman JOHNSON of Connecticut. I hope you'll go home and think about——

Mr. LUBICK. I will.

Chairwoman JOHNSON of Connecticut [continuing]. Justice, not just collections.

Mr. LUBICK. We will not only think about justice, Madam Chairman, but also some mercy.

Chairman JOHNSON of Connecticut. Thank you. Mandated mercy. Thank you. [Laughter.]

We'll move on to the GAO. It's a pleasure to welcome back Lynda Willis, the Director of Tax Policy and Administration Issues; accompanied by Ralph Block, the Assistant Director of Tax Policy and Administrative Issues, and Jonda Van Pelt, Senior Evaluator of Tax Policy and Administrative Issues.

Welcome. It's always a pleasure to have you before our committee.

STATEMENT OF LYNDA D. WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES; ACCOMPANIED BY RALPH BLOCK, ASSISTANT DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, AND JONDA VAN PELT, SENIOR EVALUATOR, TAX POLICY AND ADMINISTRATION ISSUES

Ms. WILLIS. Good afternoon. Madam Chairman, with your permission, I'll submit my entire written statement for the record, and I will give you a brief summary of my statement that touches on points that weren't covered at length in Mr. Lubick's statement. As you're aware, our reports have a lot in common.

We're pleased to be here today to discuss the innocent spouse provisions of the Internal Revenue Code. Like the Department of Treasury, we were mandated to report to the Congress on issues related to joint and several liability, as well as the application of the innocent spouse provisions. My comments today are based on our report. Our report has findings, and in several cases recommendations, similar to those in the Treasury report. My testimony today makes the following points:

First, under current law, only about 1 percent of the couples who filed joint returns in 1992 had additional tax assessments that potentially met the dollar threshold for innocent spouse relief.

Second, the limited information available indicated that IRS received few requests for innocent spouse relief and denied most of these.

Third, the current provisions in the law may not ensure that all deserving taxpayers receive equivalent treatment.

And, fourth, several options exist for administering proportionate liability.

I'd like to discuss each of these points in a little more detail, but, first, I'd like to give you two examples illustrating the types of

cases that we found when we examined the application of the innocent spouse provisions.

In the first case, a taxpayer learned of an assessment of over $3,000 against a 1985 joint return when IRS levied her wages in 1992. The assessment was generated primarily by her ex-husband's disallowed moving and business expenses, although he also had some unreported income. The taxpayer submitted documentation demonstrating that the unreported income was generated by her husband and received relief for about $200. According to an IRS official, she could not substantiate her husband's disallowed expenses and was held liable for the remainder of the tax.

In the second case, a taxpayer's ex-husband, a wanted fugitive, had not paid the tax reported for two tax years. The taxpayer remarried, and IRS placed liens against her new husband's property. IRS denied innocent spouse relief, in part, because the liability was for taxes reported on the joint return, rather than taxes assessed after the return was filed; that is, there was an underpayment of tax rather than an understatement of tax. IRS did accept an offer in compromise for both years, and for a third year, where the ex-husband had failed to report income.

Madam Chairman, we do not know how typical these cases are or even how many requests for innocent spouse requests are made. Because IRS did not have data on the number of innocent spouse requests filed, we developed an estimate of the potential universe by analyzing data related to the 1.2 million joint returns which were assessed additional taxes under IRS's 1992 audit and underreporter programs. That was the latest data that was available to us at the time that we did the report.

Of these 1.2 million returns, about 587,000 had additional tax assessments exceeding $500, which is the minimum dollar threshold required for innocent spouse relief. I'd like to point out that our estimate of 587,000 represents the maximum number of couples potentially eligible for innocent spouse relief. Fewer would actually qualify.

For instance, some couples were probably assessed additional taxes as a result of overstated deductions, credits, or bases which have higher dollar thresholds. Further, some of the couples may not have qualified for innocent spouse protection because they both knew there was a substantial tax understatement.

Since divorced taxpayers seek innocent spouse relief most frequently, we also estimated the number of taxpayers who could potentially be eligible for relief and may have divorced during the three years since the 1992 joint returns were filed. Using a 2 percent per year divorce rate from the Department of Census, we estimated that 35,000 divorced couples had additional tax assessments of over $500.

Madam Chairman, although innocent spouse relief is clearly established in law and regulation, we observed that little information about the criteria for granting it or how to apply for it was available from IRS. The innocent spouse relief provisions are described in several IRS publications, but these publications do not provide any guidance on how to request relief. Furthermore, these publications are developed to help taxpayers prepare their returns, which is far in advance of the time that taxpayers might need information

on innocent spouse relief. The publications most directly related to the enforcement and collection procedures are totally silent about innocent spouse relief.

Some IRS staff are as confused as taxpayers about how to request relief. The various IRS units we contacted took different approaches to providing relief. For example, two district offices granted relief using offers in compromise based on doubt as to liability, while staff at one service center routinely denied such requests as inappropriate.

In addition, the current provisions may not ensure the taxpayers receive equitable relief. For example, the dollar thresholds represent an eligibility criteria for relief based on income or the size of the liability. These criteria appear to be more related to an ability to pay or degree of hardship than to the innocence of the taxpayer. The logic behind the income thresholds for deductions, credits, and bases is particularly cloudy because the potential innocent spouse's income is based on the tax year ending before the notice of deficiency, which may be several years after the tax year of the joint return, and must include the income of any new spouse.

Finally, the dollar thresholds prevent taxpayers with smaller liabilities from obtaining relief since the minimum understatement in all cases must be more than $500. We estimated that if the dollar thresholds were eliminated, the maximum number of couples filing tax year 1992 returns potentially eligible for relief would have been about 1.2 million.

Treasury's February report indicates that IRS is currently undertaking a number of actions to improve the administration of the current innocent spouse provisions. Several of these actions were recommended in our report, including a new form which will be processed in a central location to assist taxpayers in preparing claims for innocent spouse relief, changes to IRS forms and publications, and efforts to ensure that employees are properly trained to assist taxpayers. We believe these and other proposed administrative actions, if implemented effectively, should make more taxpayers aware of their rights under the innocent spouse provisions and provide for more consistent application of the provisions by IRS employees.

Treasury's report also made three statutory recommendations related to problems discussed in our report. One dealt with making it easier to qualify for innocent spouse relief by changing statutory standards to help additional taxpayers, including those with smaller liabilities. These changes would include lowering or eliminating the income thresholds, allowing relief to cover underpayment as well as understatement of tax and eliminating the no basis in fact or law requirement for erroneously-claimed deduction credit or bases. While we did not recommend any of these changes, our report did point out similar problems with these provisions.

In summary, Madam Chairman, we found that the existing innocent spouse provisions are complex, difficult to understand, and pose a serious challenge for IRS and taxpayers. In addition, they result in the inequitable treatment of taxpayers. There are both administrative and statutory options for improving the innocent spouse provisions. On the administrative level, we have made recommendations for improvements that we believe should be under-

taken regardless of whether there are changes made to the statute. On the statutory level, repeal of the qualifying thresholds and the inclusion of erroneous deductions and underpayment as well as understatement of tax could make the provisions less complex and more equitable.

Finally, there is the issue of replacing the joint and several liability standard with a proportionate liability standard. There are several alternatives for doing this which are discussed in our report. Each of these represents tradeoffs between establishing individual taxpayer liability and the amount of paperwork and administrative burden created for taxpayers and IRS.

Madam Chairman, that concludes my statement. I'd be happy to answer any questions you may have.

[The prepared statement follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Oversight, House Committee on Ways and Means

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INNOCENT SPOUSE

Alternatives For Improving Innocent Spouse Relief

Statement of Lynda D. Willis, Director, Tax Policy and Administration Issues, General Government Division

Madame Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our report on the innocent spouse provisions of the Internal Revenue Code. Like the Department of the Treasury (Treasury), we were required under section 401 of the Taxpayer Bill of Rights 2 to report to the Congress on certain issues related to joint and several liability and the application of the innocent spouse provisions.

Our comments today are based on our report, which was issued in March 1997.[1] It has findings and, in several cases, recommendations similar to those in the more recent Treasury report.[2] Specifically, our report discussed (1) the universe of taxpayers potentially eligible for innocent spouse relief, (2) the Internal Revenue Service's (IRS) practices and procedures for handling requests for such relief, (3) whether the existing innocent spouse provisions provide the same opportunity for relief for all taxpayers, (4) the potential effects of replacing the joint and several liability standard with a proportionate liability standard, (5) the potential effects on IRS of requiring it to abide by the terms of divorce decrees that allocate tax liabilities, and (6) the potential effects of limiting IRS' ability to seize

[1]Tax Policy: Information on the Joint and Several Liability Standard (GAO/GGD-97-34, March 12, 1997).

[2]Report to the Congress on Joint Liability and Innocent Spouse Issues (Department of the Treasury, February 9, 1998).

community income to satisfy the tax liabilities incurred by one of the spouses before the marriage.

Our testimony today makes the following points:

-- Under current law, only about 1 percent of the couples who filed joint returns in 1992 had additional tax assessments that potentially met the dollar threshold for innocent spouse relief. If only divorced taxpayers were counted, about 35,000 of the 587,000 couples with additional tax assessments of more than $500 for 1992 may have been eligible for innocent spouse relief. However, our estimate of 587,000 couples represents the maximum number of couples potentially eligible for innocent spouse relief; fewer would probably actually qualify. For instance, some of the 587,000 couples may not have qualified for innocent spouse protection because they knew there was a substantial tax understatement. This knowledge would have made them ineligible for relief even if the tax deficiency was solely attributable to the actions of one spouse.

-- The limited information available indicated that IRS received few requests for innocent spouse relief and denied most of them. Although we could not determine why few requests were made, we observed that IRS publications provide little information on how to request innocent spouse relief and that IRS has no specific form or process for applying for such relief.

-- The current provisions may not ensure that all deserving taxpayers receive equivalent relief. For example, the dollar thresholds for claiming innocent spouse relief may preclude some deserving taxpayers from obtaining relief because of the amount of their liability. We estimated that for tax year 1992, about 40,000 additional divorced couples might have been eligible for innocent spouse relief if the dollar thresholds had been eliminated.

-- One way to address concerns with the innocent spouse provisions would be to replace the joint and several liability standard with a proportionate liability standard. Under the joint and several liability standard, each spouse becomes individually responsible for the entire amount of the tax associated with a joint return. Under a proportionate liability standard, couples would be responsible only for the taxes generated by their individual incomes and assets. Options for administering proportionate liability include (1) requiring all taxpayers to file separately, (2) modifying joint returns so that each spouse's income and deductions are reported separately, and (3) applying proportionate liability only in cases where there are unpaid taxes or subsequent tax assessments. Each of these options represents a trade-off between clearly establishing each taxpayer's liability and the amount of paperwork and administrative burden created for taxpayers and IRS. Each could also increase the costs of IRS' enforcement programs.

-- Requiring IRS to be bound by divorce decrees is impractical for two major reasons. First, federal tax matters are the exclusive jurisdiction of certain federal courts, while divorce matters are generally handled by state courts. Thus, there is currently no legal forum where IRS and the parties to a divorce could resolve issues relating to both tax and divorce matters. Second, this proposal could require IRS to become involved in every divorce settlement to ensure that the government's interest is protected. In 1994, about 1.2 million divorce decrees were granted in the United States. Even if IRS were bound by divorce decrees, these decrees could be manipulated to thwart IRS' collection efforts. For example, one spouse might retain sole ownership of the couple's residence, the couple's major asset, while the spouse without assets takes responsibility for the taxes. Thus, IRS would not be able to place a lien against the residence to force collection action for any delinquent taxes.

-- In community property states, IRS can levy one spouse's income to satisfy the premarital tax debts of the other spouse because of the joint ownership of property in those states. In contrast, IRS cannot levy the income of one spouse to pay the premarital tax debts of the other spouse in common law states because spouses do not have a legal entitlement to each other's property. Since IRS does not maintain data on how often it levies community property to settle premarital tax debts, we could not assess the potential

impact on IRS of changing the law to treat everyone the way it treats taxpayers in common law states.

-- Treasury's report parallels our report on identifying ways to improve the administration of the current innocent spouse provisions. They include revising publications to better educate and inform taxpayers on the provisions, creating a new form for applying for relief, training IRS staff on how to handle innocent spouse claims, and developing a process for ensuring consistency in processing innocent spouse claims. Also, Treasury recommended several statutory changes that would give more taxpayers opportunities to qualify for innocent spouse relief, would allow the Tax Court to review IRS denials of innocent spouse claims, and would suspend collection actions against one spouse when the other is contesting a proposed assessment in Tax Court. While we did not recommend any statutory changes, we did point out in our report the inequities of not allowing more taxpayers to be eligible for relief. Our report did not discuss having the Tax Court review denied innocent spouse claims or suspending collection actions on Tax Court cases.

I would like to discuss each of these points in more detail after providing an overview of the current innocent spouse provisions and presenting several examples of how IRS administers the provisions.

INNOCENT SPOUSE PROVISIONS

Under the joint and several liability standard, when a married couple files a joint federal income tax return, each spouse becomes individually responsible for paying the entire amount of the tax associated with that return. As a result, one spouse can be held liable for tax deficiencies assessed after a joint return was filed, even if the additional taxes were solely attributable to the income of the other spouse. Married couples can file separately and be held liable only for the taxes accruing from their own income, but couples who file this way may face a higher total tax bill than if they filed jointly.

An example of the potential liability resulting from joint filing would be if IRS discovered that one spouse actually had an additional $5,000 in income not reported on the joint return that the other spouse was not aware of. If IRS cannot collect the additional taxes owed on the unreported income from the culpable spouse, it may seek to collect the taxes from the "innocent spouse." However, the innocent spouse may obtain relief from the additional tax liability if certain conditions are met.

The current innocent spouse provisions only apply to taxes assessed after the joint return was filed. The provisions do not apply to underpayments of the taxes reported on the joint return because any underpayments are expected to be known by both spouses signing the

joint return. The provisions allow relief from the joint and several liability standard when

-- the innocent spouse has filed a joint return with the culpable spouse;

-- the innocent spouse did not know and had no reason to know there was a substantial tax understatement (knowledge test); and

-- taking into account all the facts and circumstances, it is inequitable to hold the spouse liable for the additional tax attributable to the substantial understatement of the culpable spouse.

In addition, the spouse requesting relief must meet certain dollar thresholds that vary depending on the cause of the additional assessment:

-- A tax liability resulting from an omission of gross income must exceed $500.

-- A tax liability resulting from a deduction, credit, or basis that has no basis in fact or law must exceed $500 and also be in

excess of certain income levels.[3] If the innocent spouse has remarried, the new spouse's income is included in this calculation whether or not they file a joint return.

The following case histories illustrate the types of situations that IRS and taxpayers confront when applying these standards:

-- A taxpayer learned of an assessment of over $3,000 against a 1985 joint return when IRS levied her wages in 1992. The assessment was generated primarily by her ex-husband's disallowed business and moving expenses, although he also had some unreported income. The taxpayer submitted documentation demonstrating that the unreported income was generated by her husband and received relief for about $200. According to an IRS official, she could not substantiate her husband's disallowed business expenses and was held liable for the remainder of the tax.

-- A taxpayer's ex-husband, a wanted fugitive, had not paid the tax reported for 2 tax years. The taxpayer remarried, and IRS placed liens against her new husband's property. IRS denied innocent spouse relief. This was in part because the liability was for taxes reported on the joint return rather than taxes assessed

[3]These income levels are (1) 10 percent of the innocent spouse's adjusted gross income for their preadjustment tax year if the taxpayer's income is less than or equal to $20,000; or (2) 25 percent of the innocent spouse's income if the taxpayer's income is greater than $20,000.

after the return was filed; that is, there was an underpayment. IRS did accept an Offer in Compromise for both years and for a third year where the ex-husband had failed to report income.

-- In 1995, a taxpayer wrote to IRS to protest taxes due on 3 joint returns that were attributable to income derived from her ex-husband's fraudulent activities. In 1996, IRS informed the taxpayer she was not eligible for innocent spouse relief for 2 tax years because these balances were for taxes reported as due on the original returns but not paid when the returns were filed. However, IRS staff informed the taxpayer they would consider innocent spouse relief for 1 year if the taxpayer could demonstrate she had no knowledge of the unreported income. She submitted third-party statements that she did not live a lavish or enhanced lifestyle as well as copies of police records on her ex-husband's arrest and trial. IRS eventually granted innocent spouse relief for that 1 year.

-- A taxpayer learned of an assessment of about $1,200 on joint returns for 2 years when IRS seized her 1995 tax refund. The assessment was generated by her ex-husband's unreported income. The taxpayer argued that the couple had maintained separate checking and savings accounts, and therefore she did not know of the unreported income. Furthermore, the divorce decree specified that her ex-husband would be responsible for outstanding tax debts incurred during the marriage. IRS denied innocent spouse relief

for 1 year because the additional tax assessment for that year was less than the $500 threshold. IRS denied innocent spouse relief for the other year because the taxpayer did not meet the knowledge requirement. Because the unreported income was more than 75 percent of the ex-husband's total income, IRS staff believed she should have been aware of the income earned even though the spouses had separate accounts.

-- A taxpayer was assessed over $3,000 on joint returns filed in 4 tax years generated by her husband's disallowed deductions for gambling losses. She was denied innocent spouse relief for 1 year because the additional tax assessment for that year was less than the $500 threshold. She was denied innocent spouse relief for the other 3 years because the additional tax assessment in each of those years was less than 25 percent of her adjusted gross income.

ESTIMATED UNIVERSE OF POTENTIAL INNOCENT SPOUSES

Because IRS did not have data on the number of innocent spouse requests filed, we developed an estimate of the potential universe of innocent spouses by analyzing data relating to the 1.2 million joint returns which were assessed additional taxes under IRS' 1992 audit and underreporter programs. Of these 1.2 million returns, about 587,000 had additional tax assessments exceeding $500, which is the minimum dollar threshold required for innocent spouse relief.

However, our estimate of 587,000 couples represents the maximum number of taxpayers potentially eligible for innocent spouse relief. This is fewer than would probably actually qualify. For instance, some couples were probably assessed additional taxes as a result of overstated deductions, credits, or basis, which have other dollar thresholds in addition to the $500 threshold. Further, some of the 587,000 couples may not have qualified for innocent spouse protection because they both knew there was a substantial tax understatement. This knowledge would have made them ineligible for relief even if the tax deficiency was solely attributable to the actions of one spouse.

Since divorced taxpayers seek innocent spouse relief most frequently, we also estimated the number of taxpayers who could potentially be eligible for relief and may have divorced during the 3 years since the 1992 joint returns were filed. Using a 2-percent per year divorce rate, we estimated that 35,000 divorced taxpayers had additional tax assessments of more than $500.

INFORMATION AVAILABLE ON APPLYING FOR INNOCENT SPOUSE RELIEF WAS LIMITED

Although innocent spouse relief is clearly established in law and regulation, we observed that little information about the criteria for granting it or how to apply for it was available from IRS. The innocent spouse relief provisions are described in several IRS

publications, but these publications do not provide any guidance on how to request relief. Furthermore, these publications are developed to help taxpayers prepare their returns, which is far in advance of the time that taxpayers might need information on innocent spouse relief. Moreover, the publications most directly related to the enforcement and collection procedures that apply when taxpayers are billed for their spouses' taxes are totally silent about innocent spouse relief.

Because IRS lacked well-defined procedures for taxpayers to request innocent spouse relief, the taxpayers involved in the innocent spouse cases we reviewed resorted to existing avenues that were designed to resolve other types of problems. In most cases, we found that either the taxpayers or their representatives had (1) contacted Problem Resolution Offices, which were established to assist taxpayers who cannot resolve their problems through normal IRS channels; or (2) had requested relief through an Offer in Compromise, which is used in the cases of taxpayers who cannot pay the full amount of the balance due and decide to offer a lesser amount. The fact that taxpayers are commonly using these two approaches to seek innocent spouse relief indicates to us that IRS does not provide taxpayers with adequate guidance for seeking relief.

Some IRS staff are as confused as taxpayers about how to request innocent spouse relief. The various IRS units we contacted took

different approaches to providing relief. For example, two district offices granted relief using Offers in Compromise based on doubt as to liability, while staff at one service center routinely denied such requests as inappropriate.

MODIFYING TAX CODE PROVISIONS COULD ALLOW MORE TAXPAYERS TO QUALIFY FOR RELIEF

The current provisions may not ensure that taxpayers receive equitable relief. For example, the dollar thresholds represent eligibility criteria for relief based on income or the size of the liability. These criteria appear to be more related to an ability to pay or degree of hardship than to the innocence of the taxpayer. The logic behind the income thresholds is particularly cloudy because the potential innocent spouse's income is based on the tax year ending before the notice of deficiency (which may be several years after the tax year of the joint return) and must include the income of any new spouse. Finally, the dollar thresholds prevent taxpayers with smaller liabilities from obtaining relief. Since the minimum understatement of tax in all cases must be more than $500, lower income taxpayers could be precluded from obtaining relief. We estimated that if the dollar thresholds were eliminated, the maximum number of couples filing tax year 1992 returns potentially eligible for innocent spouse relief would have been 1.2 million, which consist of all couples who were assessed additional taxes under IRS' audit and underreporter programs.

Also, under the current provisions, spouses can receive relief if deductions, credits, or basis have absolutely no basis in fact or law, but not if they are simply erroneous. The distinction between a deduction having no basis in fact or law versus its just being erroneous is difficult to comprehend and can lead to various interpretations by IRS and the courts. This problem is compounded by the fact that IRS' regulations governing innocent spouse relief were issued in 1974 and have not been updated to incorporate more recent changes to the provisions.

The "knowledge" factor is perhaps the most subjective element in the current innocent spouse provisions. For someone to prove that they did not know and had no reason to know of a financial transaction undertaken by his or her spouse would generally be difficult, if not impossible. IRS and the courts consider circumstantial factors, such as education, involvement in the family's financial affairs, and lifestyle, in assessing this contention. For example, one indicator that IRS uses to determine if spouses were aware of the tax avoidance is whether they benefited by living a lifestyle significantly better than could be supported by the reported income. However, according to critics, determining whether a taxpayer's lifestyle was significantly better because of the tax avoidance is fairly subjective and the courts have interpreted the criteria differently.

POTENTIAL IMPACT OF REPLACING THE JOINT AND SEVERAL LIABILITY STANDARD WITH PROPORTIONATE LIABILITY

One way to ensure that taxpayers are not held liable for their spouses' taxes would be to replace the joint and several liability standard with a proportionate liability standard. Under proportionate liability, taxpayers would be held responsible only for the taxes generated by their own individual incomes and assets or, for taxpayers living in community property states, for the tax associated with one-half of the community income. We identified three options for administering a proportionate liability standard. The options are to (1) eliminate joint returns and require all taxpayers to file separately, (2) retain joint returns but modify them so that each spouse's income and deductions are reported in separate columns (this is called front-end proportionality), and (3) retain the current joint return requirements but apply proportionate liability only in cases where there are delinquent taxes or subsequent tax assessments (this is called back-end proportionality).

We evaluated the potential effects of these options on IRS' tax administration processes and taxpayers' burden. Table 1 shows the pros and cons of the three options for taxpayers and IRS.

Table 1: Pros and Cons of Different Methods of Administering a Proportionate Liability Standard

Entity	Separate return option[a]	Modified joint return option[b]	Current joint return option[c]
Taxpayers			
Pros	If divorced, individual liability is more clearly established.	If divorced, individual liability is more clearly established.	No additional paperwork burden.
Cons	Must prepare two returns but receive limited or no benefit while married.	Must allocate joint income, deductions, and credits but receive limited or no benefit while married.	Must establish individual liability if additional taxes assessed.
	May have a higher tax liability.	May have a higher tax liability.	
IRS			
Pros	Individual liability more clearly established.	Individual liability more clearly established.	No additional return-processing costs.
Cons	Increased costs for processing up to twice as many returns for married couples.	Might increase costs for keying additional data into computer systems.	Must establish individual liability if additional taxes assessed.
	Increased difficulty in matching income reported on returns to information returns.	Increased difficulty in matching income reported on returns to information returns.	
	Increased collection costs because IRS would have to collect from each taxpayer.	Increased collection costs because IRS would have to collect from each taxpayer.	Increased collection costs because IRS would have to collect from each taxpayer.

[a]Each spouse files separate return.

[b]Income split out separately on joint return.

[c]Proportionate income only for returns with unpaid taxes or subsequent tax assessments.

Source: GAO's analysis of three proportionate liability options.

As shown in the table, these options represent trade-offs between clearly establishing each taxpayer's liability on their tax returns and the amount of paperwork and administrative burden created for taxpayers and IRS.

BINDING IRS TO DIVORCE DECREES
WOULD BE IMPRACTICAL

Divorcing couples may specify in their divorce decrees how future liabilities resulting from their prior joint returns are to be handled, such as one spouse is entirely liable, both spouses are equally liable, or some other permutation. However, IRS is not bound by these divorce decrees because it is not a party to the decree.

We found that a legislative change to bind IRS to divorce decrees appears impractical for two major reasons. First, current federal law provides no mechanism whereby IRS can be a party to divorce proceedings. Federal tax matters are the exclusive jurisdiction of the federal courts. Divorce matters, however, are generally handled by state courts. Federal courts have traditionally refused to consider any legal action involving divorce. Thus, providing a legal forum where IRS and the parties to a divorce could resolve issues relating to both tax matters and divorce proceedings would require a fundamental and extensive change in either federal tax law or state domestic relations law.

Second, binding IRS to divorce decrees could require IRS to become involved in every divorce settlement or trial. In 1994, about 1.2 million divorce decrees were granted in the United States. To be a

party to this many legal proceedings nationwide each year would create a significant administrative burden for IRS.

IRS officials also believe the number of appeals would increase because divorce decrees can be lengthy and complex documents that are open to more than one interpretation. Furthermore, IRS officials fear that divorce decrees would be manipulated to thwart its collection efforts. For example, one spouse might retain sole ownership of the couple's residence, the couple's major asset, while the spouse without assets takes responsibility for the taxes. Thus, IRS would not be able to place a lien against the residence to force collection action for any delinquent taxes.

IRS FOLLOWS STATE PROPERTY LAWS
IN COLLECTING PREMARITAL TAX DEBTS

About 13 million, or 27 percent, of all taxpayers who filed joint returns in 1992 lived in community property states. Some of these taxpayers may have been held financially responsible for tax liabilities incurred by their spouses before their marriage, which they would not have been if they lived in a common law state. This disparate treatment between taxpayers residing in community property states versus those living in common law states occurs because IRS, as with other creditors, follows state law in classifying married couples' rights in property.

Because the income, including wages, of taxpayers living in certain community property states is considered community property, IRS can place a levy on the wages or other separate income of either spouse to satisfy an existing tax debt, even if that tax debt was incurred by the other spouse before their marriage. In contrast, IRS cannot place a levy on the separate income of one spouse to pay the taxes due from the other spouse in a common law state. Once the income of either spouse is placed in a joint account it would be subject to IRS seizure in both community property and common law states.

According to IRS officials, the agency does not have specific procedures for placing levies on a spouse's income for premarital taxes incurred by the other spouse. Officials told us that under IRS' collection procedures, levy action is generally to be taken against the individually held income. For example, wages of the taxpayer who incurred the tax debt or any jointly held income, such as an interest-bearing account, may be levied but not the separate income of the other spouse.

TREASURY'S REPORT PARALLELS OUR ADMINISTRATIVE RECOMMENDATIONS

Treasury's February 1998 report indicates that IRS is currently undertaking a number of actions to improve the administration of the current innocent spouse provisions. Several of these actions were recommended in our March 1997 report and will include:

-- issuing a new form to assist taxpayers in preparing claims for innocent spouse relief,

-- processing the new form in one central location to ensure greater consistency in evaluating the claims,

-- developing training courses on the innocent spouse provisions for collections and examination personnel, and

-- revising tax form instructions and other publications to make innocent spouses more aware of the relief available to them.

Other actions Treasury reports IRS to be undertaking include:

-- reviewing current training materials to ensure that they stress the responsibilities of IRS employees to identify situations where innocent spouse provisions might apply, even where the taxpayer does not know of the provisions,

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

-- conducting outreach to community organizations that serve abused and battered spouses to identify those who might qualify for innocent spouse relief.

We believe these administrative actions if implemented effectively should make more taxpayers aware of their rights under the innocent spouse provisions and provide for more consistent application of the provisions by IRS employees.

Treasury's report made three statutory recommendations. One dealt with making it easier to qualify for innocent spouse relief by changing statutory standards to help additional taxpayers, including those with smaller tax liabilities who are presently ineligible for relief. These changes would include lowering or eliminating the income thresholds, allowing underpayment as well as understatement of taxes to be covered by the provisions, and eliminating the "no basis in fact or law" requirement for erroneously claimed deduction, credit, or basis, which would put these items on the same footing as omissions from income. While we did not recommend any of these changes, our report did point out similar problems with these provisions.

Treasury recommended two other statutory changes that would help taxpayers. One would allow the Tax Court to review IRS denials of innocent spouse claims, and the other would suspend collection actions against one spouse when the other is contesting a proposed assessment in Tax Court.

SUMMARY

In summary, Madame Chairman, we found that the existing innocent spouse provisions are complex, difficult to understand, and pose a serious challenge for IRS and taxpayers. In addition, they result in the inequitable treatment of taxpayers. There are both administrative and statutory options for improving the innocent spouse provisions. On the administrative level, we have made recommendations, which are echoed in the Treasury report. If the recommendations are properly implemented, they would put both taxpayers and IRS employees in a better position to understand and be in compliance with the provisions. We believe these improvements should be undertaken regardless of whether there are changes made to the statute.

On the statutory level, repeal of the qualifying thresholds and inclusion of erroneous deductions and underpayment as well as understatement of tax could make the provisions less complex and more equitable.

Finally, there is the issue of replacing the joint and several liability standard with a proportionate liability standard. While there are several alternatives for doing this, each represents trade-offs between establishing individual taxpayer liability on a tax return and the amount of paperwork and administrative burden created for taxpayers and IRS.

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This concludes our prepared statement. We would be pleased to answer any questions.

Chairman JOHNSON of Connecticut. Thank you.

I notice in your testimony you do not support recognition of divorce decrees. Why do you think this would be so difficult or inappropriate?

Ms. WILLIS. Well, Madam Chairman, I think some of the reasons that Mr. Lubick pointed out are very real concerns to us: the fact that taxpayers could manipulate the division of assets versus liabilities to the disadvantage of the Government; the fact that it does place the Government in a different position than other creditors around the issue of the economic debts of that——

Chairman JOHNSON of Connecticut. May I just interrupt there? Do you think that doesn't go on now?

Ms. WILLIS. Oh, I'm sure to some extent——

Chairman JOHNSON of Connecticut. In divorce decrees, tax consequences aren't considered?

Ms. WILLIS. Oh, absolutely. I'm just suggesting that binding IRS to divorce decrees would offer additional opportunities to manipulate tax liabilities, and I think there are two things that weren't discussed from an administrative perspective that might limit the effectiveness of divorce decrees in protecting innocent spouses. One is, if you notice in the first example that I gave you, that this was a 1985 tax return and that the person did not find out about the additional liability until 1992. So at the time the divorce decree was finalized, this was not a known liability. So it would not have been something that potentially would have even been contemplated——

Chairman JOHNSON of Connecticut. Right, I understand that, and many divorce decrees would be silent on this issue.

Ms. WILLIS. Yes.

Chairman JOHNSON of Connecticut. But where the divorce decree is not silent and specifically allocates, why—especially when it was discovered later on, so clearly it probably wasn't part of the divorce decree decisionmaking process any more than tax consequences are always taken into account when any distribution of property is taking place or any change in investments and ownership issues. So why wouldn't we give a divorce decree that has a specific decision in it in regard to taxes standing? Why wouldn't we protect that taxpayer against now having to pay a liability that was offset by other liabilities assumed at the time? I don't see that that provides a big incentive to get involved in taxes and divorce decrees—when there's already incentive for tax considerations to be considered in divorce decrees.

Ms. WILLIS. When the joint return is filed, that couple is viewed as a single economic unit that incurs not only the tax liabilities of that return but of future returns, in addition to any other debt, liabilities, et cetera, as a unit, and the divorce decrees right now do not have the ability to separate for creditors the liability for individual components of the debt. Could you do that? You could, but in doing that, the Congress would be taking the tax debt and allowing it to be allocated to individual parties in a way that is not done for other types of debt within the decree.

I think you would also have to wonder whether you still wouldn't need innocent spouse relief in cases where potentially one spouse or the other was taken advantage of in the divorce decree. So I

think that, rather than having the divorce decrees come into account, we need better provisions for dealing with situations like the one that you laid out, where there is an innocent spouse involved.

Chairman JOHNSON of Connecticut. Would it be a problem to give the divorce decree some weight? Not 100 percent weight, but that it would be one of the things that the IRS would have to take into consideration?

Ms. WILLIS. The divorce decree could be considered. Right now when IRS looks at collecting the debt, they look at the economic situation of the individual parties. They can offer hardship.

Chairman JOHNSON of Connecticut. Well, see, they do look at the individual economic situations of the two parties. If they can't find one party, they look at the economic situation of the one party. That's unfair. If they look at both parties and one's got a lower income but could pay over a longer period of time, and was specifically allocated this responsibility, that should carry some weight. I can see that maybe you wouldn't want it to be absolute because you might want to be able to look back and say, no, clearly, they had this in mind and this was a—I mean, we can't accept that. But it does seem to me that it ought to carry some significant weight.

Ms. WILLIS. And in the case of the letter that you read from the woman from California, I'm a little puzzled as to why IRS didn't offer an installment agreement to the party who was willing to assume responsibility for the debt.

Chairman JOHNSON of Connecticut. Right. I think what I see in that is this person just saw that money there; they wanted to get it settled, and the installment situation should be worked out between her and—I mean, I don't know why, but the fact is that we will never be able to protect people against other people who aren't doing their jobs with sensitivity and fairness. That's why the law has to do a little more than we're proposing at this time to put in a sense of fairness.

You read through some of these other letters, too. I mean, they're appalling. It's simply appalling. So to say that we have a new head of the IRS and we're going to be good guys now, and to say that the kind of changes that we've made, all of which are useful—and I agree, you can't do one thing; you have to do a number of things, but why can't—why shouldn't standing for a divorce decree be one of the things we do? Maybe not 100 percent standing, but maybe it would have standing unless there is written explanation from the IRS as to why this is clearly not appropriate, or it would have standing unless challenged by the spouse who had to pay it as to why it was clearly not appropriate. I'm not using the right language, but somebody knows what it is. Why is it that we can't—and I was very interested in your presentation and found it very helpful about the proportional liability standard issue. Why can't we combine some of that with the ABA's approach, that under certain circumstances that one could trigger this separation, this review, of your tax returns and try to get a more honest evaluation of where the tax liability lay? That doesn't seem to me all that hard.

Ms. WILLIS. There is no reason why you couldn't give the Secretary of the Treasury the ability to adopt regulations that would allow for the enforcement of these types of criteria and consider-

ations. I think one of the things that we'd be most concerned about is that they be developed in a way that is truly effective.

I mean, for example, in a divorce decree, if a woman wishes to get out and simply agrees to whatever half the taxes are, based on what she knows today, and it turns out down the road that she owes $300,000 extra because of an unknown tax liability that just came out of an audit process, that divorce decree is not going to protect that party. So I think we have to make sure that we have the ability to protect parties in that case as well. But certainly there could be more put into the regulations in terms of what could be considered, how liability could be proportioned, things that could be taken into account.

I think there's also things that need to be done in terms of IRS trying to find both spouses. Picking the low-hanging fruit by going after the spouse most easily found is definitely an issue. It's an issue with most collection agencies, not just IRS. So making sure that there are steps taken, that IRS makes a good-faith effort to bind both spouses and pursues the assets of both spouses is something that probably needs to be emphasized.

One of the troubling things is the amount of time it takes before many of these people find out they have a tax liability, expecially when only one spouse received the notices—and IRS is taking some steps in that regard by sending notices out to both parties. But I think that's another area where IRS needs to make sure earlier in the process that both parties to the joint return are aware of what's happening in terms of changes to the tax assessment.

But I also think that to statutorily address many of the cases that came up before Senate Finance—and I'm sure cases you've seen—you have to deal with the issue of underpayment versus understatement, because that appears to be causing a great deal of anguish and misunderstanding, and IRS can do nothing about underpayment. Underpayment is not covered by the innocent spouse provisions in the code. The provisions only cover understatement of tax. So that would be another way where you could get into more of these hardship cases.

Chairman JOHNSON of Connecticut. Thank you very much.

Mr. Coyne.

Mr. COYNE. Thank you, Madam Chairwoman.

Your report indicates that the IRS does not now track how often the innocent spouse relief is requested, granted, or denied, but it appears that relief is usually denied. Should the IRS track claims for innocent spouse relief, and if you think they should, why?

Ms. WILLIS. Mr. Coyne, we think IRS should track claims for innocent spouse relief for a number of reasons. First is to have a sense of how big the problem is, how many requests they have for innocent spouse relief, but also in terms of understanding what is driving the request for relief and whether there is more that IRS could do from an outreach or a taxpayer education perspective to prevent these situations from happening and identify for themselves and for the Congress systemic issues that need to be resolved to prevent these types of circumstances in the first place.

Many of the things that we're talking about are of just basic administrative kinds of things. Because the program applies to few

taxpayers, it's an exception-based program; it hasn't gotten much attention.

Mr. COYNE. How does the IRS's Taxpayer Advocate Office handle innocent spouse situations? Were you able to find that out?

Ms. WILLIS. Well, we looked at cases that came into the Problem Resolution Office, which is this part of the Taxpayer Advocate's Office, and they basically process them through like they do other problem cases in terms of working with the line staff to determine whether innocent spouse relief is actually warranted, et cetera. In fact, the Problem Resolution Office and the Offers in Compromise Program were the two places we found most of the requests that we found.

Mr. COYNE. Does the Advocate's Office ever grant relief on equitable grounds, as was spoken about earlier, or do they ever reverse a denial of relief by the Collection Division?

Ms. WILLIS. I am not aware of any circumstance or any cases where that has taken place.

Mr. COYNE. You didn't run across that at all?

Ms. WILLIS. No.

Mr. COYNE. All right, thank you.

Chairman JOHNSON of Connecticut. Mr. Portman?

Mr. PORTMAN. We're going to have all those new TAO's coming out now, legislation. So maybe they can be used in that regard.

Quickly, just following up on Mr. Coyne's questions, the work that you did I think was very helpful, and you know probably more about how the IRS actually handles this, and could handle it, than any organization. So maybe you can help us a little in terms of what's practical.

With regard to the form itself, how are they going to centrally process and administer it, so that it's getting out to everybody and so that there's equitable treatment of taxpayers? You mentioned that some of these end up—in response to Mr. Coyne's question—with the taxpayer advocate; others end up in other offices like offers in compromise or other areas. Are you confident that they are going to be able to do what they are indicating they'd like to do, which is to have a form that is provided to people in an equitable manner?

Ms. WILLIS. I think it's doable. I think what they are proposing is doable. Most of the recommendations that were in the Treasury report and the things that came up in Treasury's testimony are fairly recent actions that are being undertaken, and we don't have a lot of detail about exactly how they're going to do this yet. I think one of the questions about central processing gets back to the question of how many requests for relief they have and where they're going to be processed, by whom, et cetera. I understand that IRS is working on that, but certainly processing claims in a central location would allow IRS to bring together an aggregate level of expertise to be able to review these requests and also to identify some systemic problems, that could be hopefully resolved once and for all.

Mr. PORTMAN. It would be helpful if you could give us some specific advice, not necessarily today, but maybe in writing, on how to centralize that. The concern that we would have I think would be that there would be one entity within the IRS, along the lines of

the Commissioner's new notions of reorganization, that would actually be able to fairly and equitably resolve these matters as quickly as possible, give taxpayers a response, and do so in a way that applies the same criteria by the same people, or at least people with the same background and training and sensitivity. So that you wouldn't have disparate treatment, which we see in so many areas. From what your report tells me, right now it's spread out among various areas; there's a danger of that happening.

Ms. WILLIS. Yes.

Mr. PORTMAN. The other thing I think that is important is the extent to which you think Treasury's regulations need to be enforced by us in some way, report language or otherwise, so that the IRS actually follows through on them. Do you see a disconnect there? Are you comfortable that the Treasury ideas that are expressed in the budget, and so on, are going to be mandated in such a way that they actually happen at the level of the IRS?

Ms. WILLIS. I think the current——

Mr. PORTMAN. Is that the current view?

Ms. WILLIS. I think the current commitment is there.

Mr. PORTMAN. Okay.

Ms. WILLIS. But I think, obviously, as with any program that's put in place by individual Commissioners, it can also be changed at any time. As far as the regulations go, what we found when we did our work is that the IRS regulations haven't been changed since the 1984 provisions were changed. So the regulations right now are quite a bit out of date.

Mr. PORTMAN. And those regulations are regulations some of which we codify in the legislation; is that correct? And so your suggestion, it sounds to me—what I'm inferring from what you're saying is we ought to consider codifying some of those, including the requirement for a form, so that that's something that the IRS not only does in a way that's consistent with what we all think should be done, but is followed through on.

Ms. WILLIS. Codifying would better assure that.

Mr. PORTMAN. Okay. I think you can help us a lot in terms of these issues: centralization, fairness, equity in terms of how stuff is processed and dealt with, but also in terms of this notion that the Chair has on divorce decrees. I'm not at all expert on this, and I don't understand the issue well enough. I'm going to try to figure out more about it, but there may be a way, from what the Chair has been saying, that the IRS could be encouraged to respect those decrees, unless there is some unreasonableness or some other reason. In other words, have almost a presumption of correctness. That would be helpful to me, to hear your views on that, again, today, if you have them, or in writing.

That's all I have, Madam Chair.

I don't know if you want to respond to that now.

Ms. WILLIS. Not right now. Thank you.

Chairman JOHNSON of Connecticut. Let me just ask you a couple of things. I would assume from your comments on proportionality, proportional liability, that you would agree that front-end proportionate liability would be a big problem, whereas back-end, arising out of a claim for innocent spouse relief would not be such a problem?

Ms. WILLIS. It would certainly reduce the amount of paperwork both for IRS and taxpayers, and the cost involved. We looked at what it would cost to process the additional tax returns, if you had people file separately, and you're looking at close to $200 million. Even if you're just looking at having them put separate items on the line, you're still looking at close to $20 million. So if you do it only when you have a claim for relief, you reduce the number of taxpayers and the amount of cases that IRS has to work with.

Chairman JOHNSON of Connecticut. Can you make any generalization about the size and the complexity of the returns in which there's an innocent spouse claim? Am I right in kind of thinking, when you look at the average age of divorce, and for the most part it's not at the time of life where you have saved a lot of assets—there's the home; there's the car; there's debts——

Ms. WILLIS. You're going to have a lot of those returns that are fairly simple, straightforward kinds of returns. We looked at being able to trace the income that's on a return, and found that for 77 percent of the income on joint returns you could identify which spouse the income should be assigned to. It is more difficult with deductions, credits, et cetera, but a lot of people have very straightforward, basic returns, so it would not be as difficult to make these decisions.

Chairman JOHNSON of Connecticut. Was that taken into account with your estimate of $20 million, the minimum that it costs at the IRS?

Ms. WILLIS. That was basically just the returns processing cost, right.

Chairman JOHNSON of Connecticut. And do you have any specific comment on the ABA's proposal?

Ms. WILLIS. No, it's basically back-end.

Chairman JOHNSON of Connecticut. Yes, it is.

And then, lastly, income understatement versus deduction understatement, how different are the dilemmas they pose for the IRS? And should we be looking at some things in one area that we may not be capable of providing in the other area?

Ms. WILLIS. Well, income understatement tends to be easier to allot to a particular taxpayer. As I said, you can generally trace it. Whereas, the deductions may not be. Plus, the standard right now for deductions is that there may be no basis in fact around them, which is a difficult standard for people to meet, as opposed to just plain erroneous. So, I mean, I think basically the Department's recommendation that you treat all of those the same with no differing thresholds would certainly make relief available to more taxpayers and be more easily administered.

Chairman JOHNSON of Connecticut. Thank you very much.

Ms. WILLIS. Thank you.

Chairman JOHNSON of Connecticut. We appreciate your testifying and we look forward to working with you on this. Thank you.

[Whereupon, at 3:41 p.m., the hearing adjourned subject to the call of the Chair.]

[Submissions for the record follow:]

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN STATEMENT

FOR THE
OVERSIGHT SUBCOMMITTEE
OF THE
COMMITTEE ON WAYS AND MEANS
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON INNOCENT SPOUSE TAX RULES

FEBRUARY 24, 1998

AICPA WRITTEN STATMENT ON INNOCENT SPOUSE TAX RULES
HOUSE WAYS AND MEANS COMMITTEE OVERSIGHT SUBCOMMITTEE
February 24, 1998

Introduction

The American Institute of CPAs (AICPA) is the national professional organization of CPAs, with more than 320,000 members. Many of our members are tax practitioners who, collectively, do tax planning and prepare income tax returns for millions of Americans.

Background

Currently, when a married couple files a joint federal income tax return, each spouse is individually responsible for paying the entire amount of tax associated with that return. Because of this joint and several liability standard, one spouse can be held liable for tax deficiencies assessed after a joint return was filed that were solely attributable to actions of the other spouse. The current "innocent spouse" relief provisions are not effective, are too restrictive to help very many aggrieved taxpayers, and are in need of reform. The AICPA urges that the current innocent spouse rules be modified and expanded.

In addition, due to the high divorce rate in this country, the current inequitable divorce taxation rules affect a large percentage of taxpayers, many of whom do not have or cannot afford sophisticated tax advice available to them. For obvious reasons, these taxpayers are not communicating well with each other, nor functioning well as one unit. Tax filing is further complicated for separated taxpayers, who still qualify for filing joint tax returns. Many times separated taxpayers file joint tax returns because the total tax liability on the joint return is less than the total tax liability on two married filing separately tax returns, without considering the joint and several liability standard. In addition, the innocent spouse rules are ineffective for many aggrieved spouses. The government's involvement in divorce and separation matters should be as unintrusive as possible.

Section 321 of H.R. 2676

We note that Section 321 of H. R. 2676 generally makes innocent spouse relief easier to obtain. It eliminates the understatement thresholds, requires only that the understatement be attributable to an erroneous (not just a grossly erroneous) item of the other spouse, and allows relief on an apportioned basis. The provision also grants the Tax Court both jurisdiction to review any denial of relief (or failure to rule) by the IRS and authority to order refunds if it determines the spouse qualifies for relief and an overpayment exists as a result of the spouse so qualifying. The provision requires the development of a form and instructions for use by taxpayers in applying for innocent spouse relief. The provision is to be effective for understatements with respect to taxable years beginning after the date of enactment.

The AICPA supports this provision in H.R. 2676, but urges that the relief being granted be made retroactive to apply to returns for the last three taxable years provided the specific issue has not already been addressed by a final court determination rendered with respect to the taxpayer.

Examinations and Collections

Both spouses should be notified and involved in examinations of joint tax returns. This is one area that needs further study as there may be notification issues for both divorcing taxpayers and the IRS. Congress should consider the appropriate steps that should be taken in contacting both spouses early in the examination process of a joint return. We support procedures that require, at the initiation of an examination, the absent spouse to acknowledge by signature whether the other spouse may, or may not, represent the absent spouse. Since the IRS probably will not know about a separation or divorce, the spouses may need to notify the IRS of their separated status or divorce and how they can be contacted, similar to notifying the IRS of an address change by filing a Form 8822, Change of Address. Perhaps Form 8822 could be modified for such purposes. Additionally, legislation may be required to ensure that disclosure laws are changed to provide adequate information to the divorced spouse in community property states.

Currently, as described in the AICPA testimony before the House Committee of Ways and Means Subcommittee on Oversight at the March 24, 1995 hearing on taxpayer bill of rights legislation, often a divorced spouse is not aware that a liability has been created in an examination process where the other

spouse was the party examined, as in a situation where one individual has a Schedule C, Profit or Loss from Business (Sole Proprietor). Yet, after the assessment is made, the IRS will attempt to collect the tax from either party. If the taxpayers are divorced or separated and now live in different regions, or even different districts, collection efforts often only occur against the spouse living in the area of the IRS office assigned the collection case, even though the distant spouse may be the source of the liability. The root of the problem is in the examination procedures that do not (but should) require both spouses to be involved in an audit.

We are pleased to see (in Announcement 96-5, item 7, 1/5/96) the IRS administrative adoption of a rule allowing the IRS to notify one spouse of collection activity against the other spouse with regard to a joint return liability, and amending the Internal Revenue Manual to provide uniform procedures for such notifications. The disclosure of collection activities to divorced spouses is an improvement to the current situation.

In addition, due to the joint and several liability that exists today, many divorced individuals avoid contacting the IRS in hopes that the money will be collected from the other spouse, or in fear that they will have to pay the entire balance once they come forward. This new administrative change will help -- allocating the liability (as discussed below) would be better.

Innocent Spouse Rules

The present innocent spouse rules are statutorily too narrow -- many aggrieved spouses do not qualify under the current innocent spouse rules, but should be granted relief. Very few aggrieved spouses qualify as an innocent spouse due to knowledge requirements that imply that virtually all middle-income or higher income taxpayers "knew or should have known" all financial matters. This knowledge standard typically ignores the "division of duties" concept still prevalent in and maintained by countless family units.

The innocent spouse rules need a complete overhaul. At a minimum, if the current joint and several liability system is retained, the innocent spouse rules need to be modified. Furthermore, an allocated liability standard (as discussed below) -- where known tax liabilities are fixed at the time of filing and unknown liabilities are fixed at divorce -- would reduce (or eliminate) the need for innocent spouse provisions.

Alternatively, if the allocated liability standard is rejected, further consideration should be given to eliminating joint tax returns and developing a rational, individual separate tax return filing system for all taxpayers.

Allocated Liability Standard

We suggest an allocated liability standard as a replacement to the joint and several liability standard. A system that allows the known (reported) tax liability to be allocated between the spouses at the time of filing with each spouse's percentage of liability to be clearly stated on the face of the return (above the signature line or part of the tax liability line on the Form 1040), and any unknown tax liability (e.g., liabilities other than those already reported on returns) to be allocated between the spouses at the time of divorce (similar to every other liability of a married couple in the divorce process) would improve the fairness and equity of the system, as well as improve the speed and equity of the collection process. Defaults could be built into the system to allocate the liability differently if there has been undue manipulation of the rules, step transactions or fraud (including disposition or allocation of marital assets). Further analysis is needed on abusive situations and possible procedures, as well as possible transition rules for treating tax liabilities that arise from a year prior to the effective date of an allocated liability standard.

Retention of the joint tax return -- allocation of the liability. Under this approach to the allocation of a known tax liability, the spouses would determine their respective allocation percentages of the total liability reflected on the joint return. The determination would be at the taxpayers' discretion. If the taxpayers did not want to be burdened with determining a specific allocation based on a detailed income/deduction analysis, they could agree on any general allocation percentage, or not determine an allocation at all. If no allocation is chosen, the default allocation would be 50/50. It would be in the spouses' best interest to agree to the liability allocation at the time of filing and clearly state their allocation percentages on the face of the return. Furthermore, withholding, estimated, and other tax payments could be allocated in a similar way. The IRS would have the authority to reallocate in situations where there is undue manipulation of the

rules, step transactions, or fraud. This approach is referred to as the "allocated liability standard" throughout the rest of our comments.

Unknown liabilities could be allocated primarily by the divorce decree and separate maintenance agreement. If the divorce decree or separate maintenance agreement is silent on this matter, the percentage allocation of the unknown liability would be the same as the percentage allocation of the known liability on the return filed for the tax year in question. Absent any indication in the divorce decree/separate maintenance agreement or on the tax return, the allocation would be 50/50. It would be in the spouses' best interest to agree to the unknown liability allocation in the divorce decree/separate maintenance agreement. Any situation involving undue manipulation of the rules, step transactions, or fraud would invalidate these allocations and the IRS would have the authority to reallocate.

In summary, the allocated liability standard suggested above would set the allocation of the known liability at the time of filing and the unknown liability at the time of divorce, with adequate backup procedures and safeguards for abusive situations. These methods would most likely eliminate, or substantially reduce, the problems associated with the unfair results and ineffectiveness of the current innocent spouse rules, and would ultimately provide simpler and more equitable rules concerning the tax aspects of divorce and separation.

Separate tax returns. An alternative to the allocated liability on a joint return would be to allow individual tax liability to be calculated on a separate return for each spouse. This approach could eliminate or mitigate the marriage penalty (and filing status concerns) assuming that the rate/bracket structure is modified so that there is one filing status and, therefore, only one set of tax brackets/rates that apply to all taxpayers. In addition, this approach would allow the IRS to deal with only one individual at a time and would eliminate the frequent confusion involving social security numbers of taxpayers who marry and divorce. While a separate return approach would result in a more precise allocation of the liability, we recognize that in adopting such a system there would be inherent administrative complications and burdens for both the IRS (increased number of returns to be processed and examined) and practitioners/taxpayers (additional inquiries and schedules). Therefore, further study regarding separate returns is needed.

As part of any study considering changing the system of liability allocation, we suggest that, in evaluating whether joint and several liability should be retained, Congress should consider whether joint and several liability may, in some cases, actually be a hindrance to collection since some spouses may be inclined to delay the collection process in the hope that the other spouse will ultimately pay the tax.

SPECIFIC COMMENTS (based on the questions in IRS Notice 96-19)

Administrative Burden

An allocated liability standard would be an equitable improvement over the current joint and several liability standard, without increasing the administrative burden of either the IRS or taxpayers. We suggest an allocated liability standard where the tax liability would be allocated between the spouses based on their agreement rather than a mathematically calculated proportionate liability standard. We believe an allocated liability standard would be better than a proportionate liability standard because there would be no analyses required to determine the breakdown (unless the taxpayers chose to do such analyses).

We anticipate, that for the vast majority of married taxpayers, the allocated liability standard would not increase their compliance burden because they likely will either not respond to the optional allocation question on the tax return or simply respond with a 50/50 allocation since they probably view themselves as an equal partnership of a single economic unit. For the remainder of married taxpayers, the determination of the allocation would be based on an arms length negotiation or analysis undertaken by the taxpayers, not by the IRS. The "complexity" and "administrative burden," if any, would be voluntary. Therefore, the responses to questions 1-6 below focus on an allocated liability standard rather than a proportionate liability standard. We also note that our alternate proposal of separate return filings would resolve the issues of either proportionate or joint and several liability.

Spouses Not Cooperating

As stated in the allocated liability standard section above, if the liability is known and the spouses are not cooperating with each other, the allocation of liability would be determined on the tax return. If no allocation is on the return, a default allocation of 50/50 would be used. The IRS could reallocate in abusive situations.

If the liability is unknown and the spouses are not cooperating with each other, the allocation would be based on what is stipulated in the divorce decree or separate maintenance agreement. If the divorce decree/separate maintenance agreement is silent on this matter, the default would be the known liability allocation stated on the return for the year in question. If the allocation is not stated on the return for that year, then a 50/50 allocation would be used. The IRS could reallocate in abusive situations.

No Undue Advantage of the Tax System

An allocated liability standard would not allow taxpayers to take undue advantage of the tax system because spouses typically negotiate their divorce decree/separate maintenance agreement (and would negotiate their tax return liability allocation) at arms length. However, the IRS would retain the right to reallocate the liability if there is undue manipulation of the rules, step transactions, or fraud. Further analysis is needed on possible reallocation procedures. We note that there may be an increase in collections due to fairer, simpler rules.

Under an allocated liability standard, the Service would not need to trace assets and allocate deductions and credits between spouses to determine the correct liability; rather the allocation would be determined on the return for known liabilities or in the decree/separate maintenance agreement for unknown liabilities. Since the IRS would know from the allocation which spouse to collect the specific funds from, the need to trace assets would be removed, which should lead to a more efficient collection process. Assets would only need to be traced in the (hopefully few) cases involving abuse of the system.

No Burdensome Filing Requirements

An allocated liability standard would not create burdensome filing requirements because additional schedules and columns for reporting the items attributable to each spouse would not be necessary. The taxpayer would not be required to file any additional schedules showing how the allocation percentages were derived. However, at the option of the taxpayer, detailed schedules could be computed and retained for reference.

Regarding the allocation of unknown liabilities, perhaps a filing should be required to report the percentage allocation from the divorce, similar to Form 8379, Injured Spouse Claim and Allocation. These forms would qualify for electronic filing. Our comments above regarding notification of divorce status and addresses of both spouses for examination purposes may also be relevant here and may need further study.

Changes Concerning Communications, Examinations, Assessments, Collections, Payments and Refunds of tax, Penalties and Interest

If an allocated liability standard is adopted, minor changes would be needed concerning communications with taxpayers, examinations, assessments, collections, payments and refunds of tax, penalties and interest, in order to ensure that the proper spouse was contacted for the proper allocated amount. The IRS would communicate with the appropriate spouse(s) pertaining to the appropriate allocated amount(s) due. This extra burden would result in the proper person being contacted about the proper amount.

We note that the IRS changed the communication rules recently to ensure both spouses are notified of all collection activities. The IRS can already contact both spouses, so the change would be that the communication would now include an allocated amount for each spouse. Regardless of the liability standard, both spouses should be notified of all matters concerning communications, examinations, assessments, collections, payments and refunds, interest, and penalties.

Absent, or prior to, the adoption of an allocated liability standard, the IRS should pursue enhanced administrative procedures in the area of aggrieved spouses. The IRS should be directed to develop internal

procedures relating to collection that would call for "patience and restraint" when IRS agents attempt to collect from the "appropriate party" so as to avoid, whenever possible, unfairly burdening the "wrong" spouse. The IRS should be told to make every effort to first collect from the spouse responsible for the liability, as opposed to first attempting to collect from the spouse easiest to contact and with the most liquid and accessible assets. This may require patience on the part of the IRS, but may resolve many of the aggrieved spouse situations and would result in the proper person paying the liability.

Effect on State, Local, and Other Tax Systems

Adoption of such an allocated liability standard would not significantly affect state, local, and other tax systems. Presently, 44 states (including the District of Columbia) impose individual income taxes, and eight states presently calculate taxes on a separate basis. Many states do not rely on the federal tax calculations, and many states impose their own tax system different from the federal system.

Specifically, if separate federal returns are filed, the federal income and deduction amounts could be easily combined for combined state return filings, and duplicated for the separate state return filings. On the other hand, if joint federal returns are filed, the income and deduction amounts could be duplicated for joint state return filings, and for the separate state return filings, the taxpayer could (with the states' approval) either use the allocated amounts from the federal return or the amounts derived under the current system.

With respect to state tax collection matters, it would be up to each state to consider an allocated liability standard or continue with their present system.

Divorce Decree, Separation Agreement, or Other Property Settlement

Basing the respective spouses' tax obligations and liabilities on the terms of a divorce decree, separation agreement, or other property settlement would only apply to unknown liabilities. In such a case, the allocation would be fair and simple. All other liabilities of a divorce are allocated according to the divorce decree, and the strength of the state laws would add to the collection of federal tax.

This would not require the IRS to be a party to divorce proceeding. Rather, the interests of the government could be represented in such cases by the arms length negotiations that occur under state law and the default provisions. In addition, the IRS would retain the right to reallocate the liability if there is undue manipulation of the rules, step transactions, or fraud. We note that there already is precedent concerning the Service relying on divorce decrees in the areas of alimony and exemptions.

As stated above, if the divorce decree or separation agreement does not provide for allocation of the unknown tax liability, the tax allocation (for known liabilities) on the tax return in question would be used, and if no allocation was determined, a 50/50 allocation default would be used, which would be equitable in most divorce cases.

Those spouses less able to influence the terms of a divorce decree or separation agreement would not be adversely affected by this system because any situations involving manipulations or under-reporting of tax liability by one spouse would be categorized as an abusive situation whereby the IRS would be allowed to reallocate liability based on the facts and circumstances. Also, where inadequate legal representation of both parties results in the divorce decree/separation agreement being silent on this matter, the defaults (i.e., back to the return and then to 50/50 allocation), should protect the spouses and would be better than under the current rules.

Reform the innocent spouse provisions

As we stated above in our comments on innocent spouse rules, there are many situations in which the present innocent spouse provisions do not function in an appropriate manner. Since the rules are based on adjusted gross income levels and two different standards (i.e., the income and knowledge standards), they are not fair and many truly aggrieved spouses are not allowed relief. The current presumption that taxpayers "should have known" effectively eliminates the vast majority of taxpayers from successfully qualifying as an innocent spouse and receiving the appropriate relief. The access to innocent spouse relief should be expanded and simplified. In addition, the facts and circumstances should be considered when determining innocent spousal relief.

Specifically, we think I.R.C. section 6013(e)(4) is overly complex and sets differing standards for innocent spouses based on the level of adjusted gross income, thus punishing innocent spouses with adjusted gross income (AGI) of more than $20,000. This section holds spouses with AGI in excess of $20,000 to a higher standard than those with AGI of $20,000 or less. For example, the tax for a taxpayer with AGI of $20,100 in the preadjustment year would have to be understated by more than $5,025 (i.e., more than 25 percent of AGI) before the taxpayer could qualify for innocent spouse relief, while a taxpayer with AGI of $20,000 would only need an understatement of $2,001 (i.e., more than 10 percent of AGI) to qualify for innocent spouse relief.

We note that section 6013(e)(4) can be easily simplified by eliminating subparagraphs B and D, and revising subparagraph A as stated on page 6 in our March 1995 legislative proposal. Section 6013(e)(4)(A) should be changed to remove the different percentage calculations based on different levels of adjusted gross income and apply the 10 percent of AGI threshold to all aggrieved spouses regardless of their level of AGI. This change would eliminate the need for section 6013(e)(4)(B).

Further, the preadjustment income of the person seeking innocent spouse relief should not include anyone else's income, such as a new spouse. This is another discriminatory provision. A person applying for innocent spouse status should not be treated differently whether remarried or single. Section 6013(e)(4)(D), which includes the income of another spouse in computing the income of the "claiming spouse" for purposes of determining the AGI threshold, should be eliminated.

Any situations involving manipulations or under-reporting of tax liability by one spouse should allow relief to the other aggrieved spouse, and should allow the IRS to step in and reallocate liability based on the facts and circumstances. We note that an allocated liability or separate return standard would significantly reduce the need for these rules.

Expanded innocent spouse relief might be abused in only a few limited situations, and in those cases, the IRS should have the right to not apply the innocent spouse relief rules. Those cases might involve undue manipulation of the rules, step transactions, or fraud. The relief granted to those truly in need, but excluded by the present innocent spouse rules, should outweigh the limited abusive situations.

There are several changes to the Service's administrative practices that should be made with respect to the innocent spouse provisions.

An administrative change that could be implemented now to help many divorcing and separated spouses (not just innocent spouses) is to amend Form 1040-ES, Estimated Tax for Individuals. The form should provide for two amount fields so that the taxpayers can allocate the payment to each spouse's account when they are filing joint income tax returns. This would be very useful for those years during which a divorce or separation occurs. The AICPA discussed this suggested change with the IRS Tax Forms Development Committee on June 3, 1996, and included this suggestion in the AICPA 1996 Recommendations for the Revision of Tax Forms and Publications, submitted to the IRS on June 25, 1996.

In addition, as discussed above, regardless of liability standard, the IRS should pursue enhanced administrative procedures in this area of aggrieved spouses.

Lastly, we have developed regulatory domestic relations tax proposals, including a proposal to modify Treas. Reg. §1.6013-5(b) regarding the criteria applying to innocent spouse relief provisions.

Document I

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March 7, 1998

A .L. Singleton, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Treasury Department Report on Innocent Spouse Relief
105th Congress, 2nd Session, Proposed Bill S.1682
1974 Tax Liability Case
Internal Revenue Service v. David A. Koss et ux

Dear Mr. Singleton:

This letter is directed to Congressman Nancy L. Johnson, Chairman of the Subcommittee on Oversight of the Committee on Ways and Means regarding "Joint Liability and Innocent Spouse Relief" issues, the proposed Bill to amend the Internal Revenue Code of 1986 and the abusive misconduct of the IRS in handling joint tax return cases involving the "Innocent Spouse."

I am writing to you and the Committee at the suggestion of David Keating, National Taxpayers Union and Senator Roth's office concerning the issue of those taxpayers seeking legislative action to restructure the Internal Revenue's provisions of the tax code dealing with "Innocent Spouse Relief", in particular my own case as noted above.

TAXPAYER IGNORANT OF THE "INNOCENT SPOUSE RELIEF"CODE

It is encouraging to learn that the Congress and the AICPA recognize the necessity for the Taxpayer Advocacy Office to take a more assertive role on behalf of the taxpayer when addressing the IRS's shortcomings regarding joint tax liability and the innocent spouse (Section 321 of H.R. 2676). Unfortunately there are few taxpayers who are aware of the process and procedures to follow to obtain relief, and it is almost an unknown to the taxpayer that there are professionals within the IRS agency who are available for information and guidance as to what procedures are available to them. If I had been advised by the IRS and/or my husband of the "Innocent Spouse Relief" code at the onset of the investigation of my tax return in 1974 and/or prior to the tax court decision, I would not be in the unjust situation I find myself in today.

IRS AGENTS UNWILLINGNESS TO DISSEMINATE "INNOCENT SPOUSE RELIEF' OPTION TO THOSE WHO MAY BE ELIGIBLE

Apparently, the majority of IRS agents handling disputed joint tax liability cases wherein "Innocent Spouse Relief" might be an option, don't share their knowledge of this relief and frankly withhold this information from those who might be entitled to apply. The majority of spouses in my situation are ignorant as to their rights to claim this relief, and only learn of this defense if they are in a financial position to hire a tax professional who is astute in these matters. In most cases the exorbitant legal fees necessary to research and fight their cases is not available to these taxpayers, and many of them only learn of this relief option when "it is too late"....after the tax court has made their decision, as was in my case. We are then penalized for alleged tax liabilities by threats of Sheriff's sales of our family homes, liens on our cars and any money we have been fortunate enough to save for unforseen needs. Hundreds of women, and in all probability thousands of potentially eligible "innocent spouse" taxpayers haven't been heard from as yet. I, along the women who have recently testified at the Senate hearings, have experienced the cruel, inequitable, and insensitive treatment of the Internal Revenue Service agents in their effort to collect taxes allegedly due as a result of having signed joint tax returns with their spouses.

I have been involved in a joint tax liability case with the Internal Revenue Service since 1974. I learned of the tax case against my husband and me six years after the audit of our 1974 tax return when my husband asked me to sign a Petition contesting the Notice of Deficiency. At that time I had no understanding of the alleged tax liability nor did I understand the complexity of the case, and signed this piece of paper without full knowledge as to the significance of the document.

- In 1974 I signed a joint return with my husband. As in previous years, I signed the return not questioning the figures or having knowledge of his business dealings or of the stock he received for legal services rendered. He never shared his income or business dealings with me, and I knew nothing whatsoever of my husband's law practice or investments in the stock market, real estate or otherwise.

- I was not apprised of the initial written notice of tax deficiency nor was I aware of the telephone and/or written communications between my husband and the IRS agents in conjunction with the alleged tax liability until many years later.

- As a named party in the Notice of Tax Deficiency, information detailing the availability to apply for "Innocent Spouse Relief" or how one would apply for same was never included in the initial letter or follow up notices.

  Current legislative recommendation:

  The AICPA is concerned that taxpayers may not be aware of all procedures to be followed to obtain relief. To protect taxpayer rights in this area, they recommend that when a deficiency notice is mailed to a taxpayer, it be accompanied by a notice detailing the relief available and how to apply for it, along with a form for use in appealing the assessment.

- I was never interviewed by or notified by the IRS agents of the scheduled meetings between my husband and the agents, nor was I alerted at any time by the agents of my right to appear with my own legal representation , during the six year period when the IRS was examining the taxes, during the tax court proceedings or after the tax court's decision to uphold the demands of the IRS for alleged under-reported taxes.

(Taxpayer Bill of Rights 2 ("TBOR2")
Exhibit (A) Letter dated Nov. 20, 1997 to Marc Feller, Esq.from Mr .Barry Warhoftig,(agent for the IRS) in response to an appeal for "Innocent Spouse Relief" wherein he states that the denial was sustained at the Appeals level and further states:

The case was the subject of litigation in Tax Court.
Freya Koss, who was a party to the litigation, could have asserted an innocent spouse defense but did not do so.

As noted in the body of this letter:

- I did not have the opportunity to assert innocent spouse defense in tax court.
- I was not aware of the alleged initial tax liability nor was I informed of the facts and circumstances of the liability until 6 years later.
- I was not informed by the IRS of the collection process, my rights as a taxpayer of the procedure to defend myself nor the right to select my own representation in tax court.

Current legislative recommendation:

Taxpayer Bill of Rights 2 ("TBOR2") provided for the disclosure of collection activities with respect to joint returns. However, we believe additional safeguards are needed to ensure the equal and fair treatment of spouses who are separated, divorced and/or have community property issues compounding their tax problem. The root of the collection problem is in the examination procedures that do not require both spouses be involved in an audit. We recommend legislation be enacted that would require, at the initiation of an examination, the absent spouse acknowledge by signature whether the other spouse may, or may not, represent the absent spouse (as well as procedures to deal with situations where a spouse refuses to sign such a statement or cannot be located). If both parties are aware of, or participate in the examination, then no one should be caught unaware of the liability and the resulting collection process.

HISTORY OF TAX CASE and APPEAL FOR INNOCENT SPOUSE RELIEF
(Additional Document Attached - Tax History)

1974 TAX RETURN AUDITED FROM 1976 TO 1980 DUE TO AN ALLEGED DEFICIENCY
From 1976 to 1980 the I.R.S. audited us to determine tax liability (although my husband never apprised me of these audits at the time.) In 1980 the I.R.S. issued a Deficiency Notice stating that we owed $48,000 for stock valued at market price of $110,000 less $4,400 reported on 1974 tax return. I only learned of this demand for taxes in 1981 when my husband asked me to sign a document contesting the Notice of Deficiency in a tax court proceeding.

LITIGATION FROM 1981-1989

TAX COURT DECISION - ALLEGED TAX DUE - 1989
I.R.S. alleged that there was an understatement of tax in an amount of $48,788, exclusive of penalties and interest, due to an understatement of my husband's gross income in the amount of $105,600, being the value as determined by the Tax Court of stock received by my husband as a fee for services rendered. This stock was unregistered and

could not be sold for two years after receipt. The stock became worthless in 1977 because there was no market for it. No money was ever received by my husband or myself, as this stock was worthless and never sold. During 1974-1977 we took no vacations or trips, bought no cars, jewelry, extraordinary clothing, and did no entertaining. I nor my family benefited in any way from the understatement

LIEN PUT ON HOUSE - 1991

A lien was put on our house in 1991, and again my husband assured me that our house would not be taken, because he believed that he had reported his income properly and did not owe the taxes deemed due by the I.R.S. Due to the lien placed on our home in 1991, we were prevented from negotiating a lower mortgage rate as interest rates dropped considerably, and thus have been forced to pay $42,000 more with interest than we would have had to if we had been able to take advantage of the lower rates as they become available.

RETAINED ATTORNEY - INNOCENT SPOUSE RELIEF- 1996

After years of worry, in 1996 I sought a tax attorney's advice (Earl Epstein, Esq.) to research the case as to my liability. My husband agreed to pay the fee, as I had no money of my own. It was only at this time that I was informed that I could have claimed "Innocent Spouse Relief" in the tax court, and my attorney further indicated that this should have been done during the initial tax court hearings. Although I met all necessary requirements for "Innocent Spouse Relief", I was informed by him that "Innocent Spouse Relief" was ordinarily claimed before the tax court made their decision rather than after the fact. In fact, I had been misrepresented by my husband due to the fact that I was never given the opportunity to defend myself, apply for "Innocent Spouse Relief" before the Tax Court made its decision , during or after the tax court hearing and was not given an opportunity to have my own representation. Although I became aware of the I.R.S. case against us in 1981 and that there was an alleged gross understatement of taxes due, I did not understand the facts and circumstances involved and had no idea as to the seriousness of the matter and that we were in jeopardy of losing our home, automobiles and bank accounts.

PERSONAL & MARRIAGE BACKGROUND

After graduating high school in 1959 I worked as a secretary, married in 1967 and stopped working in 1968 before giving birth to the first of three children, respectively in November'68, October'70 and October'77. I spent all of my time caring for my children and home. I also cared for a child from my husband's first marriage who came to live with us. I knew nothing whatsoever of my husband's business dealings, law practice or investments. I had no income or bank account of my own. My husband gave me a fixed amount of money each week to buy food and necessities to care for the family. I had no background in business or taxation and had no education in this area. In high school I studied liberal arts and took a course in stenography and typing after high school.

Unfortunately, many of us who grew up in the 50's are products of our generation.....society schooled us to be housewives caring for home and children. My husband is a lawyer, and I left those decisions to him, never questioning. Those of us who did not work during child- rearing years left the business dealings and financial support of the family to our husbands and naively didn't question finances. We had a home, our families were fed, clothed and educated. Those were my priorities and responsibilities. I trusted that my husband would handle all financial matters, and he shared neither lucrative income news or deficient income news.

DENIED INNOCENT SPOUSE RELIEF- 1996

I appealed to Congressman Jon Fox to have a new retroactive Bill introduced for Innocent Spouse Relief, and he had written to the Internal Revenue Service several times on my behalf asking for consideration of relief in this matter, to no avail. **Letter dated March 27, 1996 (Exhibit B) from Congressman Jon Fox to Ann Rafffaelli, National Director for Legislative Affairs, Internal Revenue Service,** reiterates statement of J. Earl Epstein, Esq. (lawyer I had consulted) i.e.: the Third Circuit suggested that *administrative relief can be granted by the IRS if they should choose to do so.*

In **Letter dated January 10, 1996 (Exhibit C)** I wrote to the Internal Revenue Service asking to be relieved of the liability, interest and penalties for the year 1974 pursuant to the provisions of section 6013(e) of the IRS Code. This letter states that I was unaware and had no knowledge of my husband's business dealings or receipt of stock for legal services, that I received no benefit whatsoever from the receipt of the stock, that a joint tax return was filed and that there was a substantial understatement of tax exceeding $500 attributable to grossly erroneous items.

As per letter dated **February 18, 1997 (Exhibit D) from Jerry Soble, Chief, Section I, QAS, Internal Revenue Service,** I was denied 'Innocent Spouse Relief' stating that I had been aware of the facts and circumstances of the case because I had signed the tax return and Petition. In addition, the prerequisites listed in the tax code for consideration of "innocent spouse" were enumerated in my letter of January 1, 1996 and totally ignored by Mr. Soble, stating that the hardship created by losing my home, my only equity, was not a good enough reason to quality for entitlement of relief as an innocent spouse. NOTE: Mr. Sobel never referenced denial due to the fact that Innocent Spouse had not been brought up in the tax court.

Before determination to deny "Innocent Spouse Relief" was made, I was not questioned or interviewed by IRS agent (Barry I. Warhoftig), who was handling the case under Mr. Sobel.. He merely called my home and asked my husband if we were still married and never spoke to me. After that phone call the above referred to letter dated February 18, 1997 from Mr. Soble was received indicating denial.. On February 21,1997 I faxed a letter to Mr. Warhoftig asking for an Appeal conference, which was scheduled. The fact that I was still married should have had no bearing as to whether or not I was eligible for "Innocent Spouse Relief."

Before the IRS makes such a decision, I believe I should have been interviewed by an IRS revenue agent. I was never given the opportunity to discuss the circumstances with an agent until I was refused relief. When I received notice that I did not qualify for entitlement of relief as an innocent spouse I was advised that I could request reconsideration of the decision with an IRS Appeals Officer within 30 days, additionally noting that interest would continue to accrue on any unpaid liability.

During an informal interview with Appeals Officer (Linda Marcinek) which I attended with a friend who is a tax lawyer, namely John Kaskey, Esq., she reviewed the facts and circumstances of my case and verbally in front of both of us substantiated my definitive qualifications for "Innocent Spouse Relief", but stated that.....because "Innocent Spouse Relief" was not brought up in the tax court I was no longer eligible and IRS was not willing to grant a retroactive appeal nor would they consider all the prior facts and circumstances which had not allowed me to file for Innocent Spouse Relief and the appeal was dismissed. As stated above, I never had the opportunity to do so as I was ignorant as to the availability of the "Innocent Spouse Relief" law, was not present at initial meetings with the revenue agents, was not present at the tax court hearings, was unaware of the alleged tax deficiency and did not have effective counsel representing me in the tax case. It is my understanding that:

> *Appeals specializes in, and is trained to look at factors other than the "Service's position" as to an issue. Appeals is intended to give the issue a "fresh look" and can make independent determinations.*

My Appeal's consideration of the Philadelphia District's denial of Innocent Spouse Relief under IRC 6013(e) was denied because they claimed that they were not provided with additional information for adequate consideration of my claim.. **Letter dated October 20, 1997 to me from Frank J. Bagnanto, Jr., Associate Chief of the IRS Pennsylvania Appeals Office (Exhibit D.** Again, the facts and circumstances of the case were ignored.

In September'1997 I again appealed to my husband to assist me in paying for a tax attorney to appeal for Innocent Spouse Relief. I engaged Marc Feller, Esq. who also believed that I was eligible for Innocent Spouse Relief taking all facts in account, and he had handled a previous case for a client who was granted Innocent Spouse Relief after the Tax Court had made a decision. He wrote to **Darlene Berthod, District Director, Internal Revenue Service, Philadelphia, PA, letter dated October 9, 1997, Exhibit E** requesting administrative consideration of this claim and stating facts that substantiate that I clearly meet the elements of the Innocent Spouse test and that the consequences to me in this situation would be severe as to be cruel and unusual punishment for events solely attributable to my husband. And further, that it would be inequitable to hold me liable for the deficiency. **Letter dated November 20, 1997 from Barry Warhoftig, Offer in Compromise Examiner, IRS to Marc Feller Exhibit F** asserts that as a party to the original litigation, I *could have asserted an innocent spouse defense but did not do so*.....and denies offer in compromise. In response, **Mr. Feller wrote to John Boehm, Chief, Exam Div. of the IRS, Exhibit F(a)** stating that he had represented another taxpayer in a very similar situation with the Baltimore District. *Recognizing the unfairness and hardship resulting from the circumstances there, the District Director and Chief, Examination Div. Considered and granted innocent spouse relief to my client after consultation with the National Office* and after the Tax Court had made their decision to affirm an IRS deficiency.

Letter dated January 29, 1998 from Darlene Berthod to Marc A. Feller ExhibitG denied Innocent Spouse Relief stating that...*claims must be asserted during the original litigation and that the judicial doctrine of "res judicata" bars innocent spouse claims at a later date."* She stated that the only alternative would be to petition the Tax Court to reopen the original court case, and I have been advised that in all probability this would not begranted.

I am aware of the Congressional efforts to restructure "Innocent Spouse Relief" legislation, but it offers no assistance to innocent taxpayers who have been unfairly treated by the Internal Revenue Service prior to the three year retroactive policy which is being considered. The AICPA supports the provision to grant the Tax Court jurisdiction to review any denial of relief by the IRS, but this would be a costly legal matter for which I do not have the funds.

This operative process instituted by IRS agents has caused severe financial and emotional damage to genuinely blameless spouses and their children. For years I've awakened in the middle of the night ridden with anxiety wondering if my family would have a roof over their heads, if my car would be there in the morning or our bank account would be taken. My individual credit record has been questioned and I have been denied credit due to the lien placed on my home. The Notices of intent to levy were sent every so often, but my husband would allay my fears for short periods, assuring myself and our children that there was nothing to worry about. I was unable to fathom what I had done to be so victimized.

Taking all facts into consideration, particularly the fact that the Appeals Officer determined that the circumstances and facts of the case substantiated "Innocent Spouse Relief" eligibility, the fact that I did not participate in any of the examinations in tax court and was not given an opportunity to do so, was not effectively represented in tax court, was not at any time interviewed by IRS agents with the exception of the Appeals Officer after tax liability determination.....DOES THIS NOT QUALIFY FOR A "FRESH LOOK"?

I find it flagrantly unconscionable that the Internal Revenue Service and its agents wish to hold me responsible for a tax liability allegedly incurred by my husband as a result of certain business dealings which I had no knowledge of. I again, ask that consideration be given to a procedure that would allow me to file my Innocent Spouse Claim administratively notwithstanding the tax court's final decision and the assessment of the tax by the I.R.S. I fully support proposed Bill S.1682 and I hope that the Congress and the President of the United States will also see the immediate need to pass this Bill in order to protect innocent taxpayers.

Public confidence will only be restored in the Internal Revenue Service when it is represented by professional, educated and unbiased agents who approach taxpayers liability issues fairly with a degree of humanitarianism and dignity, and that its decisions be consistent throughout the Internal Revenue Service offering all necessary and appropriate information to the all taxpayers.

.If any additional information is required, please call or write to me. I sincerely thank you for your assistance and commitment to improving innocent spouse provisions on administrative and statutory levels.

Sincerely yours,

Freya B. Koss

Attachments: Exhibits A-G,
Summary-Comments & Recommendations

INNOCENT SPOUSE RELIEF- FREYA KOSS
TAX CASE-United States v. David A. Koss, et ux No. 95-1784

Receipt of stock by David A. Koss:

1974, February
David received 22,000 shares of Video Systems Corp. Stock as a result of litigation with David's client for a fee for services rendered by David to client. Freya had no knowledge of this litigation and no knowledge that David received the 22,000 shares in February, 1974. Freya only learned of the receipt of the shares in early 1981, when David had her sign a petition to the U.S. Tax Court contesting the Notice of Deficiency sent by the IRS in December, 1980.

1974 Tax Return:
David's Schedule C reflects receipt of $21,378 as fees, which included the sum of $4,400, as the value which David placed on the 22,000 shares because the shares were unregistered and could not be sold by David until 1976 (per SEC regulations.)

1976 - IRS audits 1974 tax return
Freya had no knowledge of the audit, as same took place at David's law office in Philadelphia.

1977 through 1980
Audit continued. Three different IRS agents performed same. All meetings with IRS agents took place at David's law office, and Freya knew nothing about same.
December, 1980

- IRS issued deficiency notice, adding $105,600 to David's income for year 1974, which was the over-the-counter market price of the 22,000 shares on February 1, 1974. ($110,000 market price less $4,400) reported by David on 1974 tax return.
- Freya filed joint tax returns with her husband from 1968 forward. David prepared the returns and asked me to sign them. I did so without studying or questioning any information or items listed on the return.
- I never benefited from the 22,000 shares of stock, as they were never sold or disposed of in any way. The shares dropped in price in 1976 to .25, and became worthless in 1977.
- I did not benefit from the failure to pay the $48,000 in income tax deficiency for the year 1974.
- During 1974-1977 we took no vacations or trips, bought no cars, jewelry, extraordinary clothing, and did no entertaining.

Document II **Freya B. Koss-Innocent Spouse**

SUPPLEMENTAL SHEET

Those individuals named in Document I:

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SUMMARY
COMMENTS AND RECOMMENDATIONS

The attached statement outlines my joint tax liability case and the history of my repeated attempts to be granted "Innocent Spouse Relief." I believe the facts and circumstances contained therein substantiate the abusive, egregious and inept performance by representatives of the IRS and the IRS regional Appeals Officers in handling my case which arose out of (United States v. David A. Koss et us No. 95-1784).

I appeal to the Congress and the President of the United States to seriously consider the allegations made in recent Senate hearings, in the attached statement and otherwise by spouses who have been unjustly and severely treated by the IRS for alleged erroneous underpayment of income tax reported on joint tax returns, and the necessity to pass Bill S.1682. It is of significant importance that the following restructuring be passed to create a fair and equitable means of handling innocent spouse relief claims:

1. Liability for payment of tax with respect to joint returns made for the questionable year should be computed with respect to income and deductions reported in proportion to the tax liability which each spouse would have incurred if each had reported his or her apportionable items on separate returns .

2. If one spouse concealed income or reported an alleged understatement of income on a joint return and the "innocent" spouse did not know of or benefit from the income, it is unfair to collect the resulting tax liability from the other spouse and should be imposed only on the culpable spouse.

3. If "innocent spouse relief" was not raised in the tax court, all facts and circumstances relating to reasons for not addressing this issue in court should be taken into consideration before attempting to collect from innocent spouse. If non-culpable spouse fulfills all criteria as set forth legislatively for eligibility of "innocent spouse relief",
consideration should be given to a procedure that would allow innocent spouse to file the claim administratively notwithstanding the tax court's final decision and the assessment of the tax by the IRS.

4. The IRS should not have the right to seize community property, innocent spouses' income, bank accounts, automobile, stocks, bonds or other property to satisfy the alleged tax liabilities attributed to the culpable spouse.

5. Relief should be granted retroactively to apply to cases in which the tax has not yet been paid and the innocent spouse has been proven to fulfill all requirements for eligibility of relief, and apply to taxable years beginning before, on, or after the date of the enactment of the revised Act including cases in which the tax court has made a decision.

6. The tax court itself should be required to determine, whether in fact, one of the spouses is an "innocent spouse" before coming to its decision that both are liable for the alleged deficiency.

7. IRS representatives handling joint tax liability cases should be educated as to the provisions of 'Innocent Spouse Relief" and IRS literature and initial correspondence to the taxpayer should clearly include and advise taxpayers of "innocent spouse relief" provisions as contained in the law; who should be considered for eligibility of "Innocent Spouse Relief", and required to disseminate the availability of this relief and how to apply for it.

8. Innocent Spouse Relief should be applied uniformly throughout each IRS office and agents throughout the country and by each judge of the tax court, and indiscriminate, biased, autonomous decisions should not be permitted.

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March 4, 1998

Mr. William R. "Mac" McKenney
Committee on Ways and Means
Subcommittee on Oversight
1136 Longsworth House Office Building
Washington, D.C. 20515

VIA MESSENGER

Dear Mr. McKenney:

Pursuant to our telephone conversation today, please find enclosed my written statement for consideration by the Subcommittee on Oversight of the House Committee on Ways and Means, and for inclusion in the printed record of the hearing of the Subcommittee on Oversight about the Treasury Department Report on Innocent Spouse Relief.

Very truly yours,

Marjorie A. O'Connell

Enclosures

cc w/ enclosures: A.L. Singleton

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TESTIMONY
OF
MARJORIE A. O'CONNELL
BEFORE THE U.S. SENATE FINANCE COMMITTEE

WEDNESDAY, FEBRUARY 11, 1998

PROPOSALS TO REFORM THE INNOCENT SPOUSE TAX RULES

Mr. Chairman, Members of the United States Senate Committee on Finance. Thank you for the opportunity to testify before you today about proposals to reform the innocent spouse tax rules.

My name is Marjorie O'Connell, I have practiced law in Washington, D.C. for 25 years. I am a tax attorney, my specialty in practice is family taxation, particularly divorce taxation. I have authored numerous articles, several books, and a tax service supplemented monthly since 1982 about divorce taxation. I have served in the American Bar Association's various Sections as a specialist, leading committees and task forces that have addressed the subject about which I testify before you today. I have provided my professional credentials as the last page of my written testimony.

Through my law practice experience, my work as a author and lecturer, and significant involvement in professional organizations' efforts to improve tax law, I have encountered hundreds of spouses innocent of tax liability, yet confounded by the tax code's current provisions to relieve them from that liability. I am here today to tell you from these experiences why current law does not work and why even as current law is improved in the House-passed Taxpayer Bill of Rights 3, the law still would not work. I choose to do this only briefly because the panel who appeared before me has told you their tales. There are more stories in legion which I know you have read in letters from stricken constituents who have squarely put the problem on your desks.

In short, current law in its overwhelming complexity has proven itself no relief but a waste of time and money for many innocent spouses. The Internal Revenue Service as you heard from Professor Beck frequently pursues the perceived lesser empowered of spouses who signs a joint return and succeeds in overwhelming that spouse through perfectly legal collection mechanisms. For those few spouses who can afford and are well enough informed to allege an innocent spouse defense, even early in the audit process, conflicting administrative rulings and court decisions defeat them. Under current law and even under the revision proposed in TBR 3, an innocent spouse must prove, among other things, that he or she did not know and had no reason to know of the item on the return which caused the tax understatement. That spouse must also prove that it

will be inequitable to hold him or her liable for the tax. Inequitable is defined to mean that the party alleging the innocent spouse status must prove that he or she did not benefit from the tax understatement. It is rare that innocent spouses can meet these two extremely difficult "negative" burdens of proof. Even in cases like those you heard this morning, and others numbering in the thousands, some decision makers will always find a basis to suspect "reason to know" (in cases in which a spouse is simply employed in the market place) or a basis to find "benefit" (in cases in which a spouse receives any portion of a marital estate after a long-term marriage).

We can have a system that is fair for taxpayers, easier to administer for the Internal Revenue Service and simpler for all. This system could work without jeopardizing tax collections.

Let us simplify the problem. What don't we like about everything we heard today? It is that a spouse is held liable, who is not responsible for the tax mistake: liable up to 100 percent of the taxes owed, plus penalties and interest; when not responsible simply because it is not the innocent spouse's income or his or her business or investment; for a reporting mistake when that spouse was not even involved in deciding how to report the item that caused the understatement.

What is the path to a solution? Well, how do we cause the

problem? When spouses sign joint returns, they undertake joint and several liability becoming fully responsible for mistakes in which they are not involved.

What's the solution? It could not be simpler, disassociate joint return signing from tax liability.

How would that work? What would happen under various systems of doing that? Professor Beck has given you some of the history and alluded to our projects principally through the American Bar Association to address this problem. Almost 15 years ago, those of us who had participated in a five-year effort to reform domestic relations taxation, thought we had truly invented a "rounder wheel" for joint return liability. Compared to then existing law, indeed, we had. But, as if sent rolling down pothole- ridden streets of Washington, D.C., this wheel has taken the blows of uneven IRS administration and inconsistent court decisions. Today, the misshapen wheel is no longer able to roll the wagon of tax equity forward.

In 1994 and 1995, 10 years after the last major legislative relief in this area, I participated with the American Bar Association to design a solution that would disassociate joint return signing from tax liability. The ABA recommendation also addresses the circumstance of the spouse in a community property state who does not sign a joint return but who might nonetheless be

held liable for the tax mistake of a spouse in whose economic activities the innocent spouse had no involvement. As is our policy in the ABA, we adopted a recommendation. Those of us who worked on the project also prepared an extensive report in support of it and drafted proposed statutory language. All of these materials are provided to the Committee in my written testimony.

It is recommended that all married persons be taxed only on their own individual incomes, without liability for tax on the income of their spouses, even when they file joint returns or are residents of a community property state.

There is ordinarily no difficulty in determining each spouse's gross income on a joint return. The difficulty, if any, results from the necessary allocation and apportionment of deductions. However, allocation and apportionment of deductions between related taxpayers is routinely required in other circumstances, and the audit process almost necessarily reveals the source of any asserted deficiency. Most deficiencies are assessed as result of matching the return with information forms W-2, 1099, K-1 and the like, which reveal the source of income.

It is important to emphasize that, in order to separate the liability of married persons for payment of income tax on a joint return, no other changes would be required. The current rate structure and filing status system would remain unchanged, and the

benefits of income-splitting for joint filers would be preserved. The basic formula for determining the separate liability of each spouse on a joint return is as follows: First, each spouse's tax would be calculated as if he or she filed a separate return of a married individual, second, the ratio of a spouse's separate tax to the sum of both separate taxes would be applied to the total joint tax due. In this way, the benefit of the income-splitting rate structure is preserved, but each spouse is liable only for the portion of the joint tax which is due to his or her separate income. The calculation will not increase the complexity or difficulty of preparing returns, because it will only be employed on audit in cases where there is a deficiency which is contested by one spouse.

Determining liability for subsequently assessed deficiencies may be thought of as an "item" approach, in which liability for the tax follows responsibility for the item, and represents a departure from strictly proportional liability.

Poe v. Seaborn, 282 U.S. 101 (1930), construed family property law in the community property states to create a separate liability on each spouse for the tax on one-half of the income of the other on the theory that all earnings during marriage inure to the marital community and are therefore owned by and taxable to each spouse in equal amounts. This form of liability does not depend upon filing a joint return, but results automatically from

residence in a community property jurisdiction. Seaborn should be legislative overruled, as has already occurred in limited contexts. In 1976, Congress in effect repealed the Seaborn rule for couples one or both of whom are nonresident aliens. It is this rule, codified under Internal Revenue Code section 879(a), which our recommendation would extend to all taxpayers, modified, as explained below, with respect to the treatment of investment income. As under section 879(a), the earned income of couples would taxable to the earner alone. Items of income and deduction from a trade or business would be treated as items of the spouse who exercises substantially all the management and control of the trade or business. Income and deductions from a partnership distributive share would be taxable entirely to the spouse who is the partner. Income from separate property would be the separate income of the spouse, notwithstanding the law of some states which treats such income as community property. Tax liability would be incurred solely by the titleholder(s) of investment property just as in common law states. The sole titleholder can usually control and dispose of investment income without consent of the other spouse, often, as a practical matter, without incurring any accounting or other liability for the non-titleholding spouse's community interest in the income.

In conclusion, we recommend that the Committee approve legislation that would (i) eliminate joint and several liability of a taxpayer who has signed a joint return with his or her spouse for

tax on income properly attributable to his or her spouse, (ii) substitute separate liability for tax shown to be due on the joint return, and (iii) repeal innocent spouse relief from liability for tax on the joint return when the liability arises from erroneous items of the taxpayer's spouse; and would (iv) overrule the holding in Poe v. Seaborn, 282 U.S. 101 (1930), so that married taxpayers who live in community property states would not be individually liable for income tax on any portion of the income earned by their spouses; (v) refer to section 879(a), with modifications, for the purpose of attributing income to a spouse in a community property state for income tax purposes; and (vi) repeal the provisions granting relief from tax on income attributed to the taxpayer as the taxpayer's share of community income earned by the taxpayer's spouse.

Thank you for your consideration of these recommendations.

[American Bar Association report being retained in Committee files.]

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