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IRS Reform: Innocent Spouse Rule

(name redacted)
Legislative Attorney
American Law Division

Summary

Married couples filing joint tax returns are liable individually and as a couple for all taxes due on the return with a limited exemption for innocent spouses. Joint and several liability has been the subject of much criticism and calls for reform or elimination. The House-passed version of IRS Restructuring and Reform legislation (H.R. 2676, 105th Congress) would amend existing law to make qualifying for the exemption much easier. The Senate adopted an amendment replacing the innocent spouse rule with a provision permitting either spouse to request apportionment of liability once a deficiency has been assessed. A hybrid version, permitting an election to apportion where spouses are divorced, legally separated or have lived separate and apart for twelve months, and retaining but liberalizing the innocent spouse exemption for all other joint filers emerged from conference and will soon be voted on.

Joint Returns and Joint and Several Liability. Joint and several liability for taxes due on joint returns was made part of the Internal Revenue Code almost 60 years ago in 1938. Twenty years earlier Congress had amended the recently enacted income tax to provide an option for the filing of joint returns by married couples. The 1918 enactment did not address the question of liability on joint returns, but IRS took the position that married taxpayers were jointly and severally liable for taxes due, regardless of who would have been liable had they filed separately. When the courts rejected this IRS interpretation of the law, Congress amended the law to reflect the IRS position. (IRC §6013(d)(3))

Experience with the operation of the joint return liability provision suggested that it could function in a manner which resulted in hardship for a spouse who signed the return with no awareness of any fraud or mistake on the part of the other spouse who filled out the return or provided the erroneous information. A spouse who filed a joint return might find IRS knocking at the door to collect back taxes, interest and penalties for taxes their spouse, perhaps ex spouse, should have paid. This might happen even though the “innocent” ex spouse has very limited means compared to her(his) former mate.

Recognizing that in some cases these liability rules might operate unfairly, Congress amended the law in 1971 to provide limited relief under what is known as the innocent spouse provision. Limited to situations involving unreported income, it was amended in 1984 to include limited relief when deductions, credits or basis adjustments were disallowed, where the understatement met certain income thresholds. (§IRC §6013(e))

Innocent Spouse Relief: Current Law. Present law contains these requisites for claiming innocent spouse protection. A valid joint return must have been made for the tax year. The return must have substantially understated the tax, and the understatement must be attributable to grossly erroneous items of one spouse. The spouse claiming to be innocent must establish that in signing the return he or she did not know and had no reason to know that there was a substantial understatement. Taking all facts and circumstances into account, it would be inequitable to hold the innocent spouse liable for the taxes in question. The statute goes on to provide some further definitions and parameters for application of the rule. Briefly, the statute says a substantial underpayment is one exceeding \$500. (IRC §6013(e)(3)) A grossly erroneous item is defined as any omission from income and “any claim of a deduction, credit or basis ... for which there is no basis in fact or law.” (IRC §6013(e)(2))

The innocent spouse rule has been the subject of extensive litigation with outcomes that are sometimes inconsistent, sometimes facially inequitable, and sometimes controversial. Defenders of joint liability argue administrative convenience and necessity require the rule, because of the burden on tax collectors if they had to sort out the incomes, deductions, credits and other tax attributes of each of the joint taxpayers. Critics argue 1) IRS really does this when they perform an audit; 2) the rule frequently imposes hardship on innocent spouses; 3) innocent spouse rules are vague and difficult to interpret and apply; and 4) courts have varied considerably in their interpretation and results.

IRS Reform Bill. H.R. 2676 (H.Rept. 105-364) passed the House on November 5, 1997. It retained the innocent spouse exemption but made qualifying as an innocent spouse easier. The Senate passed version eliminated the exemption, replacing it with a provision allowing spouses to elect to have tax liability apportioned. A hybridized version emerged from conference containing elements of both Senate and House versions, but applying them in different situations. Individuals who are divorced, legally separated or who have lived separate and apart for 12 months may elect to have the tax liability apportioned. If the election is made or if the innocent spouse standards are met, tax liability is based on items (income, deductions, etc.) allocable to each taxpayer and each taxpayer has the burden of establishing his(her) own tax liability and providing the information necessary to a determination. Obtaining innocent spouse status is made easier by the removal of monetary thresholds and changing the requirement that the understatement be attributable to “grossly erroneous items” of one spouse to simply “erroneous items.” Income and deductions would be allocated following the rules applied to those married filing separately under present law and without regard to community property laws. The Tax Court is given jurisdiction over innocent spouse and allocation disputes. Treasury is authorized to promulgate simplified rules for allocation. As it emerged from conference, the provisions eliminate or modify many of the most criticized provisions of prior law and give divorced and separated spouses, who are likely to find securing information from their former partners most difficult, the option of electing out and requesting apportionment.

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