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TAX POLICY

Information on the Joint and Several Liability Standard



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The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

The Honorable Daniel P. Moynihan
Ranking Minority Member, Committee
on Finance
United States Senate

The Honorable Bill Archer
Chairman, Committee on Ways
and Means
House of Representatives

The Honorable Charles B. Rangel
Ranking Minority Member, Committee
on Ways and Means
House of Representatives

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. 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 the actions of the other spouse. However, when one spouse, independently and without the knowledge of the other spouse, incurs the additional taxes, the other potentially “innocent spouse” may obtain relief from the additional tax liability if certain conditions are met. Because of concerns about the effectiveness of the current innocent spouse provisions and other perceived inequities caused by the joint and several liability standard, section 401 of the Taxpayer Bill of Rights 2 directed us to study and report on several issues related to the joint and several liability standard that applies to jointly filed federal income tax returns.¹ Accordingly, this report discusses (1) the potential universe of taxpayers that may be eligible for innocent spouse relief, (2) the Internal Revenue Service’s (IRS) practices and procedures for handling requests for innocent spouse relief, (3) whether the innocent spouse provisions provide the same treatment for all taxpayers, (4) the potential effects of replacing the joint and several

¹Public Law 104-168, July 30, 1996. The law also directed the Secretary of the Treasury to study and report on the same issues discussed in this report. IRS and Treasury staff jointly conducted the study. The report had not been issued at the time of our review.

liability standard with a proportionate liability standard,² (5) the potential effects on IRS of requiring it to abide by the terms of divorce decrees when those decrees allocate tax liabilities, and (6) the potential effects on IRS of changing the law so that community income of one spouse cannot be seized to satisfy tax liabilities incurred by the other spouse before their marriage.³

Background

A traditional argument for applying a joint and several liability standard to joint returns is that married couples form a single economic unit, so spouses who benefit from each other's income and assets can be held responsible for the total tax liability generated from the income and assets. The benefit of joint returns is that married couples are taxed as if their combined income were equally split between the spouses. For married couples with substantially disproportionate incomes, such income-splitting may lower their overall taxes because some of the higher earner's income could fall into a lower tax bracket and be taxed at a lower rate than if it had all been taxed as the income of one person.

The benefits of income-splitting first became available in community property states in 1930 as a result of the Supreme Court case of Poe v. Seaborn [282 U.S. 101 (1930)]. In that case, the Court held that in community property states, the wife is vested with a half-interest in her husband's income. Therefore, for federal tax returns, income was divided equally between husband and wife, regardless of who earned it. The benefits of income-splitting were denied couples living in common law states as a result of another 1930 Supreme Court case, Lucas v. Earl [281 U.S. 111 (1930)]. In that case, the Supreme Court rejected a couple's private agreement assigning one-half of each spouse's earnings to the other spouse for federal income tax purposes. Income-splitting for all joint filers was added to the Internal Revenue Code by the Revenue Act of 1948 as a means of equalizing the tax rates for married couples in common law states with the tax rates for those living in community property states.

Congress subsequently determined that in some instances, it was inequitable to hold taxpayers liable for additional taxes resulting from their spouses' unreported income. A commonly cited example was a spouse who, unknown to the other spouse, was engaged in an illegal

²Under proportionate liability, each taxpayer is responsible only for the taxes resulting from his or her individual income, even when such income is reported on a joint return. Proportionate liability was generally the standard followed before the Revenue Act of 1938, which established joint and several liability on joint returns.

³In community property states, the income and assets of each spouse belong equally to the other spouse and are available to pay the debts (including taxes) of either spouse.

activity, did not report the illegal income, and was subsequently caught and assessed the taxes on the illegal gain. In 1971, Congress enacted the innocent spouse provisions in the Internal Revenue Code (section 6013(e)) to recognize the inequity of holding spouses liable for additional tax assessments in certain cases. The provisions were broadened in 1984 to provide relief from liabilities resulting from grossly erroneous deductions, credits, or basis (i.e., the purchase price of an asset), in addition to unreported income. The current innocent spouse provisions allow relief from the joint and several liability standard when

- the innocent spouse has filed a joint return with the culpable spouse;
- the 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 (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. If the innocent spouse has remarried, the new spouse's income is included in this calculation.

IRS generally follows state law in regard to ownership of property, and the states define ownership of property very differently. In community property states, the income and assets (property) of each spouse belong equally to the other spouse and can be attached to pay the debts (including taxes) of either spouse.⁴ About 27 percent of all taxpayers live in the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin). In common law states, spouses do not have an inherent right to each other's income and assets. As a result, there is a distinct difference in the application of joint and

⁴Community property principles apply to the income and assets acquired during the marriage. Residents of community property states may own separate property, which generally consists of property owned before the marriage or property acquired by gift or inheritance. The laws of the individual states govern the treatment of such separate property and the income derived from it.

several liability between the residents of community property states versus common law states. For example, a married couple living in a common law state can avoid joint and several liability by filing a “married, filing separate” return, whereas filing a “married, filing separate” return in a community property state will not necessarily result in a similar avoidance of tax.

Results in Brief

We estimated that about 587,000, or about 1 percent, of the 48 million couples who filed joint returns in 1992, the most recent year for which data were available, had additional tax assessments of more than \$500. This estimate represents the maximum number of taxpayers potentially eligible for innocent spouse relief; however, fewer would probably actually qualify. Some taxpayers would also probably have been assessed additional taxes as a result of overstated deductions, credits, or basis, which have other dollar thresholds in addition to the \$500 threshold. Some of these taxpayers would also probably have been ineligible for relief because they would not have met the knowledge test of the innocent spouse provision. However, IRS did not have the data that we would need to estimate the number of taxpayers that fell into these categories. Furthermore, although any taxpayer signing a joint return may seek innocent spouse relief, according to IRS officials, divorced taxpayers are more likely to face the most egregious problems because their current assets could be seized to satisfy tax obligations accruing from joint returns filed prior to the divorce. Assuming a 2 percent per year divorce rate, we estimated that about 35,000 of the 587,000 couples with additional tax assessments for 1992 were divorced in the 3 years since the end of the 1992 tax year and thus a spouse from these couples may have been more likely to consider applying for relief.

The limited information that was available from several operating units within IRS indicated that IRS received few requests for innocent spouse relief and denied most of them. Although information was not available to determine why few requests were made, we observed that IRS publications provide little information on how to request innocent spouse relief and that the publications covering procedures related to the need for relief (e.g., tax examination and appeals) have no information on relief, and IRS has no specific form or process for applying for innocent spouse relief.

Critics of the innocent spouse provisions contend that the current provisions do not ensure that all deserving taxpayers receive equivalent relief. For example, they believe that the dollar thresholds for claiming

innocent spouse relief may preclude some deserving taxpayers from obtaining relief because of the amount of their liability. Four states apparently agree because, for state income tax purposes, they have no dollar thresholds. Assuming a 2 percent per year divorce rate, we estimated that for tax year 1992, an additional 42,600 divorced taxpayers might have been eligible for innocent spouse relief if the dollar thresholds had been eliminated. Since the innocent spouse relief provisions relieve the innocent spouse of responsibility for a joint liability rather than forgive the tax obligation, we could not estimate the revenue impacts of modifying the provisions because data were not available on how successful IRS has been in collecting from culpable spouses.

An alternative 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 such a standard, taxpayers would be responsible only for the taxes generated by their individual incomes and assets or, for taxpayers living in community property states, for the tax associated with one-half of the community income. Options for administering a proportionate liability standard include (1) eliminating joint returns and requiring all taxpayers to file separately, (2) retaining joint returns but modifying them so that each spouse's income and deductions would be reported in separate columns, and (3) retaining the current joint return requirements but 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. The separate and modified joint return options would increase taxpayers' filing burden and IRS' return-processing costs. All three options could increase the costs of IRS' audit, underreporter, and collection programs.

Divorcing couples may specify in their divorce decrees how future liabilities resulting from their prior joint returns are handled. IRS officials at the local level said many taxpayers are surprised to discover that IRS is not bound by these agreements because it is not a party to the decree. 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 matters and divorce proceedings. Furthermore, this proposal 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. IRS officials also raised related concerns, such as whether their interpretation of lengthy and complex divorce decrees would increase the number of appeals and whether divorce decrees would be manipulated to reduce tax liabilities.

IRS can treat taxpayers living in community property states differently from taxpayers living in common law states when collecting taxes. Unlike in common law states, IRS can levy one spouse's income to satisfy the premarital tax debts of the other spouse in community property states 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 these levy actions occur, 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.

Scope and Methodology

To calculate the potential universe of innocent spouses, we used IRS' Statistics of Income data for tax year 1992 to estimate the number of joint returns filed that year and whether or not the taxpayers lived in community property states. We used IRS' information on the results of its 1992 underreporter program to estimate the number and dollar amount of such assessments made against joint filers. We also used the Audit Information Management System (AIMS) database to identify the number and amount of audit assessments made against tax year 1992 joint returns. Finally, we used data from the Bureau of the Census and the Department of Health and Human Services to calculate an annual divorce rate and estimate the number of joint filers that divorce each year.

To determine IRS' practices and procedures for handling innocent spouse cases, we interviewed IRS officials at headquarters, four district offices, and three service centers to discuss their procedures for identifying and processing innocent spouse cases. We selected the Baltimore, Philadelphia, Arkansas-Oklahoma, and San Francisco District Offices and the Philadelphia, Austin, and Fresno Service Centers to give a diverse geographic perspective. We also reviewed innocent spouse cases at the San Francisco District Office and the Fresno Service Center located near our San Francisco office. In addition, IRS, as part of its own efforts to assess the problems related to divorced and separated taxpayers, had requested five Problem Resolution Offices to forward the innocent spouse

cases handled between January and June 1996 to its Problem Resolution Office in headquarters. We reviewed the 31 innocent spouse cases.

To determine whether the innocent spouse provisions provide the same treatment to all taxpayers, we reviewed the literature examining the provisions and IRS data, and compared the federal innocent spouse provisions to state innocent spouse provisions.

To determine the potential effects of changing the current joint and several liability standard to a proportionate liability standard, we used IRS' Statistics of Income data for tax year 1992, underreporter assessments,⁵ and the AIMS database to estimate the number of taxpayers who filed using the "married, filing jointly" status. We also worked with IRS to develop an estimate of the number of taxpayers who had an assessment made against a previously filed joint return to estimate the universe of taxpayers who would have been affected by any changes to the standard. In addition, we reviewed proposed alternatives to the joint and several liability standard prepared by the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA). We also met with North Dakota state officials, who administer a proportionate liability standard on joint state income tax returns. To determine the potential tax administration issues and taxpayer burden associated with establishing a proportionate liability standard, we developed a stratified probability sample of 200 joint tax returns from IRS' tax year 1992 Statistics of Income file to estimate the amount of income that could be identified as either joint or separate income. We projected this sample to the universe of 48 million taxpayers who used the "married, filing joint" status at a 95 percent confidence level.

To determine the potential effects on IRS of requiring it to be bound by divorce decrees, we analyzed the legal ramifications of binding IRS to the terms of lower court decisions. We also discussed the benefits and problems associated with following the provisions of divorce decrees with officials from IRS and officials from California, Wisconsin, and Delaware, whose state tax agencies are bound by divorce decrees.

To determine the potential effects on IRS of changing the law to limit its ability to attach community property, we discussed with IRS officials the

⁵In its underreporter program, IRS computers match income shown on information returns (e.g., forms W-2 and 1099 for interest and dividends) with income that taxpayers report on their tax returns to determine whether taxpayers reported all their income. When discrepancies are found, IRS contacts taxpayers to resolve the issue and assess additional taxes, if required.

policies related to the attachment of income and assets of one taxpayer to pay the debts incurred by his or her spouse before the marriage.

We performed our review from February 1996 through September 1996 in accordance with generally accepted government accounting standards. We requested comments on a draft of this report from the Commissioner of Internal Revenue, which we received on January 15, 1997. These comments are discussed on pages 23 to 25, and a copy of the comments are included in appendix VI.

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 taxpayers that could qualify under the current innocent spouse provisions. We estimated that a spouse from up to 587,000 couples may have been eligible for innocent spouse relief in 1992.

About 48 million joint tax returns were filed for tax year 1992. From IRS' data on tax year 1992 audit and underreporter programs, we estimated that 1.25 million couples filing joint returns were assessed additional taxes under these programs—250,000 were audit assessments and 1 million were underreporter assessments. Of these 1.25 million returns, about 587,000 had additional tax assessments exceeding \$500, which is the minimum dollar threshold required for innocent spouse relief. Appendix I describes the methodology we used to make these estimates.

However, our estimate of 587,000 couples represents the maximum number of taxpayers potentially eligible for innocent spouse relief; fewer would probably actually qualify. Some couples would also probably have been assessed additional taxes as a result of overstated deductions, credits, or basis, which have other dollar thresholds in addition to the \$500 threshold. Data were not available that we would need to estimate the number of joint taxpayers whose tax year 1992 additional tax assessments resulted from overstated deductions, credits, or basis. Also, 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.

Although an unknown number of the 587,000 couples could potentially seek innocent spouse relief, IRS officials told us that the severity of the problem for taxpayers seeking such relief is much greater in the case of

divorced or separated taxpayers. Therefore, 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 might have been eligible for innocent spouse relief for additional tax assessments of more than \$500. Appendix I describes how we developed this estimate.

Limited Data on Innocent Spouse Claims Were Available

IRS did not accumulate data on the number of cases requesting innocent spouse relief or the number of cases for which it grants such relief. Although IRS did not systematically collect data on innocent spouse cases, we found that some IRS operating units we visited maintained some information on the innocent spouse cases they handled. The limited information found on innocent spouse claims indicated that few requests were received, and of these, most were denied. For example, records at the Fresno Service Center indicate it received 90 Offer in Compromise cases requesting innocent spouse relief during the 3 years between March 1993 and February 1996.⁶ The service center denied 48 of these requests because either (1) they dealt with taxes reported as owed on the original return but not paid rather than with subsequent assessments; or (2) the issues causing the assessment had already been resolved by IRS' Appeals Division or the Tax Court, and the claimant had agreed to the decisions. The remaining 42 cases were referred to district offices for processing. As of September 1996, 26 of these 42 cases had been resolved, with 7 being allowed and 19 being denied.

We found that most of the cases handled by IRS' Problem Resolution Office⁷ were also denied. In fiscal year 1996, the Problem Resolution Office requested information from five offices on innocent spouse cases. We reviewed 31 Problem Resolution Office cases from 4 district offices and 1 service center where taxpayers raised the innocent spouse issue between January and June 1996. For the 21 cases where a decision had been reached, IRS granted relief in 10 cases. Appendix II shows our analysis of the Problem Resolution cases we reviewed and summaries of some of the cases.

⁶IRS identified the 90 Offer in Compromise cases by a manual review of Offer in Compromise correspondence files maintained in the Joint Compliance Branch. Although other requests for innocent spouse relief may have been received at the Fresno Service Center during this time period, we were unable to identify any other operating units at the center that maintained such information.

⁷The Problem Resolution Program, administered by IRS' Problem Resolution Office, is designed to help taxpayers who have been unable to resolve their tax problems after repeated attempts to do so with another IRS unit.

Furthermore, according to IRS officials, the Tax Court denied relief in one-third of the innocent spouse cases decided in 1996.

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 sources. The innocent spouse relief provisions are described in several IRS publications, including Your Federal Income Tax (Publication 17), Divorced or Separated Individuals (Publication 504), and Exemptions, Standard Deduction, and Filing Information (Publication 501). However, these publications do not provide any guidance on how to request relief. Furthermore, they are developed to help taxpayers prepare their returns, which is far in advance of the time that taxpayers might need information on the possibility of innocent spouse relief.⁸ In contrast, Examination of Returns, Appeal Rights, and Claims for Refund (Publication 556) and Understanding The Collection Process (Publication 594) are totally silent about innocent spouse relief, even though these publications are more directly related to the procedures that apply when taxpayers are billed for their spouses' taxes.

IRS Had No Well-Defined Procedures for Requesting and Processing Innocent Spouse Claims

IRS also lacks well-defined procedures for taxpayers to request innocent spouse relief. As noted, in those limited cases where IRS has publicized the innocent spouse provisions, there is no guidance as to how taxpayers should request such relief. In those innocent spouse cases we were able to identify and review, we found no consistent process for claiming relief. 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) 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 may indicate that taxpayers are not provided with adequate guidance for seeking relief by IRS.

In contrast, we found a much more taxpayer-friendly approach taken in the case of "injured spouse" claims. Injured spouses are joint filers whose joint refunds have been seized to pay certain of their spouses' nontax

⁸IRS generally does not begin auditing tax returns until about 6 months after the April 15 return due date. Also, it generally does not begin investigating cases in its underreporter program until 7 months after the April 15 filing date.

debts, such as past-due child or spousal support or a federal loan. Injured spouses can apply for their portion of the joint refund by completing Form 8379, Injured Spouse Claim and Allocation. The 1040 instruction booklet provides a clear explanation of the injured spouse provisions, the qualifying conditions to be met, the specific form to be prepared, and how the claim should be filed with IRS. The information is provided under the refund line item instructions and tells taxpayers to attach the Form 8379 to their tax return.

We also found confusion within IRS about how taxpayers should request innocent spouse relief. The various IRS units we contacted to determine the procedures they followed in handling innocent spouse cases took different approaches to considering relief. For example, two district offices granted relief using Offers in Compromise based on doubt of liability, while staff at one service center routinely denied such requests as inappropriate. This latter service center staff's position was that Offers in Compromise based on doubt of liability can be used only to argue that IRS miscalculated the tax assessment, not to argue that a taxpayer is not liable for paying the assessment. An official at one district office said he would advise taxpayers to fill out an injured spouse form, while an official at a service center said he was unaware that innocent spouse relief existed.

Modifying Tax Code Provisions Could Allow More Taxpayers to Qualify for Relief

Critics of the innocent spouse provisions, such as ABA and AICPA, contend that the current provisions do not ensure that taxpayers receive equitable relief. For example, they said that the dollar thresholds included in the provisions result in eligibility criteria for relief based on income and not strictly on whether the spouse was innocent. Also, under the current provisions, spouses can receive relief if deductions have absolutely no basis in fact or law, but not if the deductions are simply erroneous. Furthermore, spouses requesting relief must establish that they did not know and had no reason to know their spouses were cheating on the taxes. Critics note that the concept of "no reason to know" has not only been interpreted differently by various courts, but is difficult for the potential innocent spouse to prove. Appendix II includes several examples that illustrate the issues involved in applying the innocent spouse provisions.

According to IRS officials, Congress required innocent spouses to meet certain dollar thresholds to qualify for relief as a way of filtering out insignificant claims. The dollar thresholds clearly exclude some taxpayers from relief and may be inconsistent with the goal of providing relief to

deserving taxpayers. In the case of a tax assessment related to an improper deduction, credit, or basis, the amount of the assessment must exceed 10 percent of the claimant's adjusted gross income (AGI) for the claimant's most recent tax year if such income is \$20,000 or less, but the assessment must exceed 25 percent of AGI if it is more than \$20,000. Thus, if a taxpayer's AGI is \$20,000 or less, relief could be available on assessments of \$2,000 or less, but if the taxpayer's AGI is more than \$20,000, relief would be available only if the assessment exceeded \$5,000. This distinction appears to be more related to an ability to pay or degree of hardship than to the innocence of the taxpayer. The logic behind these dollar thresholds is clouded even more because the potential innocent spouse's AGI 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 whether or not a joint return was filed. 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, which could preclude lower income taxpayers from obtaining relief.

The 1984 Tax Reform Act extended relief to include deductions but requires that such items be grossly erroneous, meaning there is no basis in fact or law for the claim. The distinction between a deduction having no basis in law or fact 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 since that time to incorporate the changes to the innocent spouse provisions resulting from the 1984 Tax Reform Act.

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, a determination of whether a taxpayer's lifestyle was significantly better because of the tax avoidance is fairly subjective and the courts have interpreted the criteria differently. Some

district offices have designated an employee as the innocent spouse coordinator so that only one employee applies the knowledge test.

Some states have decided not to apply the federal innocent spouse provisions and have modified them for state tax purposes. Our survey of the District of Columbia and the 43 states that have personal income taxes showed that 20 do not have innocent spouse provisions, 18 have innocent spouse provisions based on the Internal Revenue Code, and 6 have less restrictive provisions (see app. III for a listing of the states).

California, Iowa, Louisiana, and Oklahoma do not apply dollar thresholds when granting innocent spouse relief, while New York applies a \$100 threshold. Massachusetts does not apply the percentage of income threshold for taxes resulting from grossly erroneous deductions. In addition, California and Oklahoma do not require that deductions have no basis in fact or law, simply that they be erroneous.

We estimated that if the federal innocent spouse tax code provisions had been modified to eliminate the dollar thresholds as was done by California, Iowa, Louisiana, and Oklahoma, the maximum number of couples filing tax year 1992 returns potentially eligible for innocent spouse relief would have been 710,000. Assuming a divorce rate of 2 percent per year, we estimate that 42,600 of these couples would have divorced within 3 years.

Modifying the provisions to allow more taxpayers to qualify for innocent spouse relief would likely result in some revenue loss because IRS might not always be successful in collecting from the culpable spouse. However, since IRS does not maintain data on how often it collects from the culpable spouse, we could not estimate the size of the potential revenue loss. IRS would also incur some additional collection costs associated with pursuing the culpable spouse.

Potential Impact of Replacing the Joint and Several Liability Standard With Proportionate Liability

An alternative 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 the generally accepted definition of 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 that 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. Two options in addition to proportionate liability that would limit IRS' ability to hold taxpayers liable for their spouses' taxes are to (1) allow taxpayers to amend their filing status after the due date of the return and (2) have each taxpayer identify on the return the percentage of the total liability for which he or she would be responsible.

Comparison of the Potential Impact of Three Administrative Options on Taxpayers and IRS

Our review of the literature identified three options for administering a proportionate liability standard. The options are to (1) eliminate joint returns and require all taxpayers to file separately,⁹ (2) retain joint returns but modify them so that each spouse's income and deductions are reported in separate columns, and (3) retain the current joint return requirements but apply proportionate liability only in cases where there are delinquent taxes or subsequent tax assessments. We evaluated the potential effects of these options on IRS' tax administration processes and taxpayers' burden. We did not consider how these options would potentially affect tax revenues. Table 1 shows the pros and cons of the three options for taxpayers and IRS.

⁹Married couples currently have the option of filing separately, which in effect proportions their tax liability to their own income, unless the couple lives in a community property state, in which case each taxpayer is liable for the taxes associated with any separate income they may have and one-half of the community income. However, only 5 percent of married taxpayers file separately, because the tax rates are generally lower if they file a joint return.

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. May have a higher tax liability under current rate structure.	Must allocate joint income, deductions, and credits but receive limited or no benefit while married. May have a higher tax liability under current rate structure.	Must establish individual liability if additional taxes assessed.
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. Increased difficulty in matching income reported on returns to information returns. Increased collection costs because IRS would have to collect from each taxpayer rather than a couple.	Might increase costs for keying additional data into computer systems. Increased difficulty in matching income reported on returns to information returns. Increased collection costs because IRS would have to collect from each taxpayer rather than a couple.	Must establish individual liability if additional taxes assessed. Increased collection costs because IRS would have to collect from each taxpayer rather than a couple.

^aEach spouse files separate return.

^bIncome split out separately on joint return.

^cProportionate income only for returns with unpaid taxes or subsequent tax assessments.

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

As shown in table 1, establishing proportionate liability on either a separate or joint return is of limited or no benefit to married taxpayers

who generally would pay their income tax from joint assets or, if they prefer, already have the option of choosing the “married, filing separately” option to limit their liability to their own income. However, such a system would clearly establish liability so that in the event of a tax shortfall, divorced taxpayers could more easily establish the extent to which they are liable for the unpaid taxes or assessments. This clarity, however, is purchased at the cost of a significant burden for taxpayers. For example, in tax year 1992, about 48 million couples filed joint returns but only about 4.5 million, or 9 percent, of them had unpaid tax liabilities or subsequent tax assessments. Thus, under the separate and modified joint return options, about 43 million more couples would have been burdened by proportionate liability than would have potentially benefited. These taxpayers would, at a minimum, have had to allocate their income, deductions, and credits on a joint return and, if required to file separately, file an additional return. Under the current joint return option, however, only the 4.5 million couples with unpaid tax liabilities or additional tax assessments would potentially have had to proportion their income, deductions, and credits. Since, according to IRS, married couples are less likely to request a proportionate split of their joint tax liability even if one of the spouses is innocent, this number may overestimate how many taxpayers would have actually benefited. We estimate that about 270,000 taxpayers would divorce during the 3 years after the returns were filed.

Furthermore, as we reported in September 1996,¹⁰ most married taxpayers would pay higher total taxes if they filed separately rather than jointly. As a result, requiring these taxpayers to file separately could create a higher tax liability for a significant number of taxpayers under the current rate structure.

IRS would also face increased return-processing costs under the separate return or modified joint return-filing options, but not under the current joint return option. For example, if taxpayers were required to file separately, IRS would have to process up to 48 million additional returns since each dual-income couple who formerly filed a single joint return would have to file two returns. We estimate that if all 48 million joint filers had to file two returns, it would cost IRS an additional \$199 million to process the additional tax returns. If married taxpayers were allowed to file jointly but had to report their income and deductions separately on the return—for example, a tax return column for each spouse—IRS might have to make twice as many data transcription entries as it currently does. If all

¹⁰Tax Administration: Income Tax Treatment of Married and Single Individuals (GAO/GGD-96-175, Sept. 3, 1996).

48 million joint filers reported two income streams, we estimate that the additional data entry costs could be about \$19 million.¹¹ Appendix IV describes our methodology for estimating these costs. IRS' underreporter program might also face additional computer matches, but we did not try to estimate these increased costs. There would be no additional return-processing costs under the current joint return option.

IRS' tax compliance costs would increase under all three options; however, it would experience significantly more costs under the separate and modified joint return options than under the current joint return option. For example, IRS' underreporter program costs could increase because it might have trouble matching proportionate tax returns (i.e., separate returns and modified joint returns) to information returns. In our review of a stratified probability sample of 200 joint tax returns for 1992 and the information returns associated with these returns, we found that 77 percent of the income reported on the returns was separately held and IRS would have little difficulty allocating this income. About 2 percent of the income was reported as joint income, and we could not determine whether 12 percent of the income was jointly or separately held. As a result, IRS would generally have difficulty allocating this income. (App. V lists the various income types and whether they were jointly or separately held.)

For separate returns, IRS would not be able to readily match jointly held income to determine whether all the income was reported unless it cross-referenced the return to the spouse's return. IRS would not have this problem with the modified joint return because both spouses' income on the joint return could be totaled by computer and matched to information returns. However, under both the separate and modified joint return options, IRS could not easily determine whether jointly held income was correctly apportioned without requiring taxpayers to either document the information provided on the return or to maintain separate information return accounts for all their income.

The advantage of establishing individual tax liability only if there was a tax shortfall is that it would create little additional burden for taxpayers or IRS. The disadvantage is that in the event of a tax shortfall, the taxpayers and IRS would have to apportion a jointly reported tax liability between the two taxpayers who signed the return. Since the current information reporting system shows certain income and deductions jointly, Congress or IRS

¹¹If the modified return had separate columns for each spouse and a total column, IRS might need to key in only the total column, with the other data being used only if a claim for innocent spouse relief arises.

would need to develop guidelines on how such income and deductions should be handled.

In addition to increased underreporter costs, IRS would likely face increased collection costs because it would have to collect from each taxpayer rather than the couple or whichever taxpayer it found first.

Proportionate Liability Established Only for Unpaid Taxes or Audit Assessments Would Be Least Costly Option

The least costly and disruptive of the three proportionate liability options would be to retain the current joint return and proportion income and deductions only in cases where there are either unpaid taxes or additional tax assessments. This option is endorsed by ABA and is practiced by North Dakota—the only state that has a proportionate liability standard. Each of these entities, however, advocates different methods for proportioning tax liabilities.

ABA, which advocates a proportionate liability standard, proposes apportioning the liability reported on the original return by calculating (1) the spouses' taxes as if they had filed using the "married, filing separately" status; and (2) the percentage of the couple's combined taxes at the separate rate attributable to each spouse. IRS would then apply each spouse's percentage to the joint tax to determine each taxpayer's liability. The burden of proof for calculating the proportionate liability would fall on the taxpayer. If IRS assesses additional taxes through an audit, the deficiency would be the liability of whichever spouse generated the unreported income or disallowed deduction, thus reducing the need for innocent spouse relief. IRS officials believe that innocent spouse relief would still be necessary in certain circumstances, such as when one spouse purchases rental property in both spouses' names and does not inform the other spouse of the asset or income.

North Dakota is the only state that applies a proportionate liability standard to the state income tax return. However, in practice, the North Dakota Tax Commission administers the state tax system as if a joint and several liability standard applied to the state joint returns because it pursues whichever taxpayer it finds first to collect the tax liability. If a divorced taxpayer claims that the tax liability is really attributable to the ex-spouse, the state applies a proportionate liability standard to the joint return. The state uses information returns from IRS to initially apportion reported income and deductions. For income reported in both taxpayers' names, the state assesses 100 percent of the joint income to both taxpayers, and the burden then falls on the taxpayer to document a

different allocation. Joint deductions, such as those for dependents, are allocated in proportion to the amount of income each spouse generated. In other words, if a spouse generated 40 percent of the income, that spouse could claim 40 percent of the deduction. Unreported income is attributed to whoever earned the income.

North Dakota Tax Commission officials said that although proportionate liability addresses the problems of some divorced taxpayers, it is not a panacea that produces a just result in all cases. For example, state officials noted that most farm land is held jointly, but the income is claimed only by the farming husband. They questioned the fairness of allowing a wife to disclaim any responsibility for income generated by an asset that was owned by both spouses. State officials said they were also bothered that nonworking taxpayers who are completely supported by their spouses can then disclaim any responsibility for their spouse's taxes. Such disclaimers are particularly ironic in that nonworking spouses generally establish their claims to assets during divorce proceedings by arguing that they enabled their spouses to generate income. State officials questioned the fairness of allowing taxpayers to make such arguments to bolster their claims to assets and then to escape any tax liability by arguing the income was not theirs.

Other Alternatives to Proportionate Income

Two other alternatives to proportionate liability have been proposed or adopted at the state level that would limit IRS' ability to hold taxpayers liable for their spouses' taxes. First, IRS could allow taxpayers to amend their filing status after the due date of the return. Nine states give taxpayers the opportunity to do this. Second, AICPA advocates replacing the joint and several liability standard with an allocated liability standard. Under this standard, taxpayers would specify on the return a percentage of the total liability for which they would each be responsible. If the taxpayers failed to specify an allocation, they would each be responsible for one-half of the tax liability.

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 handled, i.e., 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. IRS officials at the local level said many taxpayers are surprised to discover that IRS is not bound by divorce decrees. According to ABA representatives, many divorce attorneys are not

well-versed in tax matters and do not realize that divorce decrees do not provide adequate protection against additional federal taxes. According to IRS officials and private sector practitioners, IRS' practices in this regard are similar to the practices of private sector creditors, such as credit card companies, which do not feel they are bound by divorce decrees when collecting on joint debts.

According to certain members of ABA's Committee on Domestic Relations, a legislative change to bind IRS to divorce decrees appears to be 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 U.S. Tax Court, federal district courts, the U.S. Claims Court, and the U.S. Bankruptcy Court. 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.¹²

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. For example, the California Franchise Tax Board is bound by divorce decrees if the decree (1) does not reduce liability for income under the exclusive management and control of the spouse, (2) does not affect taxes that have already been paid, and (3) has been cleared by the California Franchise Tax Board when reportable gross income exceeds \$50,000 or the tax liability exceeds \$2,500. Once the California Franchise Tax Board has approved the proposed tax allocation, the state becomes a party to the decree and is bound by it. State officials said the requirement has increased demands on administrative resources, and they had a backlog of about 100 requests for approval of tax allocations.

¹²The views cited in this paragraph were submitted to the IRS in comments by ABA's Committee on Domestic Relations in response to Notice 96-19. The comments specifically noted that the positions taken represented the individual views of the members who prepared it and did not represent the position of ABA or of the Section on Taxation. With respect to the specific impact of such a legislative change on taxpayers or IRS in each state, the comments also noted that to answer the question definitively would require a law survey of all 50 states, which the Committee had not at that time done. We also have not done a law survey of the 50 states and, therefore, also cannot answer this question definitively.

The Delaware Division of Revenue is also bound by divorce decrees, even though it is not a party to the decree. As a state agency, the Delaware Division of Revenue considers itself bound by state court decisions. However, most Delaware taxpayers file separately because of the state's rate structure, so the requirement creates little administrative burden. The Wisconsin legislature recently passed legislation requiring the Department of Revenue to be bound by divorce decrees beginning in the next tax year. Wisconsin officials are just starting to consider the consequences of this legislation on processing returns and revenue collection.

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 reduce tax liabilities. 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 faced with tax liabilities incurred by their spouses before their marriage, which they would not have encountered 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. However, the placement of wages into a joint account is a matter of choice on the part of the taxpayers and can be avoided if they so choose.

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 because community property laws differ from state to state, it is up to IRS collections personnel in each community property state to determine whether they will levy a spouse's income. Nonetheless, under IRS' collection procedures, levy action is generally to be taken against the individually held income, such as wages, of the taxpayer who incurred the tax debt or any jointly held income, such as an interest-bearing account, not against the separate income of the other spouse. In 1994, IRS issued 3 million third-party levies. However, the agency did not know how many of these levies were placed on the income of a spouse living in a community property state to pay the premarital tax debts of the other spouse. As a result, we could not assess the effects of changing the law to prevent IRS from making these types of levies.

The current tax code contains several provisions that override state community property laws for noncollection activities. For example, the innocent spouse provisions, section 6013(e), specifically prevent IRS from following state community property laws in determining the tax liability on omission from gross income. Also, under section 879(a), community property laws do not apply to the earned income of nonresident aliens. However, making an exemption for this specific collection activity for premarital debts would set a precedent because it would require IRS to ignore state community property laws for a collection activity. Furthermore, unless the states change their community property laws, such a change would not necessarily protect taxpayers' assets. Private sector creditors could continue to pursue community assets to satisfy community debts even though IRS was precluded from attaching such assets.

The inequities created by having IRS follow state community property laws are not limited to levying the income of a spouse to pay the premarital tax debts of the other spouse. For example, the eligibility criteria for injured spouse relief on IRS Form 8379, Injured Spouse Claim and Allocation, specifically state that "Overpayments involving community property states will be allocated by the IRS according to state law. Claims from California, Idaho, Louisiana, and Texas will usually result in no refund for the injured spouse." Thus, IRS follows state community property laws when withholding refunds to apply against nontax debts.

Conclusions

IRS does not track how often innocent spouse relief is requested or granted; however, we estimate that a relatively small number of taxpayers are eligible for relief under the current innocent spouse provisions. The provisions, with their various qualifying criteria, are complex and difficult to meet, and they require IRS staff to weigh various factors in deciding whether to enforce the joint and several liability standard or to relieve taxpayers of their joint liability. IRS provides limited information to taxpayers about the availability of and criteria for relief and does not have a tax form and procedures for requesting and granting relief.

Several proposals have been made to modify innocent spouse relief. More taxpayers might qualify for relief if Congress eliminated or modified the dollar thresholds to allow IRS to consider relief for taxpayers with liabilities less than \$500. Replacing the joint and several liability standard with a proportionate liability standard may also provide additional relief to taxpayers, but this alternative could create a significant administrative burden for taxpayers and IRS. Requiring IRS to be bound by divorce decrees appears to be impractical because of the legal and administrative hurdles that would have to be resolved. Finally, if the law were changed to prevent IRS from levying the income of one spouse to pay the premarital tax debts of the other spouse, the inequities between taxpayers in community property states and common law states might be reduced. However, no data were available to assess the impact of such a change.

Recommendations

To improve IRS' administration of the innocent spouse provisions of the tax code, we recommend that the Commissioner of Internal Revenue (1) develop new or modify existing publications to better inform and educate taxpayers about the availability of and criteria for innocent spouse relief and, as part of that effort; (2) develop a tax form and procedures for requesting and either granting or denying innocent spouse relief. We also recommend that the Commissioner provide additional internal guidance to IRS employees so that greater consistency in processing innocent spouse cases can be achieved, establish a cost-effective process for monitoring the consistency being achieved, and update IRS' regulations to reflect current requirements.

Agency Comments and Our Evaluation

In written comments on a draft of this report (see app. VI), the Commissioner of Internal Revenue generally agreed with our conclusions and recommendations and said that the findings in our report present a real possibility for imminent legislative reform of the innocent spouse

provisions. She said that, thus, it would be preferable to determine if the current legislative session of Congress produces such reforms before devoting the resources necessary to carry out our recommendations.

With this overall caveat, the Commissioner agreed with our first recommendation that IRS should modify existing publications to better inform taxpayers about the availability of innocent spouse relief. Likewise, the Commissioner agreed with our second recommendation that IRS develop a tax form and procedures for taxpayers to request innocent spouse relief and for IRS to either grant or deny such relief. She pointed out, however, that implementation of this recommendation would require approval and clearance of such a form from the Office of Management and Budget.

The Commissioner also agreed with our third recommendation that IRS provide additional internal guidance to employees so that greater consistency in processing innocent spouse cases can be achieved. She said that the form and accompanying procedures developed under our second recommendation would also largely meet the intent of the third recommendation.

The Commissioner said that she understood the concern that prompted our fourth recommendation to establish a cost-effective process for monitoring consistency in processing innocent spouse cases. She said, however, that existing management and information systems do not have the capability to track issues on specific cases and that the only alternative way to accomplish the recommendation, manual tracking of such cases, would be cost prohibitive and less reliable.

It appears that the Commissioner misinterpreted the intent of our recommendation. We fully agree with her points about the capability of existing systems and the cost of manual tracking for such cases, and in fact, we considered these issues in arriving at the wording of our recommendation. Recognizing the problems with its existing systems and manual tracking, our intent was to have IRS explore process options that would not be cost prohibitive but would facilitate a greater level of consistency in innocent spouse decisions. We thought that such exploration was needed because we found a substantial amount of inconsistency and subjectivity, both within and among IRS districts, on how to interpret the knowledge factor in the current innocent spouse provisions.

As an example of the kind of option that we thought IRS might explore in response to our recommendation, we noted that some districts had designated an employee as the innocent spouse coordinator, so that only one employee in each of those districts applied the knowledge test. This caused us to think that IRS could explore this as an option by first determining whether the districts with such coordinators have achieved greater consistency than those without coordinators. If this proves to be so, IRS could then explore the cost effectiveness of establishing innocent spouse coordinators in the remaining districts. By serving as focal points and monitors in their respective districts, these coordinators might facilitate more consistent decisions within districts, and by networking with each other, they might facilitate consistency among the districts. There may well be other options that IRS could explore before reaching a final decision on the best approach and it was to that end that we worded our recommendation to provide IRS with latitude to decide how it goes about achieving a greater level of consistency in its administration of the innocent spouse provisions.

Finally, the Commissioner agreed in principle that IRS should update its innocent spouse regulations to reflect current law, but said that such action would be premature until Congress determines whether to reform the existing provisions. We agree with the Commissioner's position on this recommendation as well as with her overall statement that it makes sense to wait until Congress decides whether to modify the existing law in the current legislative session before devoting the resources necessary to carry out most of our recommendations.

We are sending copies of this report to various other congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. Copies will be made available to others upon request.

Please contact me at (202) 512-8633 if you or your staff have any questions. Major contributors to this report are listed in appendix VII.



Lynda D. Willis
Director, Tax Policy
and Administration Issues

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Abbreviations

ABA	American Bar Association
AGI	Adjusted Gross Income
AICPA	American Institute of Certified Public Accountants
AIMS	Audit Information Management System
IRS	Internal Revenue Service

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Estimated Number of Potential Innocent Spouse Cases

This appendix describes how we derived the potential universe of taxpayers that could be covered by the current innocent spouse provisions in the Internal Revenue Code. The innocent spouse provisions cover certain taxpayers who are assessed additional taxes of more than \$500 after they file a “married, filing joint” tax return. Additional tax assessments generally result from an IRS audit or from underreported income detected in IRS’ underreporter program. We used tax year 1992 audit and underreporter results to estimate the potential innocent spouse universe because that was the latest tax year for which most tax assessments had been completed.

Estimated Number of Innocent Spouse Cases That Could Result From an Audit

To determine the number of married couples filing joint returns that had subsequent audit assessments, we used IRS’ Audit Information Management System (AIMS) database of tax year 1992 audit cases that were closed during fiscal years 1993, 1994, 1995, and the first 9 months of fiscal year 1996. The AIMS data showed that for tax year 1992, 441,224 “married, filing joint” returns were audited and closed by IRS’ Examination Division. However, 190,393 of the 441,224 audits resulted in either no change to the tax liability or in a refund. The remaining 250,831 audits resulted in additional tax assessments. Table I.1 shows the number of tax year 1992 “married, filing joint” return audit cases with additional tax assessments that were closed each fiscal year and shows whether the assessments were for amounts of \$500 and less or for more than \$500.

Table I.1: Tax Year 1992 Closed Audit Cases for “Married, Filing Joint” Returns

Fiscal year closed	Returns with tax assessments		Total
	\$500 or less	More than \$500	
1993	1,277	2,604	3,881
1994	8,876	40,407	49,283
1995	17,426	138,395	155,821
1996	4,785	37,061	41,846
Total	32,364	218,467	250,831

Source: IRS’ AIMS file on tax year 1992 closed audit cases.

As shown in table I.1, the 218,467 taxpayers with tax assessments of more than \$500 potentially meet the eligibility criteria for innocent spouse relief. Thus, this is the maximum number of taxpayers that could request innocent spouse relief because of an audit assessment.

Estimated Number of Innocent Spouse Cases That Could Result From the Underreporter Program

Of the 1.8 million tax year 1992 underreporter cases, 89 percent (about 1.6 million) were assessed additional taxes in fiscal year 1995. The remaining 11 percent (about 200,000 cases) were assessed additional taxes in either 1994 or 1996.

Since almost 90 percent of 1992 underreporter cases were assessed in 1995, we estimated the number of potential tax year 1992 innocent spouse cases by evaluating a stratified probability sample of 463 underreporter cases assessed in 1995. Based on the tax year 1992 returns in this sample, we estimated how many of the 1.6 million tax year 1992 returns assessed in 1995 were “married, filing joint” returns and, of those, how many had assessments under \$500 and assessments of \$500 or more. Although we did not have data to make similar estimates for the 200,000 tax year 1992 returns assessed in 1994 and 1996, we assumed that the filing status and assessed amounts for these returns would be similar to the returns in the 1995 sample where the assessments occurred either 2 years or 4 years after the tax year. We could not directly test this assumption, but our analysis of the data indicates that various characteristics of the returns, such as the amount assessed and the complexity of the underreporting problem, determined when IRS processed the case. We weighted the sample of 463 underreporter cases to represent the number of 1992 tax year returns processed in 1995 and other years and then estimated the potential innocent spouse cases for tax year 1992. We accounted for the stratified sample design and unequal weights for the sample cases when calculating the sampling errors.

The point estimates and sampling errors for 1992 are given in table I.2.

Table I.2: Estimates of Tax Year 1992 Taxpayers Who Could Be Eligible for Innocent Spouse Relief Based on Underreporter Assessments

Data used to calculate underreporter cases	Point estimates and sampling errors
Estimated number of tax year 1992 assessments for “married, filing joint” returns	993,536 ± 150,469
Estimated number of tax year 1992 joint filer cases with assessments of \$500 or less	624,734 ± 151,703
Estimated number of tax year 1992 joint filer cases with assessments of more than \$500	368,802 ± 55,822

Source: GAO’s analysis of IRS’ underreporter data

Adding the tax year 1992 joint filer underreporter cases with tax assessments of more than \$500 in table I.2 to the 218,467 joint filer audit cases in table I.1 results in an estimated potential universe of innocent

spouse cases of approximately 587,000 that is bounded by a confidence interval of between 531,447 and 643,091 returns. Additional uncertainty about this estimate comes from our previously mentioned assumption about the characteristics of the 11 percent of the 1992 returns that were not assessed in fiscal year 1995.

Estimated Number of Married Taxpayers Who Divorce Each Year

To estimate the number of taxpayers who divorce each year, we obtained data from the Bureau of the Census and the Department of Health and Human Services. Census' report, entitled Marital Status and Living Arrangements: March 1993, shows that there were 114,602,000 married individuals in the United States at that time. A Monthly Vital Statistics Report, dated October 1995 and prepared by the National Center for Health Statistics within the Department of Health and Human Services, states that approximately 1,191,000 divorces were granted in the United States in 1994. Therefore, an estimated 2,382,000 individuals who were married in 1993 had divorced in 1994. Dividing this number of individuals by the total number of married individuals in 1993 results in an annual divorce rate of 2.0784 percent, which we have rounded to 2 percent for the calculations in our study. To estimate how many of the potential innocent spouse cases would involve divorced couples over a 3-year period, we multiplied 583,410 by the annual divorce rate of 2 percent and then multiplied by 3.

Information on Problem Resolution Office Innocent Spouse Cases

Cases Between January and June 1996

As part of IRS' efforts to address the problems of divorced and separated taxpayers, the headquarters Problem Resolution Office asked the Problem Resolution Offices at four district offices and one service center to identify all cases where the taxpayer raised the issue of innocent spouse relief between January and June 1996. The offices identified 51 cases and forwarded them to headquarters, where we reviewed them.

Of the 51 cases, 20 were not innocent spouse cases—for example, the taxpayer was actually an injured spouse¹³ or was requesting relief for taxes reported as owed on the original return. Of the remaining 31 cases, 4 involved taxpayers who had already been granted innocent spouse relief but IRS had not correctly transferred the tax liability to the culpable spouse. We did not include these cases since the files contained information only on the processing problem, not the innocent spouse issues. Table II.1 describes the characteristics of the remaining 27 cases.

Table II.1: Characteristics of Problem Resolution Cases

Characteristic	Average	Range	Number of cases with data ^a
Years elapsed ^b	7 years	2 years to 17 years	27
Amount of assessment	\$12,000	\$900 to \$50,000	23
Annual income	\$37,000	\$7,000 to \$77,000	13

^aThe Problem Resolution Office case files did not always include all these data .

^bYears elapsed between the tax year assessed and the taxpayer's contact with the Problem Resolution Office.

Source: IRS' Problem Resolution Office case files.

For the 24 cases where we could find data, all of the taxpayers began requesting help because of collection activity, such as having their wages levied by IRS. For the 24 cases where we could determine marital status, 20 taxpayers were divorced and 4 were separated. For the 21 cases where a decision had been reached, IRS granted relief in 10 of the cases.

Case Histories

The following cases histories illustrate some of the issues involved in innocent spouse cases.

¹³Injured spouses are joint filers whose joint refunds have been seized to pay certain of their spouses' nontax debts, such as past-due child or spousal support or a federal loan.

Confusion Over
Procedures and
Documenting Deductions

According to IRS' records, 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 contacted the Problem Resolution Office about innocent spouse relief. Problem Resolution Office staff initially could not explain how to apply for relief but provided assistance during subsequent contacts. 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.

Impact on New Spouses
and Original Return

A taxpayer whose ex-husband was a wanted fugitive had outstanding tax liabilities because her ex-husband had failed to report income on their joint return for 1 tax year and had not paid the tax reported for 2 subsequent 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 for 2 years was for taxes reported as due on the original return. IRS did accept an Offer in Compromise for all 3 years.

Relief on Original Return
and Knowledge Test

In 1995, a taxpayer wrote to IRS to protest a balance due on joint returns for 3 tax years. The taxes 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.

IRS denied her request for innocent spouse relief because she could not meet the knowledge test. Subsequently, 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.

Knowledge Test

A taxpayer learned of an assessment of over \$12,000 on a joint 1991 return when IRS levied her wages. The couple had legally separated and sold their residence. Although she had reinvested her half of the capital gain on the

sale, her ex-husband had not done so within the 24 months required to defer taxes. IRS denied innocent spouse relief because the taxpayer could not meet the knowledge test. According to IRS, she knew of the possibility of the additional tax when she signed the return.

Knowledge Test, Divorce Decree, Dollar Threshold

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 she would assume outstanding credit card debts and her ex-husband would be responsible for all other debts incurred during the marriage. IRS denied innocent spouse relief for 1 year because the 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 believe she should have been aware of the income earned even though the spouses had separate accounts.

Dollar Thresholds

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 assessment for that year was less than the \$500 threshold. She was denied innocent spouse relief for the other 3 years because the assessment in each of those years was less than 25 percent of her adjusted gross income.

State Efforts to Address Joint and Several Liability Issues

We contacted the state tax agencies to discuss how they handle various issues surrounding joint and several liability when administering the state income tax system. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not tax personal income. Since the tax agencies for these states do not administer any joint income tax returns, we excluded them from our review. The remaining 43 states and the District of Columbia do administer joint returns; however 2 states—New Hampshire and Tennessee—tax only interest and dividends.

Table III.1 provides information by state on the type of liability standard the states apply to joint returns, the type of innocent spouse relief they administer, and whether they are bound by divorce decrees.

Table III.1: State Liability Standards, Innocent Spouse Provisions, and Use of Divorce Decrees^a

State	Joint return with proportionate liability	Innocent spouse relief based on Internal Revenue Code	Less restrictive innocent spouse relief	Bound by divorce decrees
Alabama		X		
Arizona		X		
Arkansas				
California			X	X
Colorado				
Connecticut				
Delaware				X
District of Columbia		X		
Georgia		X		
Hawaii		X		
Idaho		X		
Illinois		X		
Indiana				
Iowa			X	
Kansas				
Kentucky		X		
Louisiana			X	
Maine		X		
Maryland		X		
Massachusetts			X	
Michigan		X		
Minnesota		X		
Mississippi				

(continued)

**Appendix III
State Efforts to Address Joint and Several
Liability Issues**

State	Joint return with proportionate liability	Innocent spouse relief based on Internal Revenue Code	Less restrictive innocent spouse relief	Bound by divorce decrees
Missouri				
Montana				
Nebraska		X		
New Hampshire				
New Jersey				
New Mexico				
New York			X	
North Carolina		X		
North Dakota	X			
Ohio				
Oklahoma			X	
Oregon		X		
Pennsylvania				
Rhode Island				
South Carolina		X		
Tennessee				
Utah		X		
Vermont				
Virginia				
West Virginia				
Wisconsin		X		X
Total	1	18	6	3

^aAlaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax personal income and we excluded them from our review.

Estimated Costs for Processing Separate or Modified Joint Returns

This appendix describes how we estimated the increased returns-processing costs IRS would face if a proportionate liability standard were administered by either (1) eliminating joint returns and requiring all taxpayers to file separately; or (2) retaining joint returns but modifying them so that each spouse's income, deductions, and credits are reported in separate columns.

Estimated Cost of Processing Separate Returns

To estimate the cost of processing up to 48 million additional returns, we determined the distribution of the returns among the standard forms 1040, 1040A, and 1040PC in the 1992 Statistics of Income data. We then estimated the cost of processing these returns using IRS' Document 6746, Cost Estimate Reference for Service Center Returns Processing for Fiscal Year 1994. The calculation is shown in table IV.1.

Table IV.1: Estimated Cost of Processing an Additional 48 Million Tax Returns

Type of return	Number (thousands)	Returns processing cost per thousand	Cost
1040	37,802	\$4,231.89	\$159,973,906
1040A	8,092	3,690.48	29,863,364
1040PC	2,126	4,231.89	8,996,998
Total			\$198,834,268

Source: IRS' 1992 SOI data and Document 6746, Cost Estimate References for Service Center Returns Processing for Fiscal Year 1994.

Estimated Cost of Processing Modified Returns

To estimate the additional data entry costs for 48 million tax returns if the returns were modified to show two income streams, we also used the distribution of the returns among the standard forms 1040, 1040A, and 1049PC in the 1992 Statistics of Income data and IRS' Cost Estimate Reference for Service Center Returns Processing Fiscal Year 1994. The calculation is shown in table IV.2.

Table IV.2: Estimated Additional Data Entry Costs for Modified Joint Returns

Type of return	Number (thousands)	Data entry cost per thousand	Cost
1040	37,802	\$412.64	\$15,598,617
1040A	8,092	263.54	2,132,566
1040PC	2,126	412.64	877,273
Total			\$18,608,456

Source: IRS' 1992 SOI data and Document 6746, Cost Estimate References for Service Center Returns Processing for Fiscal Year 1994.

Distribution of Joint, Separate, and Unknown Income for 1992 Joint Income Tax Returns

The extent to which adopting a proportionate liability standard would create an administrative burden for IRS depends partly on how easily IRS could use an automated reporting system to allocate income and mortgage interest payments between the two spouses. We reviewed a stratified probability sample of 200 joint tax returns selected from IRS' 1992 Statistics of Income database to determine how much income was reported separately for each spouse or jointly for the married couple. We projected the results to the universe of 48 million couples who filed using the "married, filing jointly" status at a 95 percent confidence level.

Of all the income in our sample, 77 percent was reported separately. About 2 percent of the income was reported as joint income, and we could not determine whether the income was separate or joint for 12 percent. As shown in table V.1, some types of income were generally reported separately. For example, IRA distributions and unemployment compensation were always reported separately, as was most farm income (Schedule F). As a result, IRS would have little difficulty allocating this income under a proportionate liability standard.

In contrast, state and local tax refunds are generally reported in both spouses' names. As a result, IRS could have difficulty allocating this income between the two taxpayers.

We had difficulty determining whether other income categories were separate or joint. For example, we generally could not determine which taxpayer earned the profit or loss reported on Schedule E, supplemental net gains or losses, or net operating losses.

Appendix V
Distribution of Joint, Separate, and
Unknown Income for 1992 Joint Income Tax
Returns

Table V.1: Percentage of Income Reported Jointly, Separately, or Could Not Determine

Income source	Joint income	Separate income	Could not determine	Total^a
Wages, salaries, tips	0%	96±2 %	4±2%	100%
Taxable interest income	24±10	36±12	40±17	100
Tax-exempt interest income	0	0	100	100
Dividend income	26±17	68±17	5±3	100
Taxable state and local tax refunds	82±15	4±4	15±13	100
Schedule C Net Income or Loss	0	82±29	18±29	100
Supplemental net gains or losses	0	0	100±.1	100
Taxable IRA distributions	0	100	0	100
Taxable pensions and annuities	0	100±.1	0	100
Schedule E Profit or Loss	9±14	4±5	87±16	100
Schedule F Profit or Loss	0	97±5	3±5	100
Unemployment compensation	0	100	0	100
Taxable Social Security benefits	0	83±21	17±21	100
Net operating loss	0	0	100	100

^aRows may not total due to rounding.

Source: IRS, 1992 Statistics of Income database.

Comments From the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 15, 1997

The Honorable James Hinchman
Acting Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Hinchman:

We would like to thank you for the opportunity to comment on the GAO draft report, TAX POLICY: Information on the Joint and Several Liability Standard (GGD-97-34). We appreciate your staff's effort in completing this report. We would also like to thank your staff for cooperating with IRS and Treasury staff in their efforts to produce a parallel report on the same subject, as mandated by the Taxpayer Bill of Rights 2 (TBOR 2).

The GAO draft report contains several specific recommendations for improving IRS administration of the joint and several liability standard. Before we respond to each recommendation, we would note that the findings and recommendations in both the GAO's report and the parallel IRS/Treasury TBOR 2 report present a real possibility for imminent legislative reform of the innocent spouse provisions. Thus, while the IRS generally agrees with most of the GAO's recommendations, we believe that it would be preferable to determine if the current legislative session of Congress produces such reforms before devoting the resources necessary to carry out the GAO's recommendations.

The GAO recommends that the IRS develop new or modify existing publications to better inform taxpayers about the availability of innocent spouse relief. The IRS agrees with this recommendation. Rather than develop new publications, however, the IRS believes that it would be preferable to revise Publication 556, Examination of Returns, Appeal Rights and Claims for Refund, and Publication 594, Understanding the Collection Process, the publications most relevant to taxpayers seeking innocent spouse protection.

The GAO recommends that the IRS develop a tax form and procedures for taxpayers to request innocent spouse relief and for the IRS to either grant or deny such relief. The IRS agrees with this recommendation, but implementation of this requires OMB approval and clearance of such a form.

The GAO recommends that the IRS provide additional internal guidance to IRS employees so that greater consistency in processing innocent spouse cases can be

**Appendix VI
Comments From the Internal Revenue
Service**

- 2 -

The Honorable James Hinchman

achieved. The IRS agrees with this recommendation and believes that the development of a standard form for claiming innocent spouse relief and the procedures accompanying such form would largely meet this objective.

The GAO recommends that the IRS establish a cost effective process to monitor the consistency achieved by providing its employees with greater internal guidance on administering the innocent spouse provisions. While the IRS understands the GAO's concern, existing IRS management and information systems (MIS) do not have the capability to track issues on specific cases. The only alternative to the existing MISs would be to perform manual tracking which would not only be cost prohibitive but also less reliable.

The GAO recommends that the IRS update the innocent spouse regulations to reflect current law. The IRS agrees in principle with this recommendation but believes that it would be premature to devote the resources necessary to draft such regulations for the reasons stated above. In addition, it is important to realize that simply updating the regulations to reflect current law most likely will not resolve the innocent spouse issues identified in the GAO's report, because the current statute requires an intensely factual inquiry to determine if a spouse qualifies for relief.

Finally, please be aware that we will offer our analysis and perspectives regarding the proposals to reform or replace the current joint and several liability standard and the innocent spouse provisions in our IRS/Treasury TBOR 2 report, rather than as comments to your draft report.

The IRS remains committed to administering the tax law as efficiently and fairly as possible. We appreciate your recommendations on how we can better achieve this objective for taxpayers filing joint returns.

Sincerely,



Margaret Milner Richardson

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