Tax Issues in Marriage and Divorce

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Larry Jones and Brandy Williams provide a basic overview of the tax issues that couples face when involved in marriage, separation or divorce situations.

Scope of Article

This article will discuss practical matters that relate to clients who face tax liabilities during marriage as well as those who may face tax liabilities during and after a divorce. Tax issues during marriage and divorce arise in many contexts. A spouse may realize during marriage that taxes are owed or a divorced spouse may learn that taxes are owed for years before the divorce. Each situation presents a unique set of problems and concerns. It is important to remember that dealing with clients who have tax and marital problems at the same time is difficult. When the tax problems are coupled with marital concerns, the issues become increasingly complex; therefore, it is essential to effectively communicate to the clients how the tax process operates. Often, taxpayers living in community property states have different tax concerns from those living in other states.

Before diving into the task of educating your clients, there are key concerns that must be considered. If a divorce is contemplated, you must avoid conflicts of interest and dual representation. In marital situations, the most common problem is where both spouses owe taxes. We will not focus on particular statutes or cases, but rather on some things that must be considered when advising clients in difficult situations. This is not all encompassing, but should provide guidance for working with clients who have these types of issues.

Making Sure Clients Understand the Process

In a divorce situation involving taxes owed to the IRS, we are usually dealing with unhappy spouses who are angry not only with the former spouse, but also with the IRS. It is important that we help our clients understand the tax process and their alter-

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natives. Dealing with the IRS is complicated to begin with, but even more so when it is combined with marital problems. Explaining the process to the client and identifying the options available to resolve the problem is important. In some cases, even after a meeting with the client, a written explanation should be sent to the client so there is no misunderstanding.

Things to Consider Prior to Marriage

Many people contemplating marriage are not concerned about financial and tax-related matters. However, the financial status of each prospective spouse should be discussed and fully disclosed. This does not happen in many cases. It is especially important to know whether taxes are owed by one of the spouses before marriage, because there are certain things that can be done prior to marriage to protect the assets of the nonliable spouse. Many times a tax advisor, even knowing a client is about to marry, does not discuss tax and financial matters with the client. The tax advisor generally is in a position to render advice in a friendly manner and, at least, has the ability to make the client aware of potential matters that need to be discussed.

Prenuptial Agreements

Some state laws allow couples contemplating marriage to enter into prenuptial agreements. These agreements become effective upon the date of marriage. Prenuptial agreements should be in writing and signed by both parties. Laws differ from state to state as to the formalities of these types of agreements and what they can contain. Issues that may be addressed in such an agreement include (1) rights and obligations of each spouse in any property acquired during the marriage; (2) rights concerning management and control of property, including the creation of a security interest or mortgage; (3) disposition of property in the case of divorce, death or separation; (4) spousal support; (5) wills and trusts; (6) death benefits from life insurance policies; (7) choice of law governing the construction of the agreement; and (8) other personal rights and/or obligations.

An additional issue that should be addressed is an agreement as to future income. Such an agreement effectively allows spouses to convert the character of income or community property into separate property. There is some split among the courts as to whether this issue may be properly addressed in a prenuptial agreement. Each spouse should be represented by separate counsel. The client must understand that there is a conflict of interest with one attorney representing both spouses when preparing this type of an agreement. The first spouse seen by the attorney should be advised that the other spouse or "spouse-to-be" will need separate counsel. The prenuptial agreement should contain specific language as to whom the attorneys are representing. Frequently, one of the parties to the agreement will refuse to see an attorney. If this is the case, then the attorney preparing the agreement should take special precautions to identify in the agreement which spouse is being represented. Moreover, the attorney should notify the spouse not being represented of the fact that he or she is not represented and suggest that both spouses have legal counsel before signing the agreement.

Postnuptial Agreements

In addition to prenuptial agreements, spouses may enter into a postnuptial agreement to address a partition or exchange of their community property already existing or to be acquired. Property transferred to a spouse by partition becomes his or her separate property. Spouses may agree at any time that income or property arising from the separate property owned by one of them, or which may later be acquired, shall be the separate property of the owner. Care must be exercised in entering into this type of an agreement. These agreements cannot be entered into (and in most cases will be invalid) to defraud creditors. Even if the agreement is not for the purpose of defrauding creditors, and assets are transferred, the agreement may not be valid as to creditors that are owed money at the time of the agreement.

Postnuptial agreements should be entered into carefully, particularly if taxes are owed. If a tax lien has been filed or the agreement is entered into to place assets outside the reach of the IRS, the agreement will not be valid. The tax lien will follow the assets and the IRS can still reach the assets. Making income the separate property of each spouse when taxes are owed depends on state law. In community property states, it is possible by a partition agreement to make the income the separate

property of each spouse.[1] It should be emphasized that postnuptial agreements should only be entered into after careful thought and legal advice.

Community Property

The tax issues faced by married and divorcing couples are quite different depending on whether or not the couple resides in a community property state. In a community property state, both spouses have equal and undivided interests in ownership of the property. The interest of each spouse is a present, vested and undivided one-half interest in the title to the property. This is similar to the concept of a partnership in that the spouses are partners in marriage. Each spouse, like a partner, may also own separate property. In Texas, a community property state, community property is all property acquired during marriage that is not separate property.[2] This is generally true in most community property states.

Community and separate property can be divided by death and/or divorce. A decedent can dispose of one-half of his or her community property and all of his or her separate property. Upon divorce, a court will usually divide the community property of spouses in a just manner. However, if a court grants a division of community property, there is no effect on the rights of creditors.[3]

Keeping the Property Separate

Many times, when a spouse brings separate property into the marriage, the parties will want to keep that property separate from the marital property. The spouses may consider the following:

- **Separate Set of Books.** Each spouse should consider a separate set of books and records. Bear in mind, however, that this may be difficult to accomplish.
- **Separate Trusts.** Consider the creation of separate trusts prior to marriage to manage separate property.
- **Identify Separate Property.** Identify separate property as such. Bank accounts and other accounts and assets should state that they are "Separate Property of Jane Doe."
- **Make the Client Understand.** Impress on your clients the importance of being able to trace separate property.

Things to Consider If Divorce Is Contemplated

In many cases, whether we are accountants or attorneys, we have represented both the husband and wife in various matters throughout a marriage. However, when two clients are separated or contemplating divorce, it becomes a delicate situation as to whom we should give advice, if anyone. Most importantly, conflicts of interest should be avoided. Dual representation should always be avoided, and it may be best that both spouses seek separate representation. If a decision is made to keep one spouse, then consent to that spouse's representation should be obtained in writing from both spouses. Know, however, that the spouse not being represented may not cooperate in providing this consent. In that case, while it is difficult to give up a good client, asking the client to find other representation may be the best decision in order to avoid a conflict and a potential lawsuit in the future. Regardless of the situation, advice given to the client should be confirmed in writing where appropriate.

What a Divorcing Spouse Should Do

Tax Advice

Divorcing spouses should be given tax advice. In order to properly advise a client, an attorney representing a divorcing party will need to know and consider the following:

- Tax treatment of alimony and child support. Are transfers of property a division of property or alimony? If one spouse pays certain expenses, how is this treated?
- Who will get the dependency exemption?
- Have all tax returns been filed?
- What is the possibility of an audit by the IRS?
- What is the possibility that taxes are owed?
- How will current or delinquent taxes be paid?
- Should joint or separate tax returns be filed for the year of the separation?
- Who has the financial information that will be necessary for an audit and will it be made available to the other spouse?
- Will all of the above be addressed in the divorce decree?

Statute of Limitations

The statute of limitations is important in advising clients. The following should be considered:

- The IRS generally has three years to audit after a tax return is filed.
- Divorce decrees should provide for taxes that are assessed by the IRS after the divorce for the years

that the spouses were married.

- Divorcing spouses should understand that the IRS is not bound by the divorce decree. Even though one spouse may agree to be liable for taxes assessed by the IRS after the divorce for the years the spouses were married, the IRS will attempt to collect from the spouse who has assets and can pay.
- The last three years of tax returns should be reviewed to determine audit potential. If it is determined that taxes may be owed, then the divorce decree should provide a reserve for the taxes.
- Has the statute of limitations been extended for audit or collection purposes?

Change of Address

Make sure that your client notifies the IRS of a change of address. Form 8822 should be sent to the IRS by certified mail, return receipt requested, to notify the IRS of the client's new address. The last known address on file with the IRS is a valid address for certain notices sent by the IRS.

IRS Correspondence

The divorce decree should provide that if one spouse receives any IRS correspondence regarding the tax years when the parties were married, then that spouse immediately must provide copies of that correspondence to the other spouse.

Verify If Tax Returns Are Filed and Taxes Are Owed

Some of the most overlooked aspects in a divorce are whether taxes are owed, if all tax returns have been filed and if the client is under audit or has been audited. At a minimum, if there is any doubt about taxes being owed or tax returns having been filed, a record of account for each tax year at issue should be requested from the IRS. These records of account will show whether tax returns have been filed and if taxes are owed.

Filing Joint or Separate Tax Returns

It is generally best for the spouses to file separate tax returns for all years for which they are separated. Moreover, in community property states, since the year of divorce contains income and deductions before and after the divorce, these must be analyzed to determine the correct amount of income. If tax returns are delinquent, then, almost without question, each spouse should file a separate tax return. This will split the tax liability and could reduce penalties assessed by the IRS.

Tax Items to Consider

The following tax items should be considered:

- **Withholding.** In a community property state, if the spouses file separate returns, each reporting for income tax purposes one-half of the wages received by each, then each spouse is entitled to one-half of the credit allowable for the tax withheld on those wages.[4]
- **Estimated Tax Payments.** If not made on a separate declaration of estimated tax, then the credit for the payment is to the spouse making the declaration. This is true even though the payment is made with community income. If a joint declaration is made, then both spouses share in the estimated payment.
- **Who Gets a Tax Refund?** Rev. Rul. 86-57 provides instructions for computing the refund due to each party for taxes paid prior to a divorce.[5]
- **What Happens to NOLs?** NOL carrybacks and carryforwards are determined for years in which joint returns of community income were filed under Rev. Rul. 65-140 and Rev. Rul. 71-382.[6]

Transfer Between Spouses

Transfers of property between spouses or incident to divorce are addressed by section 1041 of the Internal Revenue Code ("the Code"). As a general rule, no gain or loss shall be recognized on a transfer of property from an individual spouse (or in trust for the benefit of a spouse), or a former spouse if the transfer is incident to the divorce. The IRS views a married couple as a single, cohesive unit and maintains that image incident to divorce. The transfer is treated as a gift and the basis of the transferee in the property shall be the adjusted basis of the transferor.

If One Spouse Owes Taxes

The big surprise usually comes when one spouse learns after the divorce that taxes are owed. This may arise from taxes not previously paid or as the result of an audit and an additional assessment by the IRS for years during the marriage. Once a collection issue has arisen with the IRS, the easiest solution is to pay in full. This approach resolves the problem with the IRS in a timely manner and the taxpayer does not have to provide financial information. Unfortunately, full payment is most often not a practical solution. It should be noted, however, that it is much better to borrow funds and be indebted to someone other than the IRS. The options available when taxes are owed are discussed below.

Code Sec. 6159(a)

If a taxpayer owes more than he or she can afford to pay right away, consider asking the IRS for an installment payment agreement. Code Sec. 6159(a) permits the IRS to enter into an installment agreement where "such agreements will facilitate collection" of the tax. According to Code Sec. 6159(c), the IRS must enter an installment agreement if the tax liability does not exceed $10,000 and during the preceding tax years the taxpayer has not failed to file a tax return, failed to pay any tax required to be shown on any tax return or entered into any installment agreement under Code Sec. 6159(c). An agreement under this section must provide for full payment within three years. Such an agreement prohibits the IRS from taking enforced collection action against the taxpayer. The taxpayer should be advised that interest and failure to pay penalties will continue to accrue while the installment agreement is in force. Taxpayers can fill out Form 9465, *Installment Agreement Request,* and send it to the IRS or attach it to their tax return if a balance is owed.

Streamlined Agreement

If the amount of the payment is reasonable and the full amount owed will be paid in a reasonable amount of time, the IRS will accept the agreement in most cases. Generally, if the taxpayer owes $25,000 or less and can pay the full amount plus accrued interest and penalties in 60 months, the IRS will grant the installment agreement. The taxpayer is not required to submit financial information and the IRS will not file a tax lien as long as the taxpayer makes the required payments.

Negotiated Installment Agreement

The taxpayer may choose to negotiate the amount of an installment agreement with the IRS. If the taxpayer wishes to enter into a negotiated installment agreement, he or she will be required to submit financial information on a Form 433-A for individuals or Form 433-B for businesses. When negotiating a settlement, the IRS will consider an individual's living expenses based upon national and local standards. This means that the IRS will tell the taxpayer how much money he or she has to spend on certain items regardless of his or her actual expenditures. National standards have been established for food, housekeeping supplies, apparel and services, personal care products and services and miscellaneous expenses. Local standards address housing and transportation. If the taxpayer can justify that a larger amount is needed or can demonstrate that the full amount of the liability will be paid within three years, the IRS may allow more than what the standards prescribe. After expenses have been calculated, the amount the taxpayer may be required to pay each month is the difference between income and the IRS determined expenses. A revenue officer will analyze a taxpayer's assets, income and expenses to determine whether or not future income will be sufficient for the taxpayer to pay the liability in installments. Keep in mind that the revenue officer will note the due dates for final payments on loans and installment purchases because additional funds will then be available to apply to the tax liability.

Audit Reconsideration

When a taxpayer has ignored a statutory notice of deficiency or when there has been a communication problem between the taxpayer and the IRS, and the IRS has assessed taxes the taxpayer does not owe, an audit reconsideration may be permitted. The IRS may permit an audit of returns after collection has begun if (1) a change of address of the taxpayer has resulted since the original tax return was filed and, therefore, the deficiency notice was not sent to the taxpayer's new address; (2) the taxpayer has not received any notification from the IRS on any assessment or as to how that assessment was determined prior to receipt of the bill; or (3) the taxpayer has not had an opportunity to submit any required substantiation to tell his or her side of the story. If the audit reconsideration is unsuccessful, the taxpayer should request an appeals conference.

Currently Not Collectible

Other collection alternatives include hardship on the taxpayer, which can permit the IRS to classify the account as "currently not collectible." IRS Policy Statement P-5-71 states that if a taxpayer is experiencing financial hardship, the IRS will not collect. A hardship exists if the levy action prevents the taxpayer from meeting necessary living expenses. If a taxpayer cannot pay taxes owed without placing himself in a financial hardship, then the IRS will defer collection by classifying the case as currently not collectible.

Bankruptcy

Bankruptcy will discharge taxes in some cases. Generally, taxes must be at least three years old and have been assessed for at least 240 days. However, there are several exceptions, and tax liens may stay in place.

Rights of the Taxpayer

The two main procedures by which collection actions are appealed are the Collection Due Process (CDP) and the Collection Appeals Program (CAP). A taxpayer has the right to a CDP hearing by the IRS Office of

Appeals for collection actions involving the first time a Notice of Federal Tax Lien is filed on a tax period; before the IRS sends the first levy on a taxpayer's property for a tax period; when the IRS levies on a taxpayer's state refund; and when the IRS issues a jeopardy levy. A CDP decision may be contested in the U.S. Tax Court or U.S. District Court. An appeal through the CAP procedure is generally quicker and available for a broader range of collection activities. However, unlike a CDP hearing, a CAP decision may not be appealed in court.

To request a CDP, the taxpayer must complete Form 12153, *Request for a Collection Due Process Hearing,* by checking the IRS actions that he or she disagrees with. An explanation must be provided and all reasons for disagreement must be identified. The taxpayer may raise issues relating to the unpaid tax, including (1) appropriateness of collection actions; (2) collection alternatives; (3) appropriateness of spousal defenses; and (4) the existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the tax liability. Unless the IRS believes that collection of the tax is in jeopardy, levy action will stop during the 30 days after the levy notice and, if the appeal is timely, during the appeal process. Filing a request for a CDP hearing will also suspend the 10-year statute of limitations on collection. At the conclusion of the CDP hearing, the Appeals Office will issue a determination letter. If the taxpayer does not agree with the determination, he or she may request judicial review on or before the 30th day after the date of issuance of the determination. The court's decision will be binding on the taxpayer and the IRS.

The CAP procedure is available in more situations than the CDP. Collection actions that a taxpayer can appeal are notice of federal tax lien, notice of levy, seizure of property and denial or determination of installment agreements.

Offer in Compromise

The IRS has the authority to settle or compromise federal tax liabilities by accepting less than full payment under certain circumstances. This occurs when the taxpayer makes an Offer in Compromise—an agreement between the IRS and a taxpayer that resolves the taxpayer's liability. The IRS may legally compromise if there is doubt as to liability (that the assessed tax is correct) or doubt as to collectibility (that the taxpayer could ever pay the full amount owed). An offer can take the form of a cash offer, a short-term deferred payment offer or a deferred payment offer. A cash offer is paid within 90 days of acceptance, short-term is paid within two years and deferred is paid out over the remaining life of the collection statute. While an Offer in Compromise is being considered, the IRS will withhold collection action; if the offer is rejected, collection will be withheld for 30 days thereafter and while the taxpayer appeals the rejection of the offer. Once again, the statute of limitations is suspended while an offer is pending. This includes the 30 days after the offer is rejected and if the taxpayer appeals the rejection.

Innocent Spouse Relief

According to section 6015 of the Code, a spouse may raise an innocent spouse defense to tax liability. Relief can be obtained in one of three ways: Code Sec. 6015(b) (innocent spouse relief), Code Sec. 6015(c) (separate liability election) or Code Sec. 6015(f) (equitable relief). If a joint return has been filed for a tax year and there is an understatement of tax attributable to erroneous items of one individual filing the return, the other individual may be qualified for relief under Code Sec. 6015(b). The requesting individual must establish that in signing the return he or she had no actual or constructive knowledge of the understatement when the tax return was signed. The innocent spouse must make a separate liability election no later than two years after the date the IRS has begun collection activities against him or her. The IRS will take into account all of the facts and circumstances and determine whether it is inequitable to hold the requesting spouse liable for the deficiency in tax for the tax year attributed to the understatement.

Separation of liability may be requested if spouses who filed a joint return are no longer married, are legally separated or have not been members of the same household for a 12-month period ending on the date the election is filed. Again, there must be a deficiency of tax allocable to the nonrequesting spouse. The requesting spouse must have no actual knowledge of the item that gave rise to the deficiency at the time the tax return was signed. If an individual can establish that the return was signed under duress, then the actual knowledge requirement will be waived. This election must be made no later than two years after the date on which the IRS begins collection activities against the requesting spouse. If the IRS demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme by such individuals, then those individuals are ineligible to make the election for separate liability.

If the IRS fails to grant relief under Code Sec. 6015(b) or (c), all hope is not lost. Code Sec. 6015(f) authorizes the IRS to relieve an individual of liability if relief is not available under the previous two sections and it would be inequitable to hold the individual liable for any unpaid tax or deficiency. The requesting spouse must meet the following threshold conditions: (1) a joint return was filed; (2) relief is not available under Code Sec. 6015(b) or (c); (3) relief was requested within two years from the first collection activity with respect to the requesting spouse; (4) the liability remains unpaid at the time the relief is requested; (5) there has been no transfer of assets between spouses as part of a fraudulent scheme; (6) there has been no relief to the extent of the value of disqualified assets transferred to the requesting spouse from the nonrequesting spouse; and (7) the requesting spouse did not file a joint return with fraudulent intent. Rev. Proc. 2000-15 prescribes factors that the IRS will consider in making its determination.

Code Sec. 66

In community property states, Code Sec. 66 may help. Code Sec. 66 addresses the treatment of community income for spouses living apart all year (Code Sec. 66(a)), spouses not notified of community income (Code Sec. 66(b)) and relief of liability in other cases (Code Sec. 66(c)). Whereas Code Sec. 6015 applies in cases of joint returns, Code Sec. 66 addresses situations in which separate returns were filed.

Code Sec. 66(a) grants relief to an abandoned spouse from having a federal income tax liability on one-half of the community income earned by the other spouse when the abandoned spouse did not receive or benefit from the income. The requirements are that (1) the spouses were married for any part of the year; (2) they lived apart during the entire year; (3) they did not file a joint return; (4) either of them earned community income during the year; and (5) none of the community income was transferred between them. If relief is granted, then certain community income will be taxable in full to the spouse generating the income and no portion will be taxable to the other spouse.

Code Sec. 66(b) allows the IRS to disregard the benefits of community property laws with respect to any income if a taxpayer qualifies under the section. If the nonrequesting taxpayer acts as if he or she is the only one entitled to the income and fails to notify the spouse before the due date for filing the return for the year in which the income was derived, then the section may apply.

If an individual qualifies under Code Sec. 66(c), items of community income will not be included in that individual's gross income. The following requirements must be met:

- No joint return was filed.
- The omitted income item would be treated as income of the other spouse under Code Sec. 897(a).
- The requesting spouse had no actual or constructive knowledge of the item of community income.
- It would be inequitable to include the item of community income in the income of the spouse seeking relief.

Whether a spouse knows or has reason to know of an item of community income is essentially factual. A reasonably prudent person standard should be applied keeping in mind the person's level of intelligence, education and experience.

Conclusion

This article contains suggestions and ideas for attorneys and accountants dealing with tax issues in marriage and divorce situations. It is by no means all-inclusive, but should provide tax practitioners with a foundation to counsel clients who find themselves in the emotionally charged situation of owing taxes and ending their marriage.

ENDNOTES

1 *S.J. Calmes,* DC Tex., 96-2 USTC ¶50,336, 926 FSupp 582.

2 Tex. Fam. Code Ann. §3.002 (Vernon 2002).

3 *Rush v. Montgomery Wards,* 757 SW2d 521 (Tex. App.—Houston [14th Dist.] 1988, writ denied); *see also, Wikes v. Smith,* CA-9, 465 F2d 1142 (1972).

4 Reg. §1.31-1.

5 Rev. Rul. 86-57, 1986-1 CB 362.

6 Rev. Rul. 65-140, 1965-1 CB 127; and Rev. Rul. 71-382, 1072-2 CB 156.

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