THE PRACTITIONER

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Loss of Innocence

One Spouse's Indemnification May Cause the Other to Retain Tax Liability

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A common provision in a marital settlement agreement is a provision whereby one spouse agrees to pay the taxes on a joint return and to indemnify the other spouse. This indemnification provision is designed to protect one of the spouses from the joint-and-several liability that results from filing a joint return.

In certain circumstances, the Internal Revenue Code provides protection, known as the "innocent spouse" rule, to a spouse filing a joint return. But also in certain circumstances, an indemnification provision may have the unintended consequence of causing the nonpaying spouse to lose innocent-spouse status.

Several Tax Court opinions have dealt with this issue. The results turn on how likely the court believes the indemnification provision will be enforced.

In *Stiteler v. Commissioner*, 69 T.C.M. (CCH) 657 (1995), the parties were married in 1956. The wife received a bachelor's degree and worked for the first three years of the marriage as a teacher, and then as a secretary and receptionist. She did not work for the rest of the marriage.

The marriage was dissolved in 1984. As part of the settlement agreement, the husband agreed to pay all taxes incurred during the marriage and to indemnify and hold the wife harmless. The court found the wife was unaware of the parties' tax obligations at the time of the settlement.

The wife presented a sympathetic position. In 1964 she had been diagnosed as a bipolar manic depressive. She had a history of alcohol abuse. At the time of trial, she was earning $6 an hour and taking several medications.

The wife never made inquiries and did not read the returns before signing them. Although the husband never discussed the family's finances with the wife, he never prevented her from reviewing the returns, never forced her to sign them, never abused her physically or emotionally and never hid any assets or information from her. The court held that the wife was not entitled to innocent-spouse protection.

The key issue was whether it was equitable to impose liability on the wife. The innocent spouse rules provide a three-pronged test: A spouse is relieved of liability for a joint return if "on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse; the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement; and taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement." 26 U.S.C. Sections 6013(e) (1) (B), (C) and (D).

> **The very provision intended to protect a spouse could be the reason liability is imposed.**

The court found that wife did not satisfy the first prong of the innocent-spouse test because the husband had promised to pay the taxes and indemnify her. The court stated, "How this promise to pay the resulting tax deficiencies influences the inequity of holding [the wife] liable turns on whether this promise is reliable or speculative."

The court reviewed prior Tax Court cases in which the determination was based on an evaluation of the reliability of the promise. See *Henninger v. Commissioner*, Tax Court Memo 1991-574; *Knapp v. Commissioner*, Tax Court Memo 1989-109; and *Buchine v. Commissioner*, Tax Court Memo 1992-36 (liability imposed); *Foley v. Commissioner*, Tax Court Memo 1995-16 (liability not imposed).

The court found the husband's promise was reliable for two main reasons. First, the wife presented no evidence to support her position that the husband could not or would not pay the tax deficiencies. Second, the husband dealt fairly with the wife during the divorce, and he testified on behalf of the wife in the Tax Court proceeding. Thus, the court found that the husband's promise to pay the taxes was reliable. Accordingly, it was equitable to impose the tax liability on the wife.

The court's discussion concerning the other two prongs is also instructive. A court will look at whether the spouse benefited beyond normal support from the erroneous deduction. The court stated that the benefit may be direct or indirect and may "consist of transfers of property, including transfers received several years after the year in which the erroneous deductions were claimed." See Income Tax Regulations Section 1.6013-5(b).

Pursuant to the divorce agreement, the wife received half the marital assets: approximately $769,000 in cash, a condominium worth about $15,000, a $730,000 secured promissory note and a $300,000 promissory note from the husband. She also received $56,460 in spousal support.

Applying the indirect-benefit test, the court rejected the wife's argument that she did not benefit from the erroneous deductions. The wife argued she had not received the actual property (real estate partnerships) in which the money from the tax understatements was invested. She also argued that the assets she received were either acquired prior to the tax years at issue or were proceeds from the sale of assets acquired prior to such tax years.

The court found that the wife indirectly benefited from the erroneous deductions, because part of the property she received was in lieu of her half of the property the husband received. The husband received the real estate partnerships that were purchased from the tax understatements. Moreover, the property the wife received was worth far more than the support she received. Thus, the wife significantly benefited.

Even though the wife earned about $150 every two weeks, the court found it would not be a hardship to impose the taxes on her. She presented no credible evidence to support her claim that she no longer had the funds she received from the divorce. The wife argued that she lived in a much smaller home than she did during the marriage, and that she no longer lived the lavish lifestyle the marriage had afforded her. The court found that these facts did not necessarily mean the wife would suffer hardship if the tax liability was imposed, and that her "choice of lifestyle should not affect her entitlement to innocent spouse relief." The court also found the wife's medical and alcohol problems were "not relevant" to its decision.

Stiteler demonstrates that the very provision intended to protect a spouse, the indemnification provision, could ironically be the reason why liability is imposed. Commentator Marjorie O'Connell suggests that the party trying to maintain innocent-spouse status could include in the settlement agreement a provision that if that spouse's status as an innocent spouse is ever challenged, the indemnification provision is automatically void. See O'Connell, "Divorce Taxation," Bulletin 8, at 4-5 (Warren, Gorham & Lamont Aug. 18, 1995).

The practitioner should also consider informing the client that an indemnification provision can have the side effect of causing a party to lose the status of innocent spouse. A spouse in the same position as the wife in *Stiteler* should gather and introduce evidence on the issues for which the Tax Court found the wife deficient.

Evidence should be presented in Tax Court that the other party could not, or will not, pay the taxes, and paying the taxes would be a hardship for the spouse. The difficulties in enforcing an indemnity provision should also be argued. The family law practitioner can aid in this process by documenting all instances in which the other party was uncooperative and did not comply with court orders. This information could be relevant, sometimes many years later in a Tax Court proceeding.

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