

LOS ANGELES

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## Innocent spouse gets double the protection

By Mitchell A. Jacobs and Jennifer Morra

**A** new revenue procedure has been proposed that provides guidance regarding equitable relief from income tax liability under Internal Revenue Code Sections 66(c) and 6015(f) (the "innocent spouse" statutes), and overturns previous case law holding that the inclusion of an indemnification provision in marital settlement agreements may prevent a party from claiming innocent spouse status. This proposed revenue procedure, referred to as Notice 2012-8, went into effect on Jan. 23.

In certain circumstances, the Internal Revenue Code provides relief to a spouse from the joint and several liability that arises from filing a joint income tax return, known as the "innocent spouse" rule. A large part of the evaluation for whether a person is entitled to protection under the innocent spouse rule is an evaluation of whether providing such relief was "equitable."

This series of case law begins with *Stiteler v. Commissioner*, 108 F.3d. 339 (9th Cir. Feb. 14, 1997). Here, the court determined that an indemnification clause in a marital settlement agreement may prevent a party from later claiming innocent spouse status. *Stiteler* was based on the pre-1998 tax rules, which stated that in order to qualify for innocent spouse status, the requesting spouse must prove: they filed a joint return; on that joint return, there was a substantial understatement of tax attributable to grossly erroneous items of the other spouse; in signing the joint tax return, the requesting spouse did not know nor had reason to know of the understatement; and taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable for any deficiency attributable to the substantial understatement.

If the first three factors are met, the court then decides whether it was "not equitable" to hold the requesting spouse responsible for the tax deficiency. The reasoning in *Stiteler*, and in the cases that followed, was that where there is an indemnification clause in a marital settlement agreement holding the requesting spouse harmless, whether or not it was equitable to hold such spouse responsible for the tax deficiency turned on whether the "promise to pay" in the marital settlement agreement was reliable. If the indemnification clause was based on a reliable promise, then the requesting spouse was *not* entitled to innocent spouse status. The court's reasoning was that if the promise was reliable, it was not inequitable to hold the requesting spouse liable, as they were contractually protected from having to pay the deficit through the enforcement of the indemnification clause.

The idea was to prevent the Internal Revenue Service from having to chase after the indemnifying spouse, preferring instead to collect on the tax liability from both or either spouse, so long as the "innocent spouse" was then able to collect the debt against their former partner. Therefore, whether the spouse was indeed an "innocent spouse" ceased to matter; so long as he or she could go after the ex-spouse due to contractual obligation, protection was sufficient.

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This reasoning persisted after the tax law was changed in 1998, making it easier for a spouse to attain innocent spouse status. This was illustrated by *Levy v. Commissioner*. In *Levy*, the court held that the Commissioner of Internal Revenue will consider whether or not "the requesting spouse will not suffer economic hardship if relief is denied" when determining innocent spouse status. An evaluation of economic hardship included whether the requesting spouse was indemnified from having to pay the taxes levied against him or her through the enforcement of a marital settlement agreement. Again, this protection was based on whether the promise of the nonrequesting spouse to indemnify the requesting spouse was reliable. Thus, even after the change in the law, having an indemnification clause continued to weigh against granting a requesting spouse innocent spouse relief.

Finally, this past November, the "Federal Tax Coordinator" (2nd ed.), published by the tax research firm Research Institute of America, provided this guidance to practitioners: "Where the culpable spouse promises, under an agreement, to pay tax deficiencies for the period during which the tax understatements occurred, whether this promise to pay is a reason for denying innocent spouse relief depends on whether the promise is reliable or speculative." Through the end of 2011, so long as the indemnification included in the marital settlement agreement was made by a person who was reasonably expected to uphold their end of the bargain, a requesting spouse could be denied relief as an innocent spouse based on such an indemnification clause.

Therefore, prior to Notice 2012-8, it was our duty as family law practitioners to inform clients that by including an indemnification clause that holds their soon to be ex-spouse harmless from tax liability, they were risking their ability to claim innocent spouse status later for any understatement of taxes on the joint returns, absent evidence that their spouse was an "unreliable" person (beyond the fact that he was a cheating scoundrel or she could not be trusted with the credit cards.) Now, the IRS has recognized that the existence of an indemnification clause is actually a reason to grant innocent spouse status, not deny it.

In Notice 2012-8, the IRS has completely reversed *Stiteler* and its progeny. The proposed revenue procedure explicitly addresses whether a "legal obligation" exists that would warrant granting relief. When weighing whether it is inequitable to hold the requesting spouse liable, the Commission of Internal Revenue must consider whether the "requesting spouse or nonrequesting spouse has a legal obligation to pay the outstanding Federal income tax liability." The proposed revenue procedure goes on to state, "For the purposes of this factor, a legal obligation is an obligation arising from a divorce decree or other legally binding agreement. This factor will weigh in favor of relief if the nonrequesting spouse has the sole legal obligation to pay the outstanding income tax liability pursuant to divorce decree or agreement." It also explicitly states that the presence of an indemnification clause, which protects the requesting spouse, weigh in favor of granting innocent spouse relief. This overturns the previous interpretation of the rules and finally allows indemnification clauses to do what they are intended to do: fully protect the intended party against future liability.

As a result of Notice 2012-8 which, while not yet finalized, is currently in effect, we can now recommend the inclusion of an indemnification clause in marital settlement agreements to protect our clients against future tax liability, without having to provide them a warning that doing so may impair their ability to claim innocent spouse status.

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