Money

Divorced? Taxes May Still Bind You

Marlene M. Browne 09.07.07, 1:01 PM ET

Most spouses know that evaluating the tax effects on any proposed property distribution or support package is a critical component of every settled or tried divorce case. In fact, ignoring the tax implications in a marital dissolution matter is considered malpractice. So, if most parties and their counsel are careful to consider taxes at the time of the split, how do tax issues arise after the divorce is final?

Typically, years later, the IRS or state taxing authority sends one of the parties a notice explaining that he or she is liable for an outstanding sum owed on a joint, married income tax return.

Reason: When you file as a married person, each spouse becomes jointly and severally liable for the total taxes owed for the year of the return. Post-divorce tax liability commonly arises from cases involving a business or professional practice, where one spouse was in control of the family's financial matters, yet both signed and filed joint, married returns.

In these situations, the IRS finds deficiencies caused by the couple's overstating deductions or understating income on the joint returns in question. For instance, when the government discovers that your spouse earned $250,000 from his business (not the $125,000 reported on your return); both of you--and each of you--are responsible for the additional tax on the $125,000 dollars in unreported income, plus accumulated interest and penalties.

Similarly, if the IRS disallows deductions for the "farm" expenses that your wife reported on the joint return, you are both (as individuals) responsible for the entire amount of taxes owed on the formerly sheltered income, should the IRS determine that the farm was really her hobby.

Finding that you owe taxes on a jointly filed return can be traumatic enough while you are married. Learning that you are responsible for 100% of those joint taxes after you are divorced can be devastating, particularly if you really weren't the guilty party. What do you do when you're called upon to pay the tax debt due on long-ago filed joint returns? There are several options, but before we explore them, there are ground rules that the government (in our example, the IRS) must follow.

Normally, the IRS has three years from the date you filed your return (excluding the date of filing), or two years from the date the tax was paid--whichever is later--to issue an assessment of deficiency. If you or your spouse omitted a substantial amount of income from your filed, joint returns (25% or more), the law allows the IRS six years to issue its deficiency assessment. If you or your spouse intentionally attempted to evade paying taxes or filed fraudulent returns, the IRS can take forever to figure out what you owe and file an assessment.

In fact, in the case of intentional tax evasion, nothing, not even filing subsequent, correct, amended returns, can erase the taint of fraud. In these cases, the IRS can take all the time it wants before issuing an assessment. Naturally, if you were duped into filing a joint tax return with an unscrupulous spouse who defrauded everyone (you, as well as the government), you could be hit with a tax assessment decades after your divorce.

Moreover, the IRS will go after whomever it can find most easily. If your spouse has fled, you'll be responsible for the entire sum, which, considering the compounding interest and penalties, can be truly staggering. After the assessment issues, the IRS has 10 years to collect.

What do you do when the IRS calls on to you to collect old joint taxes? Well, depending on your circumstances, you can tell the IRS that you should not have to pay the taxes, interest and penalties attributable to a spouse's or former spouse's activities. Since 1998, there are three different ways to avoid joint and several responsibility.

Under the first, the Innocent Spouse Rule, you may qualify for relief if you meet the four following requirements:

(1) You filed a joint return with an understatement of tax due to an erroneous item relating to your spouse, or former spouse;

(2) You lacked actual, or implied, knowledge of the understatement of tax liability when you signed the return;

(3) Given all the facts and circumstances at the time the IRS seeks collection, it would be unfair to make you pay the tax and consequential interest and penalties; and

(4) You applied for relief by filing IRS Forms 8857 and 12510, within two years after the IRS commences collection efforts against you.

If you don't meet the Innocent Spouse criteria, you might find relief under the second option, the Separate Liability Election, so long as:

(1) You are either legally separated or are divorced from, or widowed by, the person with whom you filed the joint income tax returns in question, and have not been a member of the same household for any time during the 12-month period preceding the date you filed the Separate Liability Election;

(2) The IRS cannot meet the burden of proving you had actual knowledge of the item in question (that your former spouse reported) at the time you signed the return; and

(3) You apply for relief this relief by filing IRS Forms 8857 and 12510, within two years after the IRS commences collection efforts against you.

Unlike the knowledge requirement under the Innocent Spouse Rule, the Separate Liability Election does not address what a spouse should have known (also called implied or constructive knowledge) about the erroneous item when the joint income tax return was signed.

Rather, the issue concerns what the taxpayer seeking relief under this election knew in fact at the time she or he signed the return in question. Yet, the IRS will deny relief if it can prove the existence of a fraudulent scheme to avoid taxation (e.g., a transfer of assets between spouses to avoid taxes or tax collection).

If you qualify for relief under the Separate Liability Election, you will be responsible for only that part of the joint tax liability that would have been yours, if you had filed separately. Caution: Special rules apply for those in community property states--Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin; and Alaska, if elected; so see IRS Publication 971 Innocent Spouse Relief (And Separation of Liability And Equitable Relief) for these and other details.

The third option, "Equitable Relief," available since 1998, is a catchall provision, available to worthy taxpayers who fail to fit under the first two provisions. One invokes Equitable Relief by filing Forms 8857 and 12510 within two years after the IRS initiates collection. Note: If you were a victim of domestic violence, in fear of your safety when you signed any joint income tax return, you won't be held accountable for questionable items to which you acquiesced, for fear of retaliation.

The law does not deem a joint return signed under duress to be "joint" in any meaningful sense. But beware: Even if you failed to file any returns during the marriage, the IRS can still assess a marriage-era deficiency by calculating what you should have paid after performing its own review of your income and producing a "substitute return."

If you fail to find relief under the Innocent Spouse, Separate Liability Election or the Equitable Relief provisions, you have other resolution options. You can pay the IRS what you owe in full at once; or, enter into an installment agreement to pay over a course of three to five years; or, submit an offer in compromise (OIC) with a 20%, nonrefundable payment of the sum you seek to pay in compromise; or, you can request to pay nothing under a temporary hardship status.

Finally, though much tougher to achieve since the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, it's still possible to discharge personal liability for unpaid income tax debt so long as:

(1) The income taxes in question were due at least three years before filing your petition for bankruptcy;

(2) The taxes emanate from income tax returns filed at least two years before your bankruptcy's filing;

(3) More than eight months (240 days) have elapsed between the time you file your bankruptcy petition and the date the IRS assessed the tax debt in question; and

(4) The returns were not fraudulent or filed in an attempt to evade payment.

These time requirements can be tolled (delayed) for various reasons including the submission of an OIC; absence from the country; and prior bankruptcy filings. Also, discharge is no longer available for taxes owed from non-filed returns. Furthermore, no matter how successful you might be in Bankruptcy Court eliminating your personal responsibility to pay income tax debt, all pre-petition federal tax liens issued against your property (think real estate, pensions plans, bank accounts) survive.

The IRS can levy on those assets to collect its debt, discharge notwithstanding. (This would be the time for another OIC.) For more information on IRS collection protocol, see IRS Publication 594, What You Should Know About The IRS Collection Process.

In summary, your taxes--past and present, joint and several, filed and not filed-- should be neatly dealt with at the time of your divorce. If, however, if those taxes come back to haunt you, there are ways to make amends or seek relief. The IRS is intimidating: its rules arcane, its regulations complex. Do yourself a favor and hire a professional to guide you toward release, or maybe even, discharge.

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For more information about marriage, divorce and family law, read Boomer's Guide to Divorce and The Divorce Process: Empowerment Through Knowledge by family law attorney Marlene M. Browne Esq.

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