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General Government Division

B-279350

March 11, 1998

The Honorable Nancy L. Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Rob Portman
House of Representatives

Subject: Tax Administration: Innocent Spouse Relief

This letter responds to questions that you asked us to address following the Subcommittee's February 24, 1998, hearings on innocent spouse relief. Specifically, we addressed: (1) how can divorce decrees be made a consideration in determining the tax liability in innocent spouse cases; (2) how can legislation for using a proportionate liability option for innocent spouse claims be implemented; (3) how can legislation help ensure that IRS effectively administers the innocent spouse provisions; (4) what ways could IRS centralize the processing of a new innocent spouse form to help ensure that relief determinations are fair, equitable, and timely; and (5) whether IRS' current innocent spouse regulations need to be updated to reflect legislative changes.

Our comments are based on prior work we did on innocent spouse issues.

CONSIDERATION OF DIVORCE DECREES
IN INNOCENT SPOUSE DELIBERATIONS

Both our March 1997 report¹ and Treasury's February 1998 report² stated that requiring IRS to be bound by divorce decrees in innocent spouse relief determinations 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

¹Tax Policy: Information on the Joint and Several Liability Standard (GAO/GGD-97-34, Mar. 12, 1997).

²Report to the Congress on Joint Liability and Innocent Spouse Issues (Department of the Treasury, Feb. 9, 1998).

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IRS and the parties to a divorce could resolve issues relating to both tax and divorce matters. Second, this proposal could require IRS to become involved in every divorce settlement to ensure that the government's interest is protected. There is also concern that if IRS were bound by divorce decrees, these decrees could be manipulated to thwart IRS' collection efforts. It is unclear how many divorce decrees actually address the issue of unknown future tax liabilities, which may be a factor in innocent spouse situations.

While binding IRS to divorce decrees is not practical, nothing in the Internal Revenue Code or IRS regulations precludes IRS from considering the agreements laid out in divorce decrees when apportioning tax liability between two spouses in an innocent spouse determination. Thus, the Secretary of the Treasury appears already to have the authority to promulgate regulations on when it would be appropriate to consider divorce decrees in making innocent spouse determinations. A legislative provision that instructs the Secretary to develop regulations to include divorce decrees among the factors considered when making innocent spouse determinations would, however, make congressional intent clear.

Currently, IRS is training staff and developing procedures on how to make consistent innocent spouse determinations. If legislation is passed, as part of these efforts, IRS could also develop training materials and procedures necessary for determining when it is appropriate to consider divorce decrees in making innocent spouse determinations. IRS could also revise its publication entitled Divorced or Separated Individuals (Publication 504) to inform taxpayers that, although each spouse can legally be found liable for the entire amount of the tax associated with a joint return, and although IRS is not bound by divorce decrees, IRS employees can consider the terms of a decree when determining a taxpayer's liability.

PROPORTIONATE LIABILITY OPTION

If Congress wishes to make proportionate liability an option in cases where joint and several liability would result in inequitable treatment of one spouse, the existing authority of the Secretary of the Treasury could be expanded statutorily to allow for this. This could be done by allowing, at IRS' discretion, couples who filed jointly to amend their return(s) and file separately and/or by allowing IRS the option of determining the tax liability of the individual in innocent spouse cases using a proportionate liability standard.³ Regulations on how and under what specific conditions IRS would exercise this option would be necessary.

³Under current law the couple would then lose the rate advantage from filing jointly. This could be changed to allow for proportionate liability but apply the married filing jointly rate after the determination of individual liability is made.

ENSURING IMPROVEMENTS IN IRS'
ADMINISTRATION OF INNOCENT
SPOUSE PROVISIONS

Both Treasury's and our reports recommended ways to improve the administration of the current innocent spouse provisions. These recommendations include creating a form for requesting innocent spouse relief, revising publications to better educate and inform taxpayers about the provisions, training IRS staff in how to handle innocent spouse claims, and developing a process for ensuring consistency in processing innocent spouse claims. Other actions that Treasury reported that IRS is undertaking include outreach to community organizations that serve abused and battered spouses to identify those who might qualify for innocent spouse relief.

Concern was expressed at your recent hearing that IRS and Treasury may not follow through with these actions in a timely and effective manner and that legislation might be needed to ensure that they do so. While legislation would send a strong message of congressional intent to Treasury and IRS, care would need to be taken that any legislative requirements not be so prescriptive as to restrict future improvements in the administration of the innocent spouse provisions. At this time, there is limited hands-on experience with the provisions, and an understanding of the root cause of many problems is missing. An alternative to requiring IRS and Treasury to undertake certain specific actions, would be to identify in either legislation or a congressional report what Congress views to be important characteristics of a successful innocent spouse program (e.g., an easily understood application process, taxpayer education and assistance programs targeted at specific populations of taxpayers, and a self-evaluation of IRS' efforts against these criteria).

IRS needs reliable data on innocent spouse claims to implement the congressional intent of changes to the innocent spouse provisions and to help ensure that fair, equitable, and timely relief determinations are made. These data, if gathered in a systematic way, could be used to help train staff in making consistent determinations. The types of data IRS could gather might include the number of innocent spouse relief requests, the bases for the requests, and the resolutions. If Congress so desired, it could have IRS report these types of data to the Congress and other interested parties to help determine whether the innocent spouse provisions are being implemented in accordance with congressional intent.

CENTRALIZED PROCESSING
OF REQUESTS FOR RELIEF

An IRS official told us that the new innocent spouse form is expected to be available for public use by March 31, 1998, and that staff training on innocent spouse issues is under way. However, IRS has not decided where or how the form will be processed. These decisions are expected to be made by the time

the form is ready for use. The IRS official told us that most innocent spouse determinations will be made by Examination staff at a central location. The official said that some determinations, such as those connected with an ongoing audit, will be made in field offices.

As noted previously, to help ensure that consistent determinations are made, IRS could also track the number and types of innocent spouse claims it receives and use this information in training staff. Also, in our March 1997 report, we noted that some districts had designated an employee as the innocent spouse coordinator, and we indicated that IRS should assess whether districts with such coordinators had achieved greater consistency than those without. We pointed out that district coordinators might facilitate more consistent decisions within and among districts. In those situations where determinations are made in field offices, the use of coordinators may still be desirable.

INNOCENT SPOUSE REGULATIONS

As we noted in our March 1997 report, the last time innocent spouse regulations were updated was in 1974. The current regulations do not cover the innocent spouse provisions resulting from the 1984 Tax Reform Act, which extended relief to include grossly erroneous (i.e., no basis in fact or law for the claim) deductions, credits, and basis. In our report, we noted that 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.

If the changes to the innocent spouse provisions contained in the proposed Taxpayer Bill of Rights 3, which is part of the Internal Revenue Service Act of 1997 (H.R. 2676), are made, there would be no need for Treasury to write regulations dealing with grossly erroneous items.⁴ However, if the legislation does not pass this legislative session, Treasury should incorporate the 1984 changes in its regulations. If not, taxpayers seeking relief for erroneous deductions could be subjected to assorted interpretations of what constitutes a grossly erroneous item.

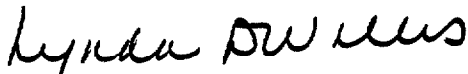
If changes are passed, as noted previously, they would also need to be accommodated through new regulations. Since Treasury has not written regulations for the 1984 innocent spouse law changes and it is important that regulations be current for consistent tax administration, a statutory deadline for developing regulations might help to ensure that the regulations are timely.

⁴The proposed Taxpayer Bill of Rights 3 includes a provision that allows innocent spouse relief where the understatement of income relates to an item that is erroneous as opposed to being grossly erroneous.

The updating of Treasury's regulations would also present an opportunity to clarify the criteria used to make determinations under the "knowledge" test. As we noted in our March 1997 report, this test is perhaps the most subjective element in the current innocent spouse provisions. The knowledge factor criteria have been interpreted inconsistently by IRS employees and the courts.

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Copies of this letter are being sent to the Secretary of the Treasury, the Commissioner of Internal Revenue, the Ranking Minority Member of your Subcommittee, the Chairmen and Ranking Minority Members of the House Committee on Ways and Means and the Senate Finance Committee, and other interested parties. We appreciate the opportunity to assist you in your deliberations on innocent spouse relief. Please do not hesitate to call me on (202) 512-9110 should you have any questions.



Lynda D. Willis
Director, Tax Policy
and Administration Issues

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