

**OVERVIEW OF PRESENT LAW RELATING TO THE INNOCENT
SPOUSE, OFFERS-IN-COMPROMISE, INSTALLMENT AGREEMENT,
AND TAXPAYER ADVOCATE PROVISIONS OF THE
INTERNAL REVENUE CODE**

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on April 5, 2001

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 5, 2001, on oversight of the IRS. This document,¹ prepared by the staff of the Joint Committee on Taxation, describes present law and provides legislative background with respect to the innocent spouse, offers-in-compromise, installment agreement, and Taxpayer Advocate provisions of the Internal Revenue Code.

The provisions described in this document were enacted or modified in various Acts referred to in this document. These Acts include the following:

(1) the Omnibus Taxpayer Bill of Rights (hereinafter referred to as “TBOR 1”), enacted in 1988,²

(2) the Taxpayer Bill of Rights 2 (hereinafter referred to as “TBOR 2”), enacted in 1996,³ and

(3) the Taxpayer Bill of Rights 3, (hereinafter referred to as “TBOR 3”), enacted in 1998⁴ as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (hereinafter referred to as the “IRS Reform Act”).

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of Present Law Relating to the Innocent Spouse, Offers-in-Compromise, Installment Agreement, and Taxpayer Advocate Provisions of the Internal Revenue Code* (JCX-22-01), April 3, 2001.

² Subtitle J of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, Nov. 10, 1988).

³ Pub. L. 104-168, July 30, 1996.

⁴ Title III of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. 105-206, July 22, 1998).

A. Relief for Innocent Spouses (sec. 6015 of the Code)

Present Law

In general

The Internal Revenue Code (the “Code”) provides that spouses who file a joint return are jointly and severally liable for the tax, as well as additions to tax, penalties, and interest, arising from that return. The IRS may collect the entire liability from either spouse. Before the enactment of TBOR 3, the Code authorized relief from joint and several liability in very limited circumstances. TBOR 3 expanded the availability of relief by replacing prior law with three methods for limiting the portion of a joint and several liability that is a spouse’s (or former spouse’s) responsibility. First, TBOR 3 expanded the circumstances in which innocent spouse relief similar to that available under prior law is available. Second, it established a separate liability election for a taxpayer who is no longer married to, is legally separated from, or has been living apart at all times for at least 12 months from the person with whom the taxpayer originally filed the joint return. Third, TBOR 3 authorized the Secretary to provide equitable relief in appropriate situations. The determinations made under these provisions are without regard to community property laws. The Tax Court has jurisdiction over disputes arising in this area.

Innocent spouse relief

Under prior law, a taxpayer could apply for relief from any deficiency arising from a joint return, provided that the understatement was substantial and that it was attributable to a grossly erroneous item of the other spouse, so long as the taxpayer did not know and had no reason to know of the understatement of tax, and it would have been inequitable to hold the taxpayer responsible for the deficiency. Under the new innocent spouse provisions, the item at issue need not have been grossly erroneous (i.e., it needs only to have been erroneous) nor must the understatement have been substantial.

The innocent spouse election is required to be made no later than the date that is two years after the Secretary has begun collection actions with respect to the individual. Innocent spouse relief may be provided on an apportioned basis. Thus, a spouse may be relieved of liability for a portion of an understatement of tax even if the spouse knew or had reason to know of other understatements of tax on the same return.

Deficiencies of taxpayers who are no longer married, are separated, or are living apart

In addition to innocent spouse relief, a taxpayer may seek a separate liability election for deficiencies arising from a joint return. The taxpayer at the time of election must be no longer married⁵ to, legally separated from, or living apart at all times for at least 12 months from, the person with whom the taxpayer originally filed the joint return. Such taxpayers may elect to limit their liability for any deficiency to the portion of the deficiency that is attributable to items allocable to the taxpayer. Items are generally allocated between spouses in the same manner as

⁵ For this purpose of this rule, a taxpayer is no longer married if he or she is widowed.

they would have been allocated had the spouses filed separate returns. However, if any item of credit or deduction would be disallowed solely because a separate return is filed, the item of credit or deduction is computed for this purpose without regard to such prohibition. An electing spouse has the burden of proof with respect to establishing the portion of any deficiency that is allocable to him or her under this provision.

The election applies to all unpaid taxes under subtitle A of the Code, including the income tax and the self-employment tax. The election may be made at any time after a deficiency for a taxable year is asserted, but not later than 2 years after collection activities begin with respect to the electing spouse.

If the deficiency relates entirely to an item attributable to one spouse, the other spouse is responsible for none of the deficiency if he or she elects limited liability under this provision. If the deficiency relates to the items of both spouses, the separate liability for the deficiency is allocated between the spouses in the same proportion as the net items taken into account in determining the deficiency. Each spouse is required to make the election in order to limit his or her liability. If either spouse fails to elect, the non-electing spouse is liable for the full amount of the deficiency, unless reduced by innocent spouse relief or pursuant to the grant of authority to the Secretary to provide equitable relief.

If the deficiency arises as a result of the denial of an item of deduction or credit, the amount of the deficiency attributable to the spouse to whom the item of deduction or credit is allocated is limited to the amount of income or tax allocated to such spouse that was offset by the deduction or credit. The remainder of the liability is allocated to the other spouse to reflect the fact that a portion of the disallowed deduction or credit originally offset income or tax allocated to that spouse.

When a deficiency is attributable to the disallowance of a credit, or to any tax other than regular or alternative minimum tax, the portion of the deficiency attributable to such credit or other tax is considered first. For example, on examination a deficiency of \$10,000 (\$2,800 of self-employment tax and \$7,200 of income tax) is determined to be attributable to \$20,000 of unreported self-employment income of the husband and a disallowed itemized deduction of \$5,000 allocable to the wife. The \$2,800 of deficient self-employment taxes is first allocated to the husband, and the remaining \$7,200 of income tax deficiency is allocated 80 percent to the husband and 20 percent to the wife.

Special rules apply to prevent the inappropriate use of the election. First, if the IRS demonstrates that assets were transferred between the spouses in a fraudulent scheme joined in by both spouses, neither spouse is eligible to make the election under the provision (and consequently joint and several liability applies to both spouses).

Second, if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election does not apply to the extent any deficiency is attributable to such item. Such actual knowledge must be established by the evidence and cannot be inferred based on indications that the electing spouse had a reason to know.

Third, the portion of the deficiency for which the electing spouse is liable is increased by the value of any disqualified assets received from the other spouse. Disqualified assets include any property or right to property that was transferred to an electing spouse if the principal purpose of the transfer is the avoidance of tax (including the avoidance of payment of tax). A rebuttable presumption exists that a transfer is made for tax avoidance purposes if the transfer was made less than one year before the earlier of the payment due date or the date of the notice of proposed deficiency. The rebuttable presumption does not apply to transfers pursuant to a decree of divorce or separate maintenance. The presumption may be rebutted by a showing that the principal purpose of the transfer was not the avoidance of tax or the avoidance of the payment of tax.

Equitable relief in other circumstances

If the taxpayer does not qualify for innocent spouse relief or separation of liability, the taxpayer may be eligible for equitable relief. To obtain equitable relief, it must be unfair to hold the taxpayer liable for the underpayment or understatement of tax taking into account all of the facts and circumstances.

Jurisdiction of the Tax Court

In addition to affirmative claims made in deficiency cases before the court, the Tax Court has jurisdiction to review a denial of relief by the IRS. A taxpayer may petition the Tax Court to determine relief from joint and several liability if the petition is filed after the earlier of the mailing date the notice final determination of relief or six months after the claim for relief is filed with the IRS, but not later than 90 days after the date the notice of final determination is mailed.

Except for termination and jeopardy assessments, the Secretary may not levy or proceed in court to collect any tax from a taxpayer claiming innocent spouse status with regard to such tax until (1) the expiration of the 90-day period in which such taxpayer may petition the Tax Court, (2) if such a petition is filed in Tax Court, before the decision of the Tax Court has become final, or (3) a waiver of the restrictions on the collection of an assessment is filed with the Secretary. The running of the statute of limitations is suspended in such situations with respect to the spouse claiming innocent spouse status.

The Code requires the Tax Court to establish rules that provide an individual not seeking innocent spouse or separate liability relief with notice of the petition filed with the Court and an opportunity to become a party to the proceeding. Under the Tax Court rules, the IRS is required to give notice to the other party to the joint return that a petition to determine relief from joint and several liability has been filed.⁶ The other party is given 60 days to intervene in the action.⁷

⁶ T.C. Rule 325(a).

⁷ T.C. Rule 325(b).

Legislative Background

Pursuant to TBOR 3, the separate liability election, expanded innocent spouse relief, and authority to provide equitable relief all apply to liabilities for tax arising after July 22, 1998,⁸ as well as any liability for tax arising on or before July 22, 1998, that remains unpaid on the date of enactment.

⁸ This was the date of enactment of that Act.

B. Offers-in-Compromise (sec. 7122 of the Code)

Present Law

In general

The Code permits the IRS to compromise a taxpayer's tax liability. An offer-in-compromise is an offer by the taxpayer to settle unpaid tax accounts for less than the full amount of the assessed balance due. An offer-in-compromise may be submitted for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code.

There are three grounds upon which the IRS may compromise a liability: (1) doubt as to liability for the amount owed, (2) doubt as to ability to pay the amount owed, or (3) when settlement would promote effective tax administration, including cases when requiring full payment would result in hardship or inequity ("equity offers"). Doubt as to liability exists when there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to ability to pay exists in any case in which the taxpayer's assets and income are less than the full amount of the assessed liability.

If a taxpayer does not qualify under the doubt as to liability or doubt as to ability to pay standards, the IRS may enter into a compromise based on an equity offer in light of all the facts and circumstances, including the taxpayer's record of overall compliance with the tax laws. The temporary regulations provide that an offer-in-compromise can be accepted to promote effective tax administration when either (1) collection of the entire liability will create economic hardship, or (2) regardless of the taxpayer's financial condition, exceptional circumstances exist which would result in collection of the entire liability being detrimental to voluntary compliance by taxpayers, and (3) compromise of the liability will not undermine compliance with the tax laws. Factors supporting (but not conclusive of) a determination of economic hardship include:

- Taxpayer is incapable of earning a living because of a long-term illness, medical condition, or disability and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition;
- Although taxpayer has certain assets, liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses; and
- Although taxpayer has certain assets, taxpayer is unable to borrow against the equity in those assets and disposition by seizure or sale of the assets would have sufficient adverse consequences such that enforced collection is unlikely.⁹

An offer-in-compromise requires the taxpayer to keep current on the taxpayer's payment and filing requirements for five years from the date of acceptance of the offer-in-compromise.

⁹ Temp. Treas. Reg. sec. 301.7122-1T(b)(4)(iv)(B)(1)-(3).

Rights of taxpayers entering into offers-in-compromise

The Code requires the IRS to develop and publish schedules of national and local allowances that will provide taxpayers entering into an offer-in-compromise with adequate means to provide for basic living expenses. The IRS also is required to consider the facts and circumstances of a particular taxpayer's case in determining whether the national and local schedules are adequate for that particular taxpayer. If the facts indicate that use of schedule allowances would be inadequate under the circumstances, the taxpayer is not limited by the national or local allowances.

The Code prohibits the IRS from rejecting an offer-in-compromise from a low-income taxpayer solely on the basis of the amount of the offer. In the case of an offer-in-compromise submitted solely on the basis of doubt as to liability, the IRS may not reject the offer merely because the IRS cannot locate the taxpayer's file. Further, the Code prohibits the IRS from requesting a financial statement if the taxpayer makes an offer-in-compromise based solely on doubt as to liability.

Suspend collection by levy while offer-in-compromise is pending

The Code prohibits the IRS from collecting a tax liability by levy (1) during any period that a taxpayer's offer-in-compromise for that liability is being processed, (2) during the 30 days following rejection of an offer, and (3) during any period in which an appeal of the rejection of an offer is being considered.¹⁰ Taxpayers whose offers are rejected and who made good faith revisions of their offers and resubmitted them within 30 days of the rejection or return would be eligible for a continuous period of relief from collection by levy.¹¹ This prohibition on collection by levy does not apply if the IRS determines that collection is in jeopardy or that the offer was submitted solely to delay collection. The statute of limitations on collection is tolled for the period during which collection by levy is barred.

Procedures for reviews of rejections of offers-in-compromise and installment agreements

The Code requires that the IRS implement procedures to review all proposed IRS rejections of taxpayer offers-in-compromise and requests for installment agreements prior to the rejection being communicated to the taxpayer. The Code also requires the IRS to allow the taxpayer to appeal any rejection of such offer or agreement to the IRS Office of Appeals. The IRS must notify taxpayers of their right to have an appeals officer review a rejected offer-in-compromise on the application form for an offer-in-compromise.

Legislative Background

The expanded authority to accept offers-in-compromise based on equity and to suspend levy collection were enacted as part of TBOR 3. Before enactment of TBOR 3, offers-in-compromise were traditionally limited to offers based on doubt as to liability and doubt as to

¹⁰ Sec. 6331(k)(1).

¹¹ Temp. Treas. Reg. sec. 301.7122-1T(f)(2)(ii).

ability to pay. The provision suspending levy is effective with respect to offers-in-compromise pending on or made after December 31, 1999.

C. Installment Agreements (sec. 6159 of the Code)

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed. An installment agreement does not reduce the amount of taxes, interest, or penalties owed, but does provide for a longer period during which payments may be made and during which other IRS enforcement actions (such as levies or seizures) are held in abeyance.

In the case of individual income taxes, the Code requires the IRS to enter an installment agreement, at the taxpayer's option, if: (1) the liability is \$10,000, or less (excluding penalties and interest); (2) within the previous 5 years, the taxpayer has not failed to file any return or to pay any tax required to be shown on such return, nor entered an installment agreement; (3) the IRS determines that the taxpayer is unable to pay the tax due in full (and the taxpayer submits such information as the IRS requests to make such a determination); (4) the installment agreement provides for full payment of the liability within 3 years; and (5) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to 3 years) that the agreement is in place.

Collection by levy is prohibited while an installment agreement is pending under rules similar to those relating to offers-in-compromise.¹²

Legislative Background

Statutory authorization for installment agreements was first enacted in TBOR 1, although the IRS would administratively enter into installment agreements before enactment of that provision. TBOR 3 added the requirement that the IRS enter into an installment agreement under the conditions outlined above.

¹² Sec. 6331(k)(2).

D. Taxpayer Advocate (secs. 7803(c) and 7811 of the Code)

In general

The Office of the Taxpayer Advocate Office was created to assist taxpayers in resolving problems with the IRS, to identify areas in which taxpayers have problems dealing with the IRS, to propose changes in administrative practices of the IRS that would mitigate such problems, and to identify possible changes in the law that might mitigate such problems.

National Taxpayer Advocate

The Secretary appoints the National Taxpayer Advocate after consultation with the Commissioner and the IRS Oversight Board (without regard to the provisions of Title 5 of the U.S. Code, relating to appointments in the competitive service or the Senior Executive Service). An individual may be appointed as the National Taxpayer Advocate only if the individual was not an officer or employee of the IRS during the 2-year period ending with such appointment and the individual agrees not to accept employment with the IRS for at least 5 years after ceasing to be the National Taxpayer Advocate. Service as an officer or employee of the Office of the Taxpayer Advocate is not taken into account, for purposes of these 2-year and 5-year rules.

A system of local Taxpayer Advocates report directly to the National Taxpayer Advocate and are employees of the Taxpayer Advocate's Office, independent from the IRS examination, collection, and appeals functions. Each local taxpayer advocate reports to the National Taxpayer Advocate or his delegate. At least one local Taxpayer Advocate is available to taxpayers in each state.

The National Taxpayer Advocate is required to monitor the coverage and geographical allocation of the local Taxpayer Advocates, develop guidance to be distributed to all IRS officers and employees outlining the criteria for referral of taxpayer inquires to local taxpayer advocates, ensure that the local telephone number for the local taxpayer advocate is published and available to taxpayers. Each local Taxpayer Advocate may consult with the appropriate supervisory personnel of the IRS regarding the daily operation of the office of the Taxpayer Advocate. At the initial meeting with any taxpayer seeking the assistance of the Office of the Taxpayer Advocate, the local Taxpayer Advocate is required to notify the taxpayer that the Office operates independently of any other IRS office and reports directly to Congress through the National Taxpayer Advocate. At the discretion of the local Taxpayer Advocate, the advocate shall not disclose to the IRS any contact with or information provided by the taxpayer. Each local office of the Taxpayer Advocate is to maintain a separate phone, facsimile, and other electronic communication access, and a separate post office address independent from the IRS.

The IRS is required to publish the taxpayer's right to contact the local Taxpayer Advocate on the statutory notice of deficiency.

Taxpayer assistance orders

A Taxpayer Assistance Order (“TAO”) can be issued if the taxpayer is suffering or about to suffer a “significant hardship” from tax law administration. A TAO may require the IRS to release property of the taxpayer that has been levied upon or to cease action, take action, or

refrain from taking action with respect to the taxpayer within a period of time specified in the TAO.¹³ A “significant hardship” is deemed to occur if one of the following four factors exists: (1) there is an immediate threat of adverse action; (2) there has been a delay of more than 30 days in resolving the taxpayer's account problems; (3) the taxpayer will have to pay significant costs (including fees for professional services) if relief is not granted; or (4) the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted. The National Taxpayer Advocate may also issue a TAO if the taxpayer meets requirements set forth in regulations. It was intended that the circumstances set forth in regulations be based on considerations of equity. A TAO may be issued as a result of a taxpayer’s specific request or as a result of independent action of the National Taxpayer Advocate.

In determining whether to issue a TAO in cases in which the IRS failed to follow applicable published guidance (including procedures set forth in the Internal Revenue Manual), the Taxpayer Advocate is to construe the matter in a manner most favorable to the taxpayer.

Once a TAO is issued it is binding on the IRS unless modified or rescinded by the National Taxpayer Advocate, the Commissioner, or Deputy Commissioner but only if a written explanation of the reasons for the modification or rescission is provided to the National Taxpayer Advocate.

Reports of the National Taxpayer Advocate

The National Taxpayer Advocate must provide two annual reports to the House Ways and Means Committee and the Senate Finance Committee. The first report is submitted by June 30 of each year and is to report on the objectives of the Office of the Taxpayer Advocate for the fiscal year beginning in that calendar year. The second report is to be submitted by December 31 of each year regarding the activities of the Office of the Taxpayer Advocate for the fiscal year ending in that calendar year. In addition, among other items, this report must identify areas of the tax law that impose significant compliance burdens on taxpayers or the IRS, including specific recommendations for remedying such problems, and identify the 10 most litigated issues for each category of taxpayers, including recommendations for mitigating such disputes. The reports are submitted directly to the committees without any prior comment from the Commissioner, the Secretary or any other officer or employee of the Department of Treasury, the IRS Oversight Board, or the Office of Management and Budget.

Legislative Background

In 1996, TBOR 2 established the position of Taxpayer Advocate, which replaced the position of Taxpayer Ombudsman, created in 1979 by the IRS. Prior to the IRS Reform Act, the Taxpayer Advocate was appointed by and reported directly to the Commissioner. The IRS Reform Act renamed the position the National Taxpayer Advocate and required that the Secretary make the appointment after consultation with the Commissioner and the IRS Oversight Board. The IRS Reform Act also replaced the regional and local problem resolution officers

¹³ Sec. 7811.

with local offices of taxpayer advocates and expanded the circumstances under which a TAO could be issued as described above.