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MALPRACTICE PREVENTION EDUCATION FOR OREGON LAWYERS

WHEN TO FILE SEPARATE RETURNS

Most married couples file joint income tax returns without giving their decision a second thought. However, some circumstances – such as finances, potential liabilities, and marital instability – can create a situation in which one or both spouses are better off filing a separate return.

Joint filing is commonly financially advantageous for two reasons. First, federal joint rates are lower than separate rates and often reduce the tax due from both spouses by more than 15%. Second, joint returns sometimes allow income earned by one spouse to be reduced by losses and deductions generated by the other spouse.

Joint filing, however, makes both spouses jointly and severally liable for any tax due – both the tax shown due on the joint return and any tax due that might later be discovered through an audit. Accordingly, joint filing makes sense when the tax has been or can be promptly paid, and the couple is confident that an audit would not result in additional tax. Some couples, on the other hand, should consider filing separate income tax returns.

This article discusses three situations in which separate filing might make sense: (1) The couple can't pay the tax due; (2) One spouse is taking aggressive positions on the couple's return; or (3) The couple is contemplating divorce or separation.

CAN'T PAY THE TAX

In most instances, a household's tax problems arise from the earnings of just

one spouse. If one spouse has incurred more tax liability than the couple can quickly and conveniently pay, the couple should seriously consider filing separate returns. The hefty penalties and interest charged on unpaid taxes make it difficult to retire large tax debts. Low-income households and households experiencing financial problems may have too little discretionary income to keep up with interest and penalty accruals. Couples at all income levels are routinely surprised at how quickly tax liabilities grow to an unmanageable size; a self-employed businessperson, for example, who fails to file three or four years of returns and make the required estimated payments usually has a liability so large that it will be difficult or impossible to pay.

The couple's instinctive reaction when one spouse has incurred a significant tax is to file a joint return to take advantage of the lower rates. If, however, so much tax has been incurred that the tax will be difficult or impossible to pay, the couple will probably have to file bankruptcy or pursue a federal or state offer in compromise. (Most income tax liabilities can eventually be discharged in bankruptcy.) If bankruptcy or an offer in compromise seems the likely or only solution, the household may weather the tax collection process ahead more easily if only one spouse is liable for the tax. Separate return filing will keep one of the spouses immune from the tax problem.

The Bankruptcy Code prevents individuals from discharging most tax liabilities during the three-year period following the date the tax return was due. Weathering the collection efforts of tax-

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ing agencies during this three-year period can be very difficult. Separate return filing means that the non-liable spouse's bank accounts, wages, and equity in assets will not be drawn into the tax and bankruptcy processes – a significant benefit to both spouses. It is true that the higher separate tax rates will result in more tax owed for the spouse who earned the income. However, this larger amount of tax will not matter if relief is eventually obtained through the subsequent bankruptcy proceeding or offer in compromise.

AGGRESSIVE RETURN POSITIONS

As noted above, joint filing makes both spouses liable for the tax shown due in a return, in addition to any tax that is later discovered through an audit. An individual who believes his or her spouse is taking overly aggressive positions on the return may want to consider filing a separate return to avoid joint liability for taxes due. He or she might be able to invoke state and federal laws that protect innocent spouses, but there is no guarantee of such relief. The best way for an innocent spouse to avoid liability for the aggressive return positions of his or her spouse is not to execute a joint return at all.

Federal and state “innocent spouse relief” is sometimes available for spouses who become liable through an audit for taxes not shown as due on joint returns. 26 USC §6015; ORS 316.368, 316.369. If available, innocent spouse relief extinguishes one spouse's liability for all or part of the taxes that were previously jointly owed. In most instances, the applying spouse must show that he or she did not know there was additional tax due when the joint return was executed and that relief from the tax liability is equitable in light of the facts and circumstances. Innocent spouse relief has become easier to obtain in the last few years, but the process is by no means convenient or certain. Successfully obtaining innocent spouse relief can be a lengthy and expensive process, as the IRS and the courts apply the requirements stringently.

Obtaining innocent spouse relief for a tax liability that was *shown on the joint return* is even more difficult. Only “equitable relief” is generally available for a spouse who signed the joint return knowing that the couple owed unpaid taxes. 26 USC § 6015(f). Equitable relief is generally available only in cases of significant hardship or when the “innocent spouse” signed the return under duress.

DIVORCE

Marital instability is another reason to consider filing separate returns. If a couple experiencing marital difficulties believes that they have paid the tax owed and that there is little chance of additional tax due, joint filing probably still makes sense. If, however, the couple cannot pay the tax owed or if one spouse insists on taking aggressive return positions, they should consider separate filing. Divorce does not undo the joint and several liability created by a jointly filed return.

Divorce and separation agreements often make one spouse responsible for paying taxes that were incurred during the marriage, but these types of agreements between the parties are not binding on taxing agencies. If the spouse who was contractually assigned the joint liabilities incurred during the marriage does not or cannot pay what is owed, the taxing agencies are free to pursue either or both spouses for the full amount of the tax, regardless of the divorce or separation agreement. In that event, the only remedy available to a spouse who is required to pay more tax than required by the divorce or separation agreement is a claim for contribution or indemnification against the other (non-paying) spouse.

If the couple is divorced or legally separated, innocent spouse relief may also be available under 26 USC §6015(c) and ORS 316.368. When relief is allowed under these statutes, the joint tax liability is allocated between the parties. The federal and state statutes allocate the liability differently. Death of a spouse may also qualify the surviving spouse for innocent spouse relief under these same statutes.

HEDGING THE BET

Internal Revenue Code (IRC) Section 6015(b) sometimes allows a couple to hedge their bet on joint versus separate filing by allowing the couple to elect joint rates after initially filing separate returns. The joint election (1) must be made within three years from the due date of the separate returns (not counting extensions) and (2) can only be made after the couple has paid sufficient tax to satisfy the liability due under joint filing. Treas. Reg. 1.6013-2(b). To elect joint rates under IRC Section 6015(b), the IRS only requires that a joint return be filed. A cover letter, however, should accompany the return to clarify that the return is being filed to elect joint rates after separate returns have been filed. This

right to later elect joint rates allows a couple undergoing financial difficulties to initially keep one spouse immune from an unpaid tax while still benefiting from the lower joint rates when the couple's financial difficulties have passed.

Couples who owe significant tax need to weigh the benefits of lower joint rates against the burden of joint liability, particularly if they are struggling with finances or their marriage. If you represent both spouses, be careful with advice on return filing strategies because of potential conflicts. If the spouses become divided on the return filing issue, encourage them to seek independent advice through separate counsel.

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