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PRO BONO TAX MATTERS (NOT A CONTRADICTION IN TERMS): A PRIMER

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This report observes, based on anecdotal evidence, that tax practitioners tend to do less pro bono work than peers who practice in other disciplines. The author rejects as an explanation for that observation (if it is even true at all) that tax lawyers are less well-meaning or charitably oriented than other practitioners. Instead the author posits that tax lawyers shy away from pro bono work for lack of familiarity with the substantive tax law, itself insidiously complex, that most frequently is the subject matter of disputes involving low-income taxpayers. Accordingly, even the most accomplished practitioners will tend to find those matters more daunting than they feel capable of taking on efficiently.

The author exhorts his colleagues in the tax bar to take on more pro bono work for low-income taxpayers. Even if the author's observation about participation of the tax bar in pro bono matters is untrue, he considers it worthwhile to attempt to address what he identifies as the main barrier that prevents many tax lawyers from taking on more pro bono work — lack of a relatively easy path to becoming familiar with the relevant subject matter. This report provides basic background and some practical insights into several of those relevant areas of law, specifically, the EITC, dependency exemptions, head of household filing status, innocent spouse relief, and more. An earlier version of this article was presented to the Tax Forum in New York City on March 27, 2005, many of whose members are now more heavily involved in pro bono tax matters.

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I. Introduction

Practicing tax law is not a bad way to make a living. We find the subject matter interesting (self-selection, of course, has a role here). The clients we deal with are generally intelligent and creative sorts. The more-or-less continuous demand for tax advice makes the practice relatively remunerative. Life is good.

We tax lawyers most likely are not different from most of the fortunate class when it comes to our inclinations to recycle our good fortune. There is no evidence that we

are less philanthropically inclined than any other group. But when it comes to heeding the admonition of our profession to provide services in kind, so as to assure the availability of legal services to those unable to pay,[1] I submit (admittedly based only on anecdotal evidence) that we are as a group among the underperformers of our profession.

Although unscientific, that observation merits at least a brief inquiry into the underlying reasons. Having some understanding of systemic barriers that may exist is a first step toward elimination or at least mitigation of those barriers. Even if my speculation about the quantitative in-kind contributions of tax lawyers is wrong, elimination of barriers can serve only to increase the availability of legal services to those who cannot afford to pay.

The main barrier, as I see it, is what I would call the ''utilitarian syndrome.''[2] Succinctly put, any one of us might say something like, ''I am an expert in the most sophisticated areas of M&A tax law. I don't know the first thing about what one does to help most pro bono clients. Criminal matters? Forget about it. Issues with government benefits, landlord issues, protection orders? I don't know the first thing about any of that.'' And so on. What usually follows is, ''The first-year associates can do a better job than I can, and besides they have lower billing rates and more elastic availability.'' And for those who feel some guilt, ''It makes much more sense for me to give money to an organization that has people trained to do a good job in these types of matters than for me to try myself,'' and then they write a check.

I have some sympathy for that point of view. I also lack interest in debating it for very long, however, because I believe there is an entirely conclusive response.

Although the mere words ''pro bono tax work'' can provoke laughter as an oxymoron, a less-than-universally understood fact is that there are virtually limitless opportunities for pro bono work within the four corners of the Internal Revenue Code. Yes, the hard-core utilitarians will sneer, ''There is all sorts of stuff in the code that I simply do not touch on professionally. It all might as well be Martian law, and is no different than any of those other types of pro bono matters that I am not particularly qualified to take on.''

Here my sympathy ends. The code is the code is the code. It has its own peculiar drafting style, one that we more than anyone else are accustomed to parsing. It is administered by an agency whose address (1111 Constitution Ave.) each of us knows as well as our own. The procedures of that agency as applied to our paying clients are familiar to us, and those procedures are basically the same for potential pro bono clients. If the utilitarian still whines, ''But c'mon, you are still talking about learning entirely new code sections with all sorts of their own complexities,'' let me only ask what the whiner did when the last set of terribly complicated consolidated return/COD regulations was released.[3]

Despite the foregoing diatribe, the principal purpose of this report is not to preach. Rather, the main goal of the report is to provide some assistance in reducing the utilitarian-based reluctance of tax practitioners to participate in pro bono matters. My premise is that the fundamental barrier to the participation of the tax bar in pro bono work is the natural and indeed understandable reluctance of (especially the most accomplished) practitioners to dive into deep unfamiliarity with the *specific* subject matter. The remainder of this report is therefore devoted to making the specific subject matter of a large (although not entirely exhaustive) set of tax-related pro bono matters readily accessible (and hopefully understandable) to those who would readily take on those matters but for being able to overcome the natural reluctance.

Part II of the report discusses the earned income tax credit and the closely related subjects of head of household filing status, dependency exemptions, and the child credit. That, for many reasons, is by far the most fertile ground for tax-related pro bono work. Part III discusses innocent spouse relief, also a source of a large number of cases in need of volunteer lawyers. Part IV discusses how to gain a tax exemption for a charitable organization. Even though that may be the most ''traditional,'' if not straightforward, of tax pro bono projects, not knowing where to start can be something of a hurdle for an otherwise willing practitioner. Part V discusses some aspects of IRS and court procedure that are often useful, if not critical, to pro bono projects and that are seldom, if ever, encountered in work for paying clients. Part VI is a modest conclusion to this opening sermon.

II. Earned Income Tax Credit

A. Introduction

The EITC is one of four refundable credits provided for by the code.[4] Remarkably, this credit currently represents the third-largest entitlement program in the United States. In 2003 EITC claims totaled more than $34 billion,[5] behind only Social Security ($453 billion) and Medicare

[1]*Model Rules of Prof'l Conduct* R. 6.1 (2002).

[2]Utilitarianism is a school of economic thought most often associated with the work of Jeremy Bentham and John Stuart Mill in the early to mid-19th century. In general terms, the utilitarian would measure subjectively the amount of benefit any particular action would have on society as a whole and encourage those actions that would produce the greatest total good. Utilitarianism has been largely discredited by the work of later economists and philosophers, in no small part because of the sheer folly of the idea that meaningful individualized measurements ever could be made.

[3]I recognize not all will be persuaded. Those who are not at least open to persuasion will have no use for the rest of the report and may stop reading.

[4]For the curious, the other refundable credits are: the gasoline and special fuels credit under section 33, the health insurance credit for eligible individuals under section 35, and the child credit under section 24. Section references are to the Internal Revenue Code of 1986, as amended, except as otherwise noted.

[5]House Comm. on Ways And Means, 108th Cong., *Background Material and Data on the Programs Within the Jurisdiction of the Committee on Ways And Means: 2004 Green Book,* 13-41, tbl.13-14 (Comm. Print 2004).

($149.9 billion), and ahead of Temporary Assistance for Needy Families (TANF) ($17 billion). That was probably not foreseen when the EITC was first enacted as part of the Tax Reduction Act of 1975.[6] The credit at first was intended to offset the burden of Social Security taxes on low-income wage earners and was viewed as a way to stimulate the economy during the recession of the 1970s.[7] Because the credit was available only to individuals who worked and had earned income, it was also intended to improve incentives to work.[8] In its original form, the EITC was a refundable credit equal to 10 percent of earned income that was available only to individuals with dependent children.[9] The credit was phased out for individuals with incomes exceeding $4,000.[10] The EITC as originally enacted was to be effective for only one year,[11] but it was renewed in 1976[12] and made permanent in 1978.[13] No inflation adjustments were provided for until 1986.[14] In 1990 the EITC was amended to provide an increase in the rate of the credit and the requirement that the taxpayer have a dependent was replaced with the requirement that the taxpayer have a ''qualifying child,'' a newly defined term.[15] The amount of the credit was significantly increased and the credit was extended to individuals without qualifying children in 1993.[16] Currently, the EITC is available to eligible individuals, subject to income limitations that vary depending on the individual's marital status and the number of qualifying children. Many states, including New York, also offer an EITC for state taxes that is based on the federal credit.[17] Beginning in 2004, New York City provides a refundable income tax credit equal to 5 percent of the federal EITC.[18]

Generally, the amount of the EITC currently is 40 percent of earned income for individuals with more than one qualifying child, 34 percent for individuals with one qualifying child, and 7.65 percent for individuals without a qualifying child, applied in each case subject to a specified maximum amount of earned income.[19] For 2004 the maximum credit available is $4,300 for taxpayers with more than one qualifying child, $2,604 for taxpayers with one qualifying child, and $390 for taxpayers with no qualifying children.[20] Currently, the EITC begins to phase out at $14,040 for individuals with one or more qualifying children,[21] and at $6,390 for individuals without a qualifying child.[22] For 2004 the income limitation amounts are $34,458 for individuals with more than one qualifying child, $30,338 for individuals with one qualifying child, and $11,490 for individuals without a qualifying child.[23] For married couples filing joint returns, the income limitations and the income level at which the phaseout begins are increased by $1,000 for tax years beginning in 2002, 2003, or 2004; by $2,000 for tax years beginning in 2005, 2006, or 2007; and $3,000 for tax years beginning after 2007.[24]

The EITC is fundamentally flawed in several ways. When one recognizes that the EITC is essentially a government benefit or entitlement program, it is all but obvious that we should expect its administration to be suboptimal (measured against even the lower expectations we might have of the government). It takes only mild cynicism to believe that by disguising the benefit as a tax credit and entrusting its administration to the IRS — an organization that is fundamentally organized to collect money for, not distribute money on behalf of, the government — the mischievous intention of its creators (or, more likely, those responsible for the enormous expansion of the EITC later on) was to grant less of a benefit than advertised and simultaneously drain the IRS of resources, so that its primary mission of tax collection would be compromised. Moreover, the technical provisions of the EITC are an exquisitely complex series of multilayered and multibranched rules with layers and branches of exceptions to match. The complexity has

[6]Pub. L. No. 94-12, 94th Cong. section 204 (1975) (former section 48).

[7]H.R. Rep. No. 94-19, at 3, 10 (1975).

[8]*Id.* at 10; Sen. Rep. No. 94-36, at 33 (1975).

[9]Tax Reduction Act of 1975, Pub. L. No. 94-12, 94th Cong. section 204 (1975).

[10]*Id.*

[11]*Id.* at section 209(b).

[12]Tax Reform Act of 1976, Pub. L. No. 94-455, 94th Cong. section 401(c) (1976).

[13]Revenue Act of 1978, Pub. L. No. 95-600, 95th Cong. section 103 (1978).

[14]Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong. section 111(c) (1986).

[15]Revenue Reconciliation Act of 1990, Pub. L. No. 101-58, 101st Cong. section 11111(a) (1990).

[16]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 103d Cong. section 13131(a) (1993). For example, the maximum EITC available to taxpayers with more than one qualifying child increased from 19.5 percent of the first $7,750 of earned income in 1993 to 26.3 percent of the first $7,750 of earned income in 1994. For 1995 and thereafter, the credit rate increased to a maximum of 34 percent of earned income for taxpayers with more than one qualifying child. H.R. Rep. No. 103-213, at 536 (1993).

[17]*See* N.Y. Tax Law section 606(d)(1); *see also* Christine Scott, Congressional Research Service, The Earned Income Tax Credit (EITC): An Overview (2003) (noting that 16 states and the District of Columbia offer an EITC for state taxes). In general, state EITCs are based on the federal EITC. Accordingly, for taxpayers in the applicable states, adjustments to a taxpayer's federal EITC will have corresponding effects on the state EITC.

[18]N.Y.C. Administrative code section 11-1706(d)(1).

[19]Section 32(b)(1).

[20]IRS Publication 596, *Earned Income Credit (EIC)*, at 43, 44 (2004) (hereinafter IRS Pub. 596).

[21]Rev. Proc. 2003-85, 2003-2 C.B. 1184, *Doc 2003-24879*, *2003 TNT 224-11*. The phaseout amount is the same for individuals with more than one qualifying child and only one qualifying child.

[22]*Id.*

[23]*Id.*; *see also* IRS Pub. 596, *supra* note 20, at 6. The earned income limitation amounts are based on the amounts listed in section 32(b)(2)(A) and adjusted for inflation under section 32(j)(1)(B)(i).

[24]Rev. Proc. 2003-85, 2003-2 C.B. 1184. The $3,000 amount also is indexed for inflation beginning in 2008. Section 32(j)(1)(B)(ii).

been compounded by frequent changes in the last several years to many of the specific rules.[25] The irony of that element is just massive, as it forces those individuals of the lowest means to require the kind of talent usually reserved for the most well-heeled.[26]

It is no surprise then that experience has validated the cynic's belief about the results, if not the motives, of the EITC's congressional patrons. Since the expansion of the EITC in 1993,[27] the major challenges of administering the EITC have been to get eligible low-income workers to claim the credit and to prevent fraudulent claims.[28] According to one source, recent official reports indicate that the government loses about $10 billion annually as a result of fraudulent or mistaken EITC claims.[29] At the same time, some recent estimates also show that up to 25 percent of eligible taxpayers nationwide fail to claim the credit.[30] Those results are not surprising, given the complexity of the EITC rules and the substantial amount of credit a taxpayer could receive.

In her 2003 Annual Report to Congress, National Taxpayer Advocate Nina Olson stated that, ''despite over 4.1 million examinations and math assessments, over 16,000 preparer outreach visits, and a national advertising campaign, by the IRS's own reports, the percentage of EITC overclaims remains as high today as in 1994.''[31] Part of the problem may be attributable to the IRS's failure to develop a structure that is wholly dedicated to administering the EITC.[32] For example, the National Taxpayer Advocate noted that in 1999, more than 18 IRS functions were involved in processing EITC claims, and most of those functions report to different management chains that may have conflicting goals.[33] To be sure, some progress in administering the EITC has occurred more recently. In the National Taxpayer Advocate's 2004 report, for the first time since the inaugural report in 1996, the EITC was not listed as a ''Most Serious Problem'' of taxpayers.[34] The National Taxpayer Advocate credits the improvement to IRS initiatives, including conducting basic research and working more closely with low-income taxpayer clinics.[35] However, the report notes continuing problems with compliance and participation because of ineffectual communication between the IRS and taxpayers and a need for clear and understandable explanations of the documentation requirements.[36]

With all its flaws, however, the EITC remains a critical component of the existence of millions of the working poor in this country.[37] Viewed from the ground on which our ivory tower sits, the flaws are insignificant relative to the results that border on the miraculous for virtually every legitimate beneficiary. For the sake of the beneficiaries, it behooves us to praise and not to bury the EITC, and more importantly as practitioners, to be prepared to work with the various issues that arise.

For the sake of the beneficiaries, it behooves us to praise and not to bury the EITC, and more importantly as practitioners, to be prepared to work with the various issues that arise.

This section of the report will discuss the EITC and the often closely related issues of eligibility for claiming dependency exemptions[38] and head of household filing status.[39] Those latter two issues become entwined with the EITC, because the IRS routinely challenges eligibility in connection with EITC examinations. At least some of the excessive compliance difficulties in this area have been caused by what until very recently were the similar, but not identical, criteria used to determine when a

[25]*See, e.g.*, Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 107th Cong. section 303 (2001); Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 106th Cong. section 412 (1999). The Working Families Tax Relief Act of 2004, discussed below, makes some very welcome simplifying changes though.

[26]Note, for example, the statutory language describing the phaseout of the EITC: ''The amount of the credit allowable to a taxpayer under paragraph (1) for any tax year shall not exceed the excess (if any) of (A) the credit percentage of the earned income amount, over (B) the phase-out percentage of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the tax year as exceeds the phase-out amount.'' Section 32(a)(2). Most of the relevant amounts are indexed for inflation and thus do not appear in the code, and change annually. The drafters of the statute recognized the impenetrability of that language and mandated that the IRS produce tables that show the amount of EITC that is available for different types of eligible taxpayers with different amounts of income in $50 increments. Use of the table as a practical matter uniformly preempts any attempt to calculate the EITC on a formulaic basis. *See, e.g.*, Rev. Proc. 2003-85, 2003-2 C.B. 1184.

[27]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 103d Cong. section 13131 (1993); *see also supra* note 16 and accompanying text.

[28]National Taxpayer Advocate, 2003 Annual Report to Congress, at 26-27 (2003).

[29]Allen Kenney, ''Community Lashes Out Over EITC Test,'' *Tax Notes*, Nov. 8, 2004, p. 794 (hereinafter Kenney, ''Community Lashes Out''); *see also* Philip J. Harmelink et al., ''The Challenge of the EITC,'' *Tax Notes*, Aug. 18, 2003, p. 955.

[30]*Id.*; *see also* IRS Announcement 2003-40, 2003-40 C.B. 1132, *Doc 2003-14495, 2003 TNT 115-6* (stating that ''studies indicate that between 75 and 86 percent of eligible taxpayers participate in the EIC program'').

[31]National Taxpayer Advocate, 2003 Annual Report to Congress, at 27 (2003).

[32]*Id.* at 30. Can you really blame the IRS? Would it even have occurred to anyone to create a structure wholly dedicated to administering the foreign tax credit?

[33]*Id.* at 27. For example, while the submissions processing function's goal is to process tax returns and issue refunds within 45 days to avoid triggering the government's obligation to pay interest, the Criminal Investigation function is responsible for identifying fraudulent returns and stopping payment of associated refunds. *Id.*

[34]National Taxpayer Advocate, 2004 Annual Report to Congress, volume I, at v, n.11 (2004).

[35]*Id.*

[36]*Id.*

[37]*See supra* text accompanying notes 6-9.

[38]Section 151(c).

[39]Section 2(b).

taxpayer could claim a child as a qualifying child for the EITC, or as a dependent for claiming the dependency exemption or head of household filing status. Consequently, a taxpayer may have qualified for one of those three tax benefits for a particular child but not either of the others. The Working Families Tax Relief Act of 2004 (WFA)[40] aims to alleviate that problem by implementing a (nearly) uniform definition of qualifying child for purposes of the EITC, dependency exemption, and head of household filing status.[41] Each of those tax benefits primarily will be discussed as recently amended by the WFA. However, because those newly enacted provisions are effective for tax years beginning after 2004, and controversies for prior years will undoubtedly continue for some time, any significantly different eligibility requirements for tax years beginning before 2005 also will be discussed.

B. EITC Qualification Requirements

For tax years beginning after 2004, to qualify for the EITC, a taxpayer must: (1) have earned income,[42] (2) have a valid Social Security number,[43] (3) be a citizen or resident of the United States (that is, not a nonresident alien), (4) not be a qualifying child of another person,[44] (5) not have passive-type investment income in excess of a stated amount,[45] and (6) file a joint return if married.[46] With the exception of the investment income limitation, each of those elements can raise any number of legal and practical issues.

Certain additional requirements apply to individuals claiming the EITC without a qualifying child. The definition of ''qualifying child'' is particularly important because the amount of the EITC available is significantly greater for eligible taxpayers who have one or more qualifying children.[47] Consequently, a large portion of EITC controversies arise from the qualifying child requirement.[48] The following discussion will begin with a more detailed description of the general requirements for claiming the EITC applicable to all taxpayers and then focus on the qualifying child requirement. This part will then summarize the additional requirements applicable to individuals claiming the EITC without qualifying children. Finally, this part will discuss the controversial EITC ''precertification'' procedures that the IRS has attempted to implement.

1. Earned income. Earned income generally can be thought of as compensation for services. It generally includes taxable wages, salaries, tips, and other employee compensation and net earnings from self-employment.[49] Among the items excluded from earned income are: (1) welfare benefits,[50] (2) Social Security benefits,[51] (3) alimony and child support,[52] (4) unemployment compensation,[53] (5) workers' compensation,[54] (6) amounts received as a pension or annuity,[55] and (7) interest and dividends.[56] Because the EITC is structured so that the amount of credit a taxpayer receives increases with additional income up to the point at which the credit begins to phase out, the EITC presents an unusual incentive for *overstating* income.

The IRS discussed the problem of income overstatement in EITC cases in Service Center Advice 1998-052.[57] There the IRS noted that a large number of income tax returns report an amount of net earnings from self-employment that maximize the taxpayer's EITC. In those cases, the amount of EITC a taxpayer receives would generate a large refund, even after covering the income and self-employment tax owed by the taxpayer. The IRS described the self-employment income claims as those that involve small cash transactions, such as hair braiding or babysitting, that have little or no expenses claimed against gross receipts.

Because of that underlying problem, the IRS may require taxpayers to substantiate any amount shown on their income tax returns and may disregard any self-employment income that a taxpayer fails to substantiate when determining EITC eligibility.[58] Substantiating wages generally does not present a problem because Form W-2 generally is considered adequate proof of earned income. Nonetheless, when a taxpayer works ''off the books,'' most likely at the insistence of the employer (a significant part of whose income also is likely to be off the books), the amount of the wages can be considerably

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[40]Pub. L. No. 108-311, 108th Cong. sections 201-208 (2004).

[41]The new rules also apply to the child credit under code section 24 and the dependent child credit under section 21.

[42]Section 32(a)(1).

[43]Section 32(c)(1)(E).

[44]Section 32(c)(1)(B).

[45]Sections 32(i)(1) and (j)(1)(B)(i). For the 2004 tax year, the investment income limitation was $2,650. Rev. Proc. 2003-85, 2003-2 C.B. 1184. This amount is adjusted for inflation each year.

[46]Section 32(d).

[47]*See* text accompanying *supra* notes 20-25.

[48]*See* Internal Revenue Service, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 1998-FY 2002,* at 3 (2002); *see also* Allen Kenney, ''Hartford to IRS: See You in Court,'' *Tax Notes,* Dec. 6, 2004, p. 1305 (hereinafter Kenney, ''Hartford Goes to Court'').

[49]Section 32(c)(2)(A).

[50]IRS Pub. 596, *supra* note 20, at 11; *see also Powers v. Commissioner*, T.C. Memo. 2000-5, *Doc 2000-1103, 2000 TNT 5-8, aff'd* 234 F.3d 1269, *Doc 2000-28719, 2000 TNT 217-6* (6th Cir. 2000), *reported in full at* No. 00-1215, 2000 U.S. App. LEXIS 28046, *cert. denied* 532 U.S. 995 (2001), discussed in Part II.B.1, above.

[51]*Id.*

[52]IRS Pub. 596, *supra* note 20, at 11.

[53]Treas. reg. section 1.32-2(c)(2).

[54]*Id.*

[55]Section 32(c)(2)(B)(ii).

[56]IRS Pub. 596, *supra* note 20, at 11; *see also Schomberg v. U.S.*, No. S-80-799-MLS, 1981 U.S. Dist. LEXIS 14231, at *3-4 (E.D. Cal. 1981) (holding that investment income is not earned income by the terms of the EITC statute and rejecting argument that investment income is earned income because it represents ''the fruits of earlier earnings'').

[57]Dec. 23, 1998, *Doc 98-36940, 98 TNT 250-28*.

[58]SCA 1998-052 (Dec. 23, 1998); CCA 200022051 (June 2, 2000), *Doc 2000-15571, 2000 TNT 108-64*; *see also Akhter v. Commissioner*, T.C. Summ. Op. 2001-20, *Doc 2001-6005, 2001 TNT 41-14* (finding that taxpayer had no earned income when the taxpayer failed to substantiate tailoring business and reported income to claim the EITC).

harder to prove. Not surprisingly, the underground-economy employer usually does not welcome the opportunity to write a letter to the IRS explaining how he had been paying Ms. Jones a regular salary for the last two years.

Self-employment income is more difficult to prove to the IRS. As proof of self-employment income, the IRS requires taxpayers to keep adequate books and records to establish the amount of gross income, deductions, credits, and any other items the taxpayer is required to report on an income tax return.[59] Because of the high incidence of fraudulent overstatement of self-employment income, the IRS is particularly vigilant in examining that item. Not only is the IRS aware of the potential for overstatement of gross income from self-employment, but it is just as aware of the potential for understatement of deductions. When a taxpayer claims the EITC and reports net earnings from self-employment without deducting for expenses that the IRS determines to be applicable, the IRS will estimate and deduct those expenses to calculate the taxpayer's EITC entitlement.[60] The basic incongruity of the IRS distributing money is here reflected in its stance of presuming taxpayers to have less income and more deductions than reported, with a corresponding mangling of the usual dynamics of proof.

The exclusion of welfare and Social Security benefits from earned income oddly enough was not made clear either in the statute or regulations, but has been established through case law and rulings. For example, in *Powers v. Commissioner*,[61] the court held that payments the taxpayer received from the AFDC program (now TANF) as well as Social Security disability benefits were not earned income. In denying the taxpayer's EITC claim, the court noted that the taxpayer's return failed to reflect any payment from employment or business-related sources despite the taxpayer's claim that she worked during the tax year.[62] Similarly, in Notice 99-3,[63] the IRS held that payments received from state welfare programs such as TANF were not considered earned income. However, Notice 99-3 also stated that payments that are made both to promote the general welfare *and* as compensation for services would be considered earned income unless all of the following circumstances apply: (1) the only payment for work activities is received directly from a welfare agency; (2) the payments are based on need; and (3) the size of the payments is determined by applicable welfare law when the number of work hours are limited by the amount of payment divided by the minimum wage.[64]

2. Social Security number. A taxpayer and the taxpayer's spouse, if filing a joint return, and any qualifying child, each must have a valid Social Security number.[65] An SSN will not be considered valid unless issued in a form that renders the individual eligible for employment. For example, a Social Security card that is issued to enable the taxpayer to receive a federally funded benefit, such as Medicaid, will state on the face of the card that it is not valid for employment; the SSN on such a card is not valid for purposes of EITC eligibility.[66] In addition, an individual taxpayer identification number (ITIN) does not qualify for this purpose.[67]

3. Nonresident aliens. A taxpayer who is a nonresident alien for any portion of the tax year cannot claim the EITC unless the taxpayer is (1) married to a citizen or resident of the United States and (2) elects to be treated as a resident for the entire tax year by filing a joint return.[68] A nonresident alien is an individual who is neither a citizen nor a resident of the United States within the meaning of section 7701(b)(1)(A).[69] That exception typically addresses situations in which a taxpayer who is a

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[59]*See* section 6001; CCA 200022051. Not many likely EITC claimants have accountants or either the foresight or capacity to maintain even remotely adequate records. The frequent absence of bank accounts compounds the problems of proof.

[60]*See, e.g.*, CCA 200022051.

[61]*Powers*, T.C. Memo. 2000-5, *supra* note 50.

[62]*Id.*

[63]1999-1 C.B. 271, *Doc 98-37285, 98 TNT 243-8*.

[64]*Id.*; *see also* Rev. Rul. 71-425, 1971-2 C.B. 76. Payments received from participation in work-training programs are excluded from gross income for federal income tax purposes

(Footnote continued in next column.)

under section 61(a)(1) because those payments are not considered compensation for services when participation in the work-training programs is financed by a public agency that provides benefits based on personal and family subsistence requirements and when the amount of the payments is not greater than the public welfare benefits the taxpayer would have otherwise received. However, if the payments received exceed welfare benefits, the entire amount is considered earned income to the extent that those payments do not exceed the fair market value of the services performed.

[65]Sections 32(c)(1)(E), (c)(3)(D)(i). The IRS has held, however, that a taxpayer who does not have a valid SSN but is otherwise eligible for the EITC in a given year, may file an amended return and claim the EITC in a later year if the taxpayer subsequently receives a valid SSN and the applicable statute of limitations has not expired. *See* Chief Counsel Adv. 200126030, (May 15, 2001) *Doc 2001-17920, 2001 TNT 127-26*; FSA 200032013 (Aug. 11, 2000), *Doc 2000-21133, 2000 TNT 157-21*.

[66]*See* section 32(m).

[67]*Id.* The ITIN is a nine-digit taxpayer ID number that is made available to non-U.S. persons who are not legal residents, but who nonetheless have income tax return filing obligations. ITINs are easy to distinguish from SSNs. All ITINs begin with a "9."

[68]Section 32(c)(1)(D). Both the nonresident alien taxpayer and his or her spouse, who is a U.S. citizen or resident, must make the election under sections 6013(g) or (h) to be eligible for the EITC. Section 6013(g)(2). If a taxpayer elects to be treated as a United States resident for the tax year by filing a joint return, the taxpayer and the taxpayer's spouse will be taxed on their worldwide income and cannot claim any tax treaty benefits as a resident of a foreign country during that tax year.

[69]Section 7701(b)(1)(B). Section 7701(b)(1)(A) provides that an individual will be treated as a resident of the United States if he or she: (1) is lawfully admitted for permanent residence in the United States at any time during the calendar year; (2) meets the "substantial presence test" under section 7701(b)(3); and (3) elects to be treated as a resident of the United States under section 7701(b)(4). An individual meets the substantial presence test if the individual was present in the United States on at least 31 days during the calendar year and the sum of A, B, and C is at least 183, when "A" equals the number of days on which the individual was present during the calendar year, "B" equals one-third of the number of days on which the individual was

(Footnote continued on next page.)

nonresident alien first comes to the United States to join his or her spouse who is a U.S. citizen or resident.

4. Qualifying child. An individual is a qualifying child with respect to a taxpayer claiming the EITC if the following three tests are met: (1) the relationship test, (2) the age test, and (3) the residency test.[70] The relationship test is met if the individual is the taxpayer's child, grandchild, sibling (including a stepsibling), descendant of a sibling or stepsibling (that is, a niece or nephew),[71] or "eligible foster child."[72] The age test is met if the child is under the age of 19 or is a full-time student[73] under the age of 24 as of the close of the calendar year, or if the child is permanently and totally disabled at any time during the calendar year.[74] The residency test is met if the child has the same principal place of abode in the United States as the taxpayer for more than half of the tax year.[75] Also, a qualifying child cannot be married unless the taxpayer is entitled to claim that child as a dependent under section 151, discussed more fully below.[76]

Because of the financial incentive for claiming the existence of qualifying children, and the high incidence of either fraud or innocent error, the IRS is fairly stringent about requiring documentation of the qualifying child requirements. On audit, the IRS requires the following supporting documents for taxpayers claiming the EITC based on a qualifying child: (1) birth certificates of the child to prove the taxpayer's relationship to the child[77] and the child's age;[78] (2) a letter on official letterhead from the child's school, medical provider, clergy, or other similar organization showing the names of the taxpayer and the child, common addresses, and dates to prove that the taxpayer and the child occupied the same principal place of abode for more than half of the tax year;[79] and (3) if the child is a student over age 19 and under age 24, official school transcripts and records showing the child's dates of attendance to verify that the child was a full-time student for at least five months of the tax year.[80] Practical challenges to obtaining that seemingly simple documentation should not be underestimated.

A complex set of "tiebreaker" rules govern situations in which an individual is claimed as a qualifying child by more than one taxpayer. If more than one taxpayer claims an individual as a qualifying child and only one of the taxpayers is the parent of that individual, the individual will be treated as the qualifying child of the taxpayer who is the parent.[81] If both taxpayers are parents of the individual and they do not file a joint return, the individual will be treated as the qualifying child of (a) the parent with whom the individual resided for the longest period of time during the tax year, or (b) if the individual resided with both parents for the same amount of time during the tax year, the parent with the highest adjusted gross income.[82] If none of the taxpayers claiming the individual as a qualifying child is a parent of that individual, the taxpayer with the highest AGI may claim

present in the next preceding year, and "C" equals one-sixth of the number of days the individual was present in the second preceding year.

[70]*See* section 32(c)(3), which refers to the definition of a qualifying child under section 152(c) with some modification. As discussed in the text accompanying note 41, the WFA consolidated the definition of a qualifying child under section 152(c).

[71]Section 152(c)(2).

[72]Section 152(f)(1)(A)(ii). An eligible foster child is a child who is placed with the taxpayer by an authorized agency or by judgment, decree, or other order of any court of competent jurisdiction. Section 152(f)(1)(C). The WFA eliminated the requirement that the taxpayer care for the foster child as his or her own, discussed *infra* in text accompanying notes 84-86.

[73]A full-time student for this purpose is an individual who, for at least five months of the calendar year, is a student at an educational organization that normally maintains a regular faculty and curriculum and that normally has a regularly enrolled student body in attendance. Sections 152(f)(2) and 107(b)(1)(A)(ii).

[74]Sections 152(c)(3)(A), (B).

[75]Sections 32(c)(3)(C) and 152(c)(3)(C). Whether the child has the same principal place of abode as the taxpayer is determined under rules similar to those applicable to head of household filing status, discussed in Part II.D, below. The principal place of abode does not have to be a traditional home. For example, a homeless shelter can be the principal place of abode for purposes of claiming a qualifying child. IRS Pub. 596, *supra* note 20, at 15. For tax years beginning before 2002, the residency requirement for an eligible foster child was the entire year. Section 32(c)(3)(B)(iii)(III), before amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 107th Cong. section 303(e) (2001).

[76]Section 32(c)(3)(B); *see infra* Part II.C.

[77]A marriage certificate is also required where the qualifying child is a stepchild. IRS Form 886-H-EIC, "Supporting Documents for Taxpayers Claiming EIC on the Basis of a Qualifying Child(ren)" (2003) (hereinafter IRS Form 886-H-EIC).

[78]For qualifying child claims based on a permanently and totally disabled individual of any age, a letter from the child's doctor, other healthcare provider, or any other social service program verifying that the child is permanently and totally disabled ordinarily will provide adequate proof. *See* IRS Form 886-H-EIC, *supra* note 77. Various versions of IRS Form 886 addressing the EIC, Head of Household, or Dependency Exemptions generally accompany the initial contact letter from the IRS notifying the taxpayer that his or her income tax return is under examination.

[79]Despite these documentation requirements, in *Coats v. Commissioner*, T.C. Memo. 2003-78, *Doc 2003-7047, 2003 TNT 53-9*, the taxpayer was able to claim his daughter as a qualifying child despite school records showing the daughter's address to be the same as her mother's. The Tax Court found that the taxpayer successfully explained the discrepancy in the school record, arguing that his daughter lived with him because her mother's residence was located in a volatile neighborhood during the tax year at issue and the taxpayer did not want to change his daughter's school. The Tax Court stated that under the circumstances, more weight was afforded to the taxpayer's testimony than to the school records.

[80]IRS Form 886-H-EIC, *supra* note 77; *see also* Georgia University College of Law Tax Clinic Web site for a good summary of the EITC rules and requirements and a list of supporting documents to submit on IRS audit, available at http://www.law.gsu.edu/taxclinic/Earned_Income_Credit.htm.

[81]Section 152(c)(4)(A)(i).

[82]Section 152(c)(4)(B).

the qualifying child.[83] Because those tiebreaker rules apply only if more than one taxpayer actually claims an individual to be a qualifying child, taxpayers that are eligible to claim an individual as a qualifying child can elect among themselves who will actually claim the qualifying child.

Compounding confusion for all concerned, the qualifying child rules have been subject to significant change. For tax years beginning before 2005, a taxpayer claiming a sibling, stepsibling, or a descendant of that individual (that is, a niece or nephew), or an eligible foster child, as a qualifying child must meet the additional requirement of caring for that individual as his or her own child.[84] Neither the code nor the regulations define how a taxpayer cares for a child as his or her own. Therefore, courts have assessed the facts and circumstances of a particular case to determine whether a taxpayer meets that requirement. For example, in *Barajas v. Commissioner*,[85] the Tax Court found that a taxpayer was entitled to claim his younger siblings as qualifying children when the taxpayer cared for his siblings in a parental capacity by being the primary source of financial support for the household and by taking on responsibilities such as disciplining his siblings and helping them with their homework. In other cases, the Tax Court has held that providing financial support alone does not rise to the level of caring for a child as the taxpayer's own.[86]

For tax years beginning before 2002, the tiebreaker rule was considerably less taxpayer friendly.[87] For those years, when an individual met the qualifying child definition with respect to more than one taxpayer, only the taxpayer with the highest AGI could claim an individual as a qualifying child, regardless of whether the taxpayer actually did so, or was for that matter even eligible to claim the EITC.[88] That rule frequently led to taxpayer hardship in three-generation households.

A related requirement is that the taxpayer claiming the EITC with a qualifying child cannot be the qualifying child of another taxpayer.[89] That issue also can easily arise in a three-generation household.

5. Married filing separately. The EITC generally is not available to any married individual who files a separate return. Section 7703(b) provides relief, however, in certain cases to individuals who are married but separated from their spouse. More specifically, section 7703(b) provides that a taxpayer who is married and files a separate return will not be considered as married if: (1) the taxpayer maintains as his or her home a household that is the principal place of abode for a dependent child for more than half of the tax year; (2) the taxpayer furnishes over half the cost of maintaining that household during the tax year; and (3) the taxpayer's spouse was not a member of that household during the last six months of the tax year.[90] If those conditions are satisfied, a married taxpayer filing separately may claim the EITC. This test for determining marital status also applies to head of household claims, as discussed further in Part II.D, below.[91]

> ***Compounding confusion for all concerned, the qualifying child rules have been subject to significant change.***

In an EITC audit in which marital status is an issue, unmarried status may be evidenced by a divorce decree or separation agreement if the taxpayer is divorced or legally separated. While actual marital status is relatively easy to prove when the taxpayer is divorced or legally separated, proving "considered unmarried" status under section 7703(b) is more difficult. For a taxpayer attempting to prove unmarried status, the IRS may consider any of the following to be adequate proof: a lease agreement, utility bills, or a letter from clergy or from a local social services agency showing that the taxpayer's spouse did not live with the taxpayer during the last six months of the tax year.[92]

Marital status occasionally is the subject matter of litigation. The courts have determined marital status in these cases by assessing the facts and circumstances of a particular case. For example, in *Williams v. Commissioner*,[93] the Tax Court found that a taxpayer qualified for unmarried status despite the fact that his spouse continued to use the same mailing address as the taxpayer and had left various items of personal property, including clothing, jewelry, and furniture at the taxpayer's residence. Noting that the determination of marital status under section 7703(b) is a question of fact, the Tax Court found the testimony of the taxpayer and his spouse to be credible and concluded that the taxpayer qualified for unmarried status because his spouse moved out of his residence in April of the tax year at issue (that is, more than six months before the end of the tax year).[94]

However, in *Madrigal v. Commissioner*,[95] the Tax Court denied a claim of unmarried status when it found

[83]Section 152(c)(4)(A)(ii).

[84]Section 32(c)(3)(B) (as in effect for tax years beginning before January 1, 2005); *see also supra* note 72.

[85]T.C. Summ. Op. 2002-59, *Doc 2002-12846, 2002 TNT 103-16*.

[86]*See Mares v. Commissioner*, T.C. Memo. 2001-216, *Doc 2001-21648, 2001 TNT 157-6*; *Smith v. Commissioner*, T.C. Memo. 1997-544, *Doc 97-33120, 97 TNT 237-7*.

[87]*See* section 32(c)(1)(C), as in effect before amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 107th Cong. section 303(f) (2001).

[88]*Id.*

[89]Section 32(c)(1)(B).

[90]Estranged spouses who are married and continue to live under the same roof are considered members of the same household and must file joint returns to claim the EITC. *See Chiosie v. Commissioner*, T.C. Memo. 2000-117, *Doc 2000-10190, 2000 TNT 67-10*.

[91]Conditions (1) and (2) of claiming unmarried status will be discussed in Part II.D, regarding head of household filing status.

[92]IRS Form 886-H-HOH, "Supporting Documents for Head of Household Filing Status" (2003) (hereinafter IRS Form 886-H-HOH).

[93]T.C. Summ. Op. 2001-12, *Doc 2001-4891, 2001 TNT 33-20*.

[94]*Id.*

[95]T.C. Memo. 1998-345, *Doc 98-29237, 98 TNT 189-9*.

inconsistent testimony between the taxpayer and her husband. In particular, the Tax Court noted that the husband's testimony that he lived at a different residence from the taxpayer conflicted with the address stated on his federal income tax return. The Tax Court also noted that a lease produced by the taxpayer to prove that her husband lived at a different residence was not credible when neither the taxpayer nor her husband could remember who prepared the lease and when they gave conflicting testimony as to the amount of rent paid.[96]

6. EITC requirements for individuals without a qualifying child. For taxpayers who do not have a qualifying child, in addition to satisfying the requirements applicable to all taxpayers (listed in the introductory paragraph of Part II.B, above), a taxpayer must also: (1) be at least age 25 but under age 65;[97] (2) not be the dependent of another person;[98] and (3) have lived in the United States for more than half of the tax year.[99]

C. Dependency Exemptions

Under section 151(c), a taxpayer may claim a deduction for each individual who is a ''dependent'' of the taxpayer. The WFA significantly changed the definition of dependent. Section 152(a) now defines a dependent as a ''qualifying child'' or a ''qualifying relative.'' The amended definition applies for tax years beginning after 2004. The sections that follow describe the current requirements for meeting the definition of qualifying child and qualifying relative, along with the significant changes from prior law.

1. Qualifying child. To claim a qualifying child as a dependent, the taxpayer must satisfy the same three tests discussed above for purposes of claiming the EITC (that is, the relationship, age, and residency tests).[100] In addition to satisfying the EITC requirements, to be eligible for the dependency exemption, the qualifying child must *not* have provided over half of his or her own support for the calendar year in which the taxpayer's tax year begins.[101] The change made by the WFA is quite drastic in that regard. Previously, even a parent was required to prove he or she provided more than half the child's support to qualify for the dependency exemption. Although that requirement seems simple, it often is highly problematic in practice.[102] In cases involving a qualifying child, it will be far easier to prove the child did not provide more than half of his or her support than to prove that the parent provided more than half the support for such child. That welcome change in law will make the dependency exemption available in many sympathetic cases in which it was previously denied. When two or more taxpayers claim the same qualifying child as a dependent, the same tiebreaker rules used for the EITC apply.[103]

2. Qualifying relative. If an individual fails to satisfy the requirements to be treated as a qualifying child, the taxpayer may still be able to claim a dependency exemption if that individual is a qualifying relative. The qualifying relative provision generally permits taxpayers to continue applying the dependency exemption rules in effect before the changes made by the WFA.[104] The definition of a qualifying relative covers a broader category of individuals than the definition of qualifying child. The category includes a taxpayer's child, grandchild, sibling, stepsibling, niece or nephew, parents, or ancestors of the taxpayer's parents, stepparents, aunt or uncle, son- or daughter-in-law, father- or mother-in-law, brother- or sister-in-law, and any other individual who is not the taxpayer's spouse, and who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.[105]

For an individual to be a qualifying relative, the following additional conditions must be met: (1) the individual must not be a qualifying child of the taxpayer or of any other taxpayer;[106] (2) the individual's gross income for that tax year must be less than the exemption amount set forth in section 151(d);[107] and most significantly, (3) the taxpayer must meet the support test for the individual, as applicable under the pre-WFA definition of dependent.[108]

3. Support test. The support test for claiming a qualifying relative as a dependent is the same as the support test for

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[96]*Id.*; *see also Diaz v. Commissioner*, T.C. Memo. 2004-145, *Doc 2004-12689, 2004 TNT 118-12* (unmarried status denied when taxpayer gave conflicting testimony as to when his wife moved out and did not submit any other reliable evidence); *Newsom v. Commissioner*, T.C. Memo. 1999-297, *Doc 1999-28886, 1999 TNT 172-92* (unmarried status denied when taxpayer gave conflicting testimony and evidence as to whether his wife lived with him at any point during the tax year at issue).

[97]Section 32(c)(1)(A)(ii)(II). This age limitation is aimed at preventing students and retired persons from claiming the EITC when those individuals generally receive other sources of support to compensate for their low income. *See* S. Rep. No. 94-36, at 33 (1975).

[98]Section 32(c)(1)(A)(ii)(III).

[99]Section 32(c)(1)(A)(ii)(I). The United States includes the 50 states and the District of Columbia. Puerto Rico is not included, but some military locations abroad are included.

[100]For tax years beginning before 2005, a taxpayer does not need to satisfy the residency test, but must meet a support test to claim a dependency exemption based on a qualifying child.

[101]Section 152(c)(1)(D). Note that this requirement does not apply to claiming a qualifying child for EITC purposes.

[102]The definition of support is discussed in Part II.C.3, *infra*.

[103]*See supra* text accompanying notes 81-83 and 87-88.

[104]H.R. Conf. Rep. 108-696, at 38 (2004).

[105]Section 152(d)(2). In general, a taxpayer will need applicable birth certificates and marriage certificates to verify his or her relationship to the qualifying relative if that relative is not the taxpayer's natural or adopted child. IRS Form 886-H-DEP, ''Supporting Documents for Dependency Exemptions'' (2003) (hereinafter IRS Form 886-H-DEP).

[106]For example, a taxpayer cannot claim the same individual as both a qualifying child and a qualifying relative, and a taxpayer cannot claim as a qualifying relative an individual that is claimed as a qualifying child of another taxpayer. The significance of this puzzling-sounding requirement is apparent when more than one taxpayer claims an individual as a dependent.

[107]The exemption amount is indexed for inflation. Section 151(d)(4). For 2004 the exemption amount is $3,100. Rev. Proc. 2003-85, 2003-2 C.B. 1184.

[108]Section 152(d)(1)(C). The residency test applicable under prior law, as discussed in Part II.B.4, does not have to be satisfied, however.

claiming *any* dependent for tax years beginning before 2005. The support test is met if the taxpayer provides over half of the qualifying relative's support for the calendar year in which the tax year begins.[109] Support for those purposes include ''household expenses'' and ''personal expenses.'' Household expenses are expenses that are not directly related to any particular member of the household, such as lodging, food, utilities, and household repairs.[110] Personal expenses are expenses directly related to supporting the individual for whom the exemption is claimed. Personal expenses include amounts spent on that individual's clothing and education, travel and recreation, and medical and dental expenses not covered by insurance.[111] Whether the taxpayer meets the support test for a qualifying relative is determined by comparing the amount the taxpayer contributed to the qualifying relative's support with the entire amount of support the qualifying relative received from all sources, including from the qualifying relative's own funds. Most significantly, public assistance such as welfare payments, food stamps, and government housing subsidies are considered support provided by a third party, not the taxpayer.[112]

Failure to meet the support test is a leading cause of IRS denials of dependency exemptions on audit. In controversies about whether the support test is met, the IRS may want the taxpayer to provide the following documentation to determine whether a taxpayer satisfies the support test: (1) for cost of lodging, copies of leases, canceled checks or receipts showing rental expenses, or a statement showing fair rental value of the taxpayer's home; (2) for other household expenses such as utilities and repairs, canceled checks or receipts showing amounts paid by the taxpayer; and (3) for personal expenses of the qualifying relative, such as travel, clothing, and medical or dental care, canceled checks or receipts showing amounts paid by the taxpayer.[113] If the taxpayer received any public assistance, such as a housing subsidy or food stamps, a statement from any government agency verifying the amount and type of benefits received by the taxpayer and the taxpayer's dependent may be required.[114]

Failure to meet the support test is a leading cause of IRS denials of dependency exemptions on audit.

4. Special support rules. Section 152(e) provides a special rule for divorced or legally separated parents claiming a qualifying child or a qualifying relative as a dependent. Generally, a child may be treated as a dependent of the noncustodial parent if: (1) the child receives more than half of his or her support during the calendar year from parents and (2) the child is in the custody of one or both of the parents for more than half the calendar year.[115] Also, the noncustodial parent must be granted the right to claim the exemption by a decree of divorce or separate maintenance or a written agreement between the parents stating that: (a) the noncustodial parent is entitled to the

[109]*Id.* To add to the confusion, the support test for claiming a dependency exemption differs from the support test for claiming head of household filing status. *See* text accompanying notes 125-126 *infra*.

[110]IRS Publication 17, *Your Federal Income Tax*, at 32 (2004) (hereinafter IRS Pub. 17). The amount of household expenses attributable to the qualifying relative is determined by dividing the total amount of household expenses by the number of persons living in the household. In the case of lodging, if the taxpayer owns his or her home, the taxpayer is deemed to have incurred an amount equal to the fair rental value of the home. Treas. reg. section 1.152-1(a)(2)(i).

[111]IRS Pub. 17, *supra* note 110, at 32.

[112]*See, e.g.*, *Jones v. Commissioner*, T.C. Memo. 1998-444, *Doc 98-37928, 98 TNT 245-9* (in denying dependency exemptions for taxpayer's daughter and granddaughters, the Tax Court noted that the taxpayer's daughter and granddaughters received support of about $600 per month from the city of Philadelphia in the form of public housing assistance; those amounts constituted support paid by third parties). When public assistance for lodging is provided in kind, the fair market value of that lodging can become something of an imponderable. Consider, for example, what is the fair market value of a night's stay in a homeless shelter.

[113]IRS Form 886-H-DEP, *supra* note 105. How crucial supporting documents are to a taxpayer's case ultimately may vary. For example, in *Lear v. Commissioner*, T.C.M. 2004-253, *Doc 2004-21634, 2004 TNT 217-13,* the Tax Court sustained the IRS's determination that the taxpayer was not entitled to a dependency exemption for his daughter despite finding the taxpayer's testimony that he made various expenditures to support his daughter credible. The Tax Court noted that the taxpayer failed to establish the total amount of support provided for his daughter from other sources. *See also Joseph v. Commissioner*, T.C. Summ. Op. 2004-137, *Doc 2004-19816, 2004 TNT 196-14* (denying dependency exemption when taxpayer had no records to establish amounts he claimed to have paid in support of his daughter and when the total support he allegedly paid exceeded his reported taxable income). However, in *Taylor v. Commissioner*, T.C. Summ. Op. 2002-25, *Doc 2002-7743, 2002 TNT 61-6,* the Tax Court upheld the taxpayer's EITC, dependency, and head of household claims where the IRS had disallowed those claims but challenged only whether the taxpayer had legal custody of his children. The Tax Court stated that it found the taxpayer's testimony regarding his relationship with his children credible and despite ''scant evidence in the record concerning the financial support of the children, the cost of maintaining their household, or the income of the children's mother,'' the taxpayer was entitled to the claimed tax benefits because the IRS conceded the other issues. Note that because those cases concerned pre-2002 tax years, whether another taxpayer with a higher AGI could claim the same child for head of household filing status and the dependency exemption was also a consideration.

[114]IRS Form 886-H-DEP, *supra* note 105; *see also* Georgia University College of Law Tax Clinic Web site, available at http://www.law.gsu.edu/taxclinic/Dependency_Exemptions.htm.

[115]Section 152(e)(1). The parents must be: (a) divorced or legally separated, (b) separated under a written separation agreement, or (c) living apart at all times during the last six months of the calendar year.

deduction or (b) the custodial parent will sign a written declaration that he or she will not claim the child as a dependent for the tax year.[116]

As if only to add further complexity, the above rule does not apply to situations involving multiple support agreements. In that case, a taxpayer is deemed to have provided more than half the support of a qualifying relative if: (1) no one person contributed more than half the support of the qualifying relative; (2) more than half of the qualifying relative's support was contributed by two or more persons, each of whom would be entitled to a dependency exemption but for the support test; (3) each person in (2) who provided more than 10 percent of the qualifying relative's support files a written declaration that he or she will not claim the qualifying relative as a dependent; and (4) the taxpayer contributed more than 10 percent of the qualifying relative's support.[117]

D. Head of Household Filing Status

A taxpayer is eligible to claim head of household filing status only if the taxpayer is unmarried (or considered unmarried) and entitled to claim a dependency exemption.[118] Also, the taxpayer must maintain as his or her home a household that constitutes the principal place of abode for a qualifying child or qualifying relative who is a member of the taxpayer's household for more than half of the tax year,[119] provided that in the case of a qualifying child, the child is not married at the close of that tax year.[120] A taxpayer is considered to maintain a household if the taxpayer provides over half the cost of keeping up a home for the tax year.[121]

Another maddening inconsistency in similar rules is that the maintenance of a household test for these purposes differs from the support test used to determine whether a taxpayer is eligible for the dependency exemption. Under the maintenance of a household test, the cost of keeping up a home is broadly defined as ''the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants.''[122] Those expenses include amounts the taxpayer paid for property taxes, mortgage interest expense, rent, utilities, upkeep and repairs, property insurance, food consumed on the premises, and other household expenses.[123] If the total amount the taxpayer paid for those items is more than the aggregate total of the amounts paid by others, the taxpayer satisfies the requirement of paying more than half the cost of maintaining a home.[124] While some of the expenses used to calculate the cost of keeping up a home overlap with

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[116]Section 152(e)(2). Under section 152(e)(1), for tax years beginning before 2005, the custodial parent was deemed to provide more than half the child's support for the calendar year. *See, e.g.*, *Fritscher v. Commissioner*, T.C. Summ. Op. 2001-45, *Doc 2001-9744, 2001 TNT 165-15* (holding that taxpayer was not entitled to dependency exemptions for his children because their mother had legal custody of them for the greater portion of the tax year and therefore the children's mother was deemed to have provided more than half of their support despite final divorce decree granting custody of the children to the taxpayer). However, in *McCullar v. Commissioner*, T.C. Memo. 2003-272, *Doc 2003-20707, 2003 TNT 181-17,* the Tax Court found that the taxpayer was entitled to a dependency exemption for his daughter despite the fact that his ex-wife had primary custody where the taxpayer kept a detailed account of the time he spent with his daughter for the tax year at issue. *See also King v. Commissioner*, 121 T.C. 245 (2003), in which the Tax Court held that the special support rules apply to unmarried parents who lived apart at all times during the years at issue. In that case, the biological parents of a child were never married and the mother released her right to claim her daughter as a dependent to the daughter's father. In holding that the special support rules apply to *never-married* parents, the Tax Court concluded that the exception permitting a noncustodial parent to claim a dependency exemption applied despite records showing that the mother provided more than half of the daughter's support and despite the fact that the daughter lived with the mother at all times during the years at issue.

[117]Section 152(d)(3). For tax years beginning before 2005, a written declaration by persons who provided more than 10 percent of a dependent's support may be provided on IRS Form 2120. For tax years beginning after 2004, the appropriate form and manner in that such declaration should be made will be prescribed by forthcoming Treasury regulations.

[118]Section 2(b)(1). The taxpayer also cannot be a ''surviving spouse.'' Generally, a surviving spouse is a taxpayer whose spouse died during either of the two tax years immediately preceding the current tax year and who maintains as her home a household that constitutes the principal place of abode for a dependent who is a member of that household and is the

(Footnote continued in next column.)

taxpayer's child or stepchild for whom the taxpayer is entitled to claim a dependency exemption. *See* section 2(a)(1).

[119]A taxpayer must reside in the same household as his or her children to claim head of household filing status. *See* Treas. reg. section 1.2-2(c)(1). For example, in *Roberts v. U.S.*, 337 F. Supp. 1188 (N.D. Cal. 1971), the taxpayer was denied head of household filing status despite being the sole source of support for her daughter and grandchildren where the taxpayer maintained two residences but only lived in one while her daughter and grandchildren lived in the other. *See also* Rev. Rul. 72-43, 1972-1 C.B. 4 (stating that the IRS will grant head of household filing status only to a taxpayer who lives in the same household as his dependent and provided that that household is the principal place of abode for the taxpayer and his dependent). However, that requirement does not apply to head of household claims based on the taxpayer's *parents* as dependents. Thus, the taxpayer's parents are not required to live with the taxpayer for the taxpayer to claim head of household filing status. Section 2(b)(1)(B).

Note, however, that two taxpayers who live in one house with their dependent children may both claim head of household filing status if they each pay more than half the cost of maintaining their respective households, regardless of their shared physical space. *See* SCA 1998-041, *Doc 98-36799*, *98 TNT 250-22* (Apr. 3, 1998).

[120]Section 2(b)(1)(A).

[121]Section 2(b)(1) flush language.

[122]Treas. reg. section 1.2-2(d).

[123]*Id.*; *see also* IRS Pub. 17, *supra* note 110, at 26.

[124]For example, in *Ramirez-Ota v. Commissioner*, T.C. Summ. Op. 2002-27, *Doc 2002-7746, 2002 TNT 61-5,* the Tax Court denied head of household filing status to a taxpayer who lived with her children in her former in-laws' residence and in her brother's home at varying times during the two tax years at issue. Despite the taxpayer's claim that she paid monthly rent, utilities, and cable bills while living at her brother's house as well as expenses for her children's clothing and school supplies, the court found that the taxpayer was unable to establish that

(Footnote continued on next page.)

items that are included in the support test (for example, shared expenses such as utilities and upkeep and repairs), the maintenance test excludes those expenses that may be viewed as personal to a particular member of the household. For example, items such as clothing, education, medical treatment, vacations, life insurance, and transportation are excluded from the maintenance test but included in the support test.[125] To add to the confusion, whereas the fair rental value of lodging is used in making calculations under the support test for claiming a dependency exemption, only actual outlays are used for purposes of making calculations under the household maintenance test.[126]

In general, the documents used to verify a taxpayer's right to a dependency exemption based on a qualifying child or qualifying relative will support a claim of head of household status in an audit. Also, because marital status is relevant, a divorced or legally separated taxpayer may need to submit his or her divorce decree or separation agreement.[127] If the taxpayer is married but claims to be considered unmarried under section 7703(b), the same documentation used to prove this status for purposes of claiming the EITC may be needed.[128] Finally, to prove that the taxpayer provided over half the cost of keeping up a home under the household maintenance test, the taxpayer may need copies of: (1) rent and utility bills; (2) receipts showing payment of property taxes, property insurance, and mortgage interest expense; and (3) receipts for food consumed on the premises and other household expenses, to the extent that those documents were not already required for claiming a dependency exemption.[129]

E. Child Tax Credit

1. General history. The child tax credit, provided for under section 24 enacted in 1997,[130] is a partially refundable credit available to taxpayers with qualifying children. According to the legislative history, the dependency exemptions were inadequate in reducing tax liability as the family size increases,[131] and Congress "believe[d] that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values."[132] Thus, unlike the EITC, the number of qualifying children for whom the child credit may be claimed is unlimited.

2. Overview. The child credit offers a credit of up to $1,000 for each qualifying child claimed as a dependent.[133] While the maximum amount of $1,000 was originally set to be reduced starting in 2005, the WFA extended the $1,000 maximum through tax years beginning in 2010,[134] when it will then sunset.[135] A portion of the child credit is refundable if certain requirements are met, as discussed further below.

To claim the child credit, the taxpayer must have a qualifying child.[136] For tax years beginning after 2004, the definition of qualifying child is the same as the definition used for purposes of claiming dependency exemptions,[137] with two exceptions: (1) the child must be under age 17 as of the close of the calendar year in which the tax year of the taxpayer begins and (2) the child must be a U.S. citizen or resident alien.[138] Before the WFA, and applicable to tax years beginning before 2005, the definition of qualifying child was the same as the definition used for the EITC,[139] except the child had to be under age 17 and able to be claimed as a personal exemption under section 151.

There are certain limitations on the availability of the child credit discussed further below.

3. Limitations based on income. The available child credit is phased out at income levels above certain thresholds. The relevant income computation for this purpose is the modified adjusted gross income (MAGI). MAGI is AGI, increased by: (1) any income previously excluded from Puerto Rico, (2) foreign earned income, and (3) any income previously excluded for bona fide residents of American Samoa.[140]

For married taxpayers filing jointly, the phaseout begins with MAGI of $110,000.[141] For single, head of household,[142] or qualifying widower taxpayers, the phaseout begins at $75,000.[143] For married taxpayers filing separately, the phaseout begins at $55,000.[144] In each case, the credit is reduced by $50 for each $1,000 by which the taxpayer's MAGI exceeds the relevant limit.[145] The threshold amounts are not indexed for inflation.

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she provided more than half the cost of maintaining a household. The court noted that there was "no evidence as to the annual cost of maintaining [the taxpayer's] household; that is, mortgage payments, utility bills, telephone bills, food or grocery bills, and other expenses relating to the household."

[125]*See* IRS Pub. 17, *supra* note 110, at 26.

[126]*Id*.

[127]IRS Form 886-H-HOH, *supra* note 92; *see also* Georgia University College of Law Tax Clinic Web site, available at http://www.law.gsu.edu/taxclinic/Head_of_Household.htm.

[128]*See supra* Part II.B.5. A taxpayer who has never been married does not need to submit any documents to prove single status. IRS Form 886-H-HOH, *supra* note 92.

[129]IRS Form 886-H-HOH, *supra* note 92; *see also* SCA 1998-041 (noting such documents as acceptable verification of the taxpayer's expenses in maintaining a home).

[130]Taxpayer Relief Act, Pub. L. No. 105-34, 101, 111 Stat. 788, 796-99 (adding section 24) (1997).

[131]H.R. Rep. No. 105-148, at 310 (1997); *see also* Zelenak, Lawrence, "Redesigning the Earned Income Tax Credit as a Family Size Adjustment to the Minimum Wage," 57 *Tax L. Rev.* 301, 336-337 (2004).

[132]H.R. Rep. No. 105-148, at 310 (1997).

[133]Section 24(a).

[134]WFA, *supra* note 40, section 101.

[135]P.L. 107-16, section 901(a), Sunset of Provisions of Act.

[136]Section 24(c).

[137]Section 152(c); *see* Part II.D, *supra*.

[138]Section 24(c).

[139]*See* Part II.B.4, *supra*.

[140]Section 24(b)(1).

[141]Section 24(b)(2)(A).

[142]*See supra* Part II.D for the head of household status determination test.

[143]Section 24(b)(2)(B).

[144]Section 24(b)(2)(C).

[145]Section 24(b)(1).

4. Limitations based on tax liability/limited refundability. Like other personal credits, the child credit generally is subject to a limitation based on tax liability. However, special provisions apply that mitigate the limitations applied to the child credit and of making a portion of the child credit refundable. Because of significant changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the computation of the limits differs for tax years beginning before 2006 and for tax years beginning after 2005.[146]

a. Tax liability limitation. For tax years beginning after 2005, the child credit may not exceed the excess of the adjusted tax liability over the ''specified credits'' for the tax year. Adjusted tax liability is the sum of the regular tax liability and the minimum tax liability.[147] ''Specified credits'' for this purpose include the household and dependent care credit, the elderly and disabled credit, the home mortgage interest credit, the education credit, and the foreign tax credit.[148]

For tax years beginning before 2006, the aggregate amount of specified credits for any one tax year could not exceed the sum of the regular tax liability less any foreign tax credit and the minimum tax.[149]

b. Refundable portion. For tax years beginning before 2001, a portion of the child credit was refundable only to families with three or more children. The amount refundable was computed slightly differently[150] than the current law, which, as amended by EGTRRA, allows a portion of the credit to be refundable without regard to the number of qualifying children.[151]

The computation of the refundable amount for tax years beginning after 2000 is as follows. The aggregate specified credits allowable will be increased (thus allowing an increase in the refundability of the child credit) by the lesser of: (a) the child credit that would be allowed without taking into account any limitations or (b) the amount by which the aggregate amount of credits allowed would increase if the tax liability limitation applicable to the tax year were increased by the greater of either: (i) 15 percent of the taxpayer's taxable earned income in excess of $10,000 or (ii) in the case of a taxpayer with three or more qualifying children, the excess of the taxpayer's ''Social Security taxes'' for the tax year over the taxpayer's EITC for the tax year.[152]

The code provides for inflation adjustments for tax years beginning in a calendar year after 2001. The $10,000 base amount is increased annually by the cost of living adjustment.[153] For tax years beginning in 2004, the amount is $10,750.[154] For tax years beginning in 2005, the amount is $11,000.[155]

''Social Security taxes'' for this purpose include the amount of Social Security taxes withheld from wages, railroad retirement taxes, 50 percent of self-employment taxes for the tax year, 50 percent of any railroad employee representative taxes, and taxes paid under agreements entered into by American employers for foreign affiliates.[156] ''Social Security taxes'' do not include the amount of the tax refund entitlement due to withholding from multiple employers.[157]

The computation used to determine the refundable portion of the child credit is complex, but generally speaking, the refundable portion will never exceed the maximum possible amount of the child credit.[158] For example, if a family has four qualifying children, they would be potentially eligible for $4,000 of child credit. Assuming that this family's tax liability limitation caps their credit at $500, the amount of refundable child credit would then be increased by a maximum of $3,500.

F. Compliance Provisions

1. Penalties and recertification requirements. The Taxpayer Relief Act of 1997 included several provisions aimed at improving taxpayer compliance with the EITC rules. Specifically, section 32(k)(1) was enacted to deny the EITC for 10 years to taxpayers who fraudulently claimed the credit[159] and for two years to taxpayers who were reckless or who acted with intentional disregard of the rules and regulations.[160] That penalty applies in addition to any fraud or accuracy-related penalty that may also be imposed on the taxpayer.[161] Whether a taxpayer fraudulently claimed the EITC or was reckless or acted with intentional disregard of the rules and regulations is determined on the basis of the facts and circumstances of each case.[162] For purposes of imposing the two-year EITC disallowance, a taxpayer's failure to respond or adequately respond to a request by the IRS to

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[146]P.L. 107-16.

[147]Section 24(b)(3)(A).

[148]Section 24(b)(3)(B).

[149]Section 26(a)(2).

[150]Section 24(d)(1) (amended 2001). The refundable portion was available only to those families with three or more children. The calculation was similar to the calculation as amended by EGTRRA.

[151]P.L. 107-16.

[152]Section 24(d).

[153]Calculations can be found in section 24(d)(3) and flush language.

[154]Rev. Proc. 2003-85, 2003-2 C.B. 1184.

[155]Rev. Proc. 2004-71, 2004-50 IRB 970, *Doc 2004-22303, 2004 TNT 225-10*.

[156]Section 24(d)(2).

[157]*Id.*

[158]*Id.*

[159]Section 32(k)(1)(B)(i).

[160]Section 32(k)(1)(B)(ii).

[161]Under section 6663, a penalty of 75 percent of the portion of underpayment attributable to fraud may be imposed on the taxpayer and under section 6662, a penalty of 20 percent of the portion of the underpayment attributable to negligence or intentional disregard may be imposed on the taxpayer. In SCA 200113028 (Mar. 30, 2001), *Doc 2001-9198, 2001 TNT 63-40,* the IRS clarified that while a final determination of fraud or reckless or intentional disregard must be made before imposing the 10- or 2-year disallowance, the statute does not require that a fraud or accuracy penalty also be asserted to deny the EITC for the disallowance period.

[162]SCA 200245051 (Nov. 8, 2002), *Doc 2002-25021, 2002 TNT 218-75*.

substantiate an EITC claim alone is not sufficient to be considered reckless or acting with intentional disregard.[163]

The Taxpayer Relief Act of 1997 also enacted a ''recertification requirement'' for taxpayers who were denied the EITC in a prior year.[164] Generally, a taxpayer must file IRS Form 8862, ''Information to Claim Earned Income Credit After Disallowance,'' to demonstrate the taxpayer's eligibility for the EITC after the taxpayer's claim in a prior year was reduced or disallowed for any reason other than for a math or clerical error.[165] Once the taxpayer has demonstrated his eligibility and is recertified, the taxpayer is not required to file Form 8862 in future tax years unless the IRS denies the taxpayer's EITC claim again.[166] Failure to file Form 8862 will result in automatic disallowance of the EITC as a math error (which does not carry with it any of the procedural measures required for other types of audit adjustments). The IRS's current practice is that the filing of a Form 8862 will trigger an automatic examination.

Finally, the Taxpayer Relief Act of 1997 imposed due diligence requirements on paid preparers of tax returns who claim the EITC on behalf of a taxpayer.[167] Among other due diligence requirements,[168] the paid preparer must not know, or have reason to know, that any information used by the preparer in determining the taxpayer's eligibility for the EITC is incorrect.[169] In that regard, the paid preparer ''may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete.''[170] Generally, failure to satisfy the due diligence requirements results in a penalty of $100 for each failure.[171]

2. EITC certification programs. In an initiative to improve EITC compliance, the IRS announced a pilot certification program on June 13, 2003, to be conducted during the 2004 filing season.[172] The goal of the certification program was to identify erroneous EITC claims before they are paid. Noting that EITC noncompliance is high in part because it is difficult for the IRS to verify whether a child claimed by a taxpayer meets the residency and relationship tests before the credit is paid, the certification program required certain taxpayers, identified (based on IRS research) as ones that are more likely to erroneously claim a qualifying child, to demonstrate that they meet the residency requirement for a claimed child.[173] Specifically, taxpayers who were selected to participate in the certification program were asked to complete a form setting forth identifying information and to provide certain documentation, such as a third-party affidavit or school letter, to establish that the taxpayer met the residency requirement for a qualifying child.[174] Taxpayers were required to provide this documentation with their tax returns and failure to do so at the time of filing and after a second request by the IRS would result in a denial of the EITC.[175] Preliminary results from the 2004 certification program indicate that of the 25,000 taxpayers selected to participate, about 65 percent filed their returns and claimed the credit, about 20 percent claimed no credit, and about 15 percent had not yet filed a return as of May 2004.[176] The IRS has cited those results to show that requiring additional documentation for the certification program significantly reduced the number of taxpayers claiming the credit.[177]

Whereas the 2004 certification program involved a sample of 25,000 EITC claimants from across the country, a new certification program for the 2005 filing season attempts to determine what happens when certification is required in a metropolitan area that is representative of the typical EITC-claiming community.[178] The IRS chose Hartford, Conn., to conduct the program, stating that the city closely resembles the national demographics and will allow the IRS to gauge the effect of a community's support structure in dealing with the certification requirements.[179] About one-third of the 25,000 EITC claimants selected to participate in the 2005 certification program will come from Hartford. In addition to focusing on a single community, the IRS is also encouraging taxpayers who are selected to participate in the 2005 program to certify in advance of filing their tax returns that a claimed child meets the EITC residency requirement.

While the IRS insists that Hartford was selected as the focus of the 2005 certification program because its population reflects the EITC population nationwide, the city of Hartford along with two individual plaintiffs filed a class-action suit against the IRS in November 2004, asserting, among other claims, that the certification program violates Hartford taxpayers' civil rights because it discriminates against persons of color, deprives the selected Hartford taxpayers of property without due process, and is illegal because it is not authorized under the code.[180] As of the writing of this report, the Hartford lawsuit has not been resolved. Accordingly, whether the EITC certification programs are legal, fair, or effective remains to be seen.

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[163]*Id.*

[164]Section 32(k)(2).

[165]Treas. reg. sections 1.32-3(a), (c).

[166]Treas. reg. section 1.32-3(a).

[167]Section 6695(g).

[168]*See* Treas. reg. section 1.6695-2(b) for specific requirements a paid preparer must satisfy.

[169]Treas. reg. section 1.6695-2(b)(3).

[170]*Id.*

[171]Treas. reg. section 1.6695-2(a).

[172]IRS Announcement 2003-40, 2003-40 C.B. 1132, *Doc 2003-14495, 2003 TNT 115-6*; *see also* IRS News Release IR-2003-97 (Aug. 6, 2003), *Doc 2003-18131, 2003 TNT 151-5* (reducing pilot sample from 45,000 to 25,000 taxpayers).

[173]IRS Announcement 2003-40, 2003-40 C.B. 1132.

[174]*Id.; see also* IRS Form 8836, ''Qualifying Children Residency Statement'' (2004).

[175]*Supra* note 173.

[176]Kenney, ''Community Lashes Out,'' *supra* note 29.

[177]*Id.*

[178]*Id.*

[179]*Id.; see also* Kenney, ''Hartford Goes to Court,'' *supra* note 48.

[180]*City of Hartford v. Commissioner,* No. 3:04CV20195 (D. Conn. Nov. 29, 2004).

III. Innocent Spouse Relief

Married taxpayers who file a joint tax return are jointly and severally liable for any tax, interest, or penalties due on the joint return. With great frequency among low-income taxpayers, married couples become estranged after filing joint returns, and on examination of a previously filed joint return, it is determined that there is a tax deficiency to be paid. Limitless variations of sad stories could be told. One does not need a great deal of imagination, however, to envision numerous circumstances in which it would simply be unfair for the IRS to collect any of the unpaid tax from one of the spouses (whom we shall call the Innocent Spouse, while we call the other spouse the Guilty Spouse). Happily at this intersection of tax law and life, the tax law yields, although quite typically, only after requiring us to work through a maze of rules and exceptions.

Generally referred to as ''innocent spouse relief,'' relief may be granted to a spouse from liability for any amounts owing under a joint tax return. Relief may be granted under any one of three approaches under section 6015.[181] First, section 6015(b) provides relief for a spouse who has an understatement of tax on a joint return and that did not know and did not have reason to know of the understatement.[182] Relief under this provision is formally known as ''innocent spouse relief'' (Innocent Spouse Relief). Second, under section 6015(c), relief is available for taxpayers who are no longer married or legally separated or who have lived apart for at least 12 months.[183] Relief under this section is formally known as ''separation of liability'' (Separation of Liability). Finally, under section 6015(f), a spouse who does not fulfill the requirements for Innocent Spouse Relief or Separation of Liability may seek relief on purely equitable grounds, known as ''equitable relief'' (Equitable Relief).[184]

The requirements for each of the three types of relief differ, and the exact relief available under each differs as well. A relatively recent revenue procedure and numerous court decisions are helpful in analyzing the requirements of each type of relief and in determining the best approach available for an individual.[185] This section explains the details of each type of relief, offers a comparison of the different approaches, and provides some practical guidance for assisting an Innocent Spouse seeking relief.

Before reviewing the specific requirements, note that the filing of a joint return is a prerequisite to requesting relief under each of the three approaches. If there is no joint return, there is no joint or several liability from which to be relieved. It may be possible for the Innocent Spouse to prove that the return for which the liability is asserted is not a joint return. If a joint return is signed by the Innocent Spouse under legal duress, for example, no joint return is considered to have been filed and therefore there is no joint liability to be avoided.[186]

A. Innocent Spouse Relief

Innocent Spouse Relief is available if the Innocent Spouse proves: (1) a joint return was filed with an understatement of tax due to an erroneous item, (2) the Innocent Spouse did not know and did not have reason to know of the understatement, and (3) it would be unfair to hold the Innocent Spouse liable.[187]

1. The Innocent Spouse must have filed a joint return with an understatement due to erroneous items. The joint return must have an understatement of tax liability attributable to ''erroneous items.'' For an understatement to be attributable to an erroneous item, it must be due to income received by the Guilty Spouse that was not properly reported or characterized on the joint return, or to a deduction, credit, or basis incorrectly claimed by the Guilty Spouse.[188] For example, incorrectly characterizing income as capital gain rather than as ordinary income or improperly deducting certain expenses on a joint return may result in erroneous items. Penalties and interest are not erroneous items. Nor is a mere underpayment of a correctly computed tax liability an erroneous item.

2. The Innocent Spouse must show a lack of knowledge of the understatement. The second requirement for Innocent Spouse Relief is that the Innocent Spouse must prove that he or she does not have actual or constructive knowledge of the understatement.[189] All facts and circumstances are considered in determining an Innocent Spouse's knowledge.[190] The regulations provide limited examples of factors that may be considered. While actual knowledge should be readily apparent on an analysis of the facts, the tests that have been applied for constructive knowledge require more explanation.

In general, an Innocent Spouse has constructive knowledge of an understatement if a reasonable person

[181]A spouse who has filed a joint return is not entitled to relief in the following situations: there is a final decision of tax liability by a court of competent jurisdiction and the spouse's liability was raised as an issue or the spouse had the opportunity to raise it as an issue, or a spouse has entered into an offer in compromise or a closing agreement with the IRS for the liability, unless the closing agreement was entered in a proceeding relating to partnership items. IRS Publication 971, *Innocent Spouse Relief* (Revised March 2004) (hereinafter IRS Pub. 971).

[182]Section 6015(b).

[183]Section 6015(c).

[184]Section 6015(f).

[185]David Lee Rice, Gwindolyn K. Hight, and Todd Russell Reinstein, ''IRS and the Courts Provide Guidance for Taxpayers Seeking Relief as an Innocent Spouse,'' *Journal of Taxation*, August 2003 (hereinafter Rice, ''Guidance for Taxpayers'').

[186]Treas. reg. section 1.6015-4(d). The mere absence of a signature is not conclusive of the absence of a joint return, however. In *Collier v. Commissioner*, T.C. Memo. 2002-144, *Doc 2002-13917, 2002 TNT 112-16,* the Innocent Spouse did not sign the return but the court considered the facts and circumstances and determined that both spouses intended to file a single joint return. As a result, the Innocent Spouse was not relieved of joint and several liability for tax due on the joint return merely by reason of having failed to sign the return.

[187]Sections 6015(b)(1)(A)-(D).

[188]Treas. reg. section 1.6015-1(h).

[189]Section 6015(b)(1)(C). The burden is shifted to the IRS to prove knowledge if an Innocent Spouse seeks relief under Separation of Liability. Section 6015(c)(3)(C).

[190]Treas. reg. section 1.6015-2(c).

would have known in a similar set of circumstances.[191] If the spouse knows enough about the transaction or income to know that the amounts reported on the joint return are incorrect, he or she may be denied relief. Constructive knowledge may be found when the Innocent Spouse has made a deliberate effort to avoid learning about the erroneous item.[192] The IRS uses a facts and circumstances test to determine if a spouse has reason to know of an understatement. Regulations list the following facts and circumstances that may be considered: (1) the nature and amount of the erroneous item, (2) the financial situation of the couple, (3) the Innocent Spouse's educational background and business expertise, (4) the Innocent Spouse's participation in the activity that resulted in the erroneous item, (5) whether the Innocent Spouse had an ownership interest in the property that resulted in the understatement, (6) whether items were different from a pattern reflected in returns from prior years, and (7) whether the Innocent Spouse failed to inquire about items on the return that a reasonable person would question.[193]

In applying those factors, one particular area of judicial focus has been whether the Innocent Spouse has met the duty of inquiry (item (7) above). For example, in *Butler v. Commissioner*,[194] a wife sought Innocent Spouse Relief for tax liabilities resulting from unreported income attributable to her husband's S corporation. The Tax Court considered several factors in deciding whether the Innocent Spouse met her duty of inquiry and whether she had a reason to know of the understatement of income on the joint return. The factors included the Innocent Spouse's level of education, her involvement in the family's financial affairs, any expenditures that appeared lavish or unusual when compared to the family's past income levels and spending patterns, and the Guilty Spouse's evasiveness and deceit concerning the family's finances.[195] In *Butler*, the Innocent Spouse had a college degree and experience handling the business and financial affairs of her own business; she had a significant role in the family's financial affairs, including maintaining responsibility for bank accounts and household bills and contributing to the preparation of the joint tax returns; she made significant purchases and maintained a high standard of living; and her husband was not evasive or deceitful about his finances and business income. As a result, the Tax Court held that the Innocent Spouse did not meet her duty to inquire about the income from her husband's S corporation income and that she had constructive knowledge of the understatement on their joint return.

In *Braden v. Commissioner*,[196] a husband was aware that his wife received certain distributions but did not know that they were subject to tax. The court held that he satisfied his duty of inquiry when he inquired about the tax treatment of the payments and was satisfied that his joint return was correct after receiving answers from his wife, who was an estate lawyer and retired IRS agent. After finding that the Innocent Spouse satisfied his duty of inquiry regarding the income, the court held that the Innocent Spouse did not have actual or constructive knowledge of the understatement on the joint tax return.

In contrast, *Silverman v. Commissioner*[197] presented a very different set of circumstances to the Tax Court. In *Silverman*, the Innocent Spouse was caring for two small children, she did not participate in preparing the tax return or sign it, and the couple's tax returns were not filed at the same time every year because they regularly filed for extensions of time. In the relevant year, although the fact that her husband did not bring the tax return for her to sign should have put the Innocent Spouse on notice of some irregularity, imposing a duty of inquiry on her, the court found that her failure to inquire was reasonable and excusable.[198] The court held as a result that the Innocent Spouse did not have actual or constructive knowledge of the erroneous item that resulted in a disallowed deduction on the tax return.

Judicial interpretation of determination of an Innocent Spouse's lack of constructive knowledge otherwise has resulted in standards that may differ depending on the circumstances in which the understatement arises. Moreover, different approaches have been taken by appellate courts in different circuits.

a. Omitted income. In cases that examine the lack of constructive knowledge of understatements attributable to omitted income, courts generally consider whether the Innocent Spouse had actual or constructive knowledge of the underlying transaction. In *Cheshire v. Commissioner*,[199] the Innocent Spouse had actual knowledge of a distribution of retirement proceeds and certain interest earned. She asked her husband about the retirement proceeds and was informed that the treatment of the proceeds on the joint tax return was proper and based on the advice of the couple's accountant. The Innocent Spouse argued that even though she knew of the underlying transactions, she did not know that there was an understatement of tax on the joint return. The court held that because she had actual knowledge of the transactions, her request for Innocent Spouse Relief must be denied.[200]

b. Disallowed deduction. When it comes to disallowed deductions, several circuits use the test for constructive knowledge of an understatement attributable to omitted income (that is, actual or constructive knowledge of the underlying transaction), while other circuits have adopted a different test.[201] The test established by the Ninth Circuit requires that, in addition to knowledge of

[191]*Id.*
[192]*Id.*
[193]*Id.*
[194]114 T.C. 276, *Doc 2000-12209, 2000 TNT 84-62* (2000).
[195]*Id.*
[196]T.C. Memo. 2001-69, *Doc 2001-8552, 2001 TNT 57-12*.
[197]T.C. Memo. 1996-69, *Doc 96-5248, 96 TNT 36-15, rev'd on another issue* 116 F.3d 172, *Doc 97-18154, 97 TNT 119-13* (6th Cir. 1997).
[198]*Id.*
[199]*Cheshire v. Commissioner*, 115 T.C. 183, *Doc 2000-22640, 2000 TNT 170-10* (2000).
[200]*Cheshire v. Commissioner*, *citing Reser v. Commissioner*, 112 F.3d 1258, *Doc 97-15269, 97 TNT 103-8* (5th Cir. 1997).
[201]Rice, "Guidance for Taxpayers," *supra* note 185, at nn. 11-14 and accompanying text.

the underlying transaction, the spouse must know that the resulting deduction caused a substantial understatement.[202] As a result, in circuits adopting that test, knowledge of the underlying transaction will not by itself prevent a spouse from being granted relief. However, transactions resulting in large or ''dramatic'' deductions on a return that substantially reduce or eliminate tax liability put a spouse on notice and he or she must meet the duty of inquiry as a result.[203]

In *Price v. Commissioner*,[204] a spouse requesting Innocent Spouse Relief had little involvement in the couple's financial situation beyond her own earnings and household expenses and had even less knowledge of the business affairs of her husband. Her participation in the preparation of the joint tax return was limited to supplying her own W-2 form for the wages she earned, briefly reviewing the joint return, and signing it. She knew that her husband invested in a certain business venture, but she did not know the details of a large deduction claimed for expenses related to this business venture. She questioned her husband and received assurances from him that the return was properly prepared. She trusted and deferred to what she considered her husband's ''excellent business reputation and experience.'' The Tax Court held that the Innocent Spouse did not carry the burden of proof of the knowledge element of Innocent Spouse Relief because she knew about the investment underlying the improper deduction. The Ninth Circuit reversed, holding that the Innocent Spouse did not know the legal consequences of the deduction or that it resulted in a substantial understatement, and that the Innocent Spouse did not have constructive knowledge of the substantial understatement because of her limited involvement and knowledge of the investment and family finances.

In adopting the Ninth Circuit's test, the Eighth Circuit held in *Erdahl v. Commissioner*[205] that the test for determining whether an Innocent Spouse's knowledge was sufficient to impose the duty of inquiry is whether a reasonably prudent taxpayer in the Innocent Spouse's circumstances could be expected to know that the item on the return was erroneous or that further inquiry was warranted. In *Erdahl*, the Innocent Spouse knew of the underlying transaction and of the losses that were claimed on the tax return, but the lower court did not consider any other circumstances in determining whether she met a duty to inquire further.[206] Applying the Ninth Circuit test, the Eighth Circuit reversed the lower court's decision that the Innocent Spouse had constructive knowledge of the erroneous item.

The Second Circuit also follows the Ninth Circuit's approach. For example, in *Friedman v. Commissioner*,[207] a spouse knew of the underlying transaction that resulted in the disallowed deduction. However, because she did not know that the deduction was improper and had no reason to know it was improper based on her husband's responses to her inquiry, the court held that she lacked the requisite knowledge.

3. It would be inequitable to hold the Innocent Spouse liable. The third requirement for Innocent Spouse Relief is that the Innocent Spouse must show that, considering all facts and circumstances, it would be inequitable to hold him or her liable. The regulations and other Treasury guidance offer factors to be considered in determining whether this requirement is satisfied. One factor is whether the Innocent Spouse received a benefit, directly or indirectly, in excess of normal support as a result of the understatement.[208] Other factors include whether the spouses have divorced or separated, if the Innocent Spouse has been deserted by the Guilty Spouse, and if the Innocent Spouse received a benefit on the return from the understatement. The regulations refer to the factors discussed in Rev. Proc. 2000-15, which provides guidance for determinations of equity under Innocent Spouse Relief and Equitable Relief.[209] Those factors are explained in the discussion of Equitable Relief in Part III.C.3 below.

4. Relief available. If an Innocent Spouse qualifies for Innocent Spouse Relief for any tax year, he or she is absolved of all liability for the tax, interest, penalties, and other amounts due for that year that are attributable to the understatement.[210] If the Innocent Spouse can satisfy the requirements for Innocent Spouse Relief for only a portion of an erroneous item, the Innocent Spouse may be granted partial relief for the tax attributable to that portion.[211] In certain situations, a refund may be obtained for payments made by the Innocent Spouse.[212] Specifically, if the Innocent Spouse made and provided the funds for separate payments for tax due, he or she is eligible for a refund. The Innocent Spouse must establish the source of the funds for the payments and show that the payments were not made either by the other spouse or in connection with the joint return.[213] Similarly, if an Innocent Spouse made payments under an installment agreement with the IRS (and has not defaulted on the agreement), he or she is eligible for a refund of any payments made after filing for and being granted relief.[214] Again, the Innocent Spouse must show that he or she provided the funds used to make the payment. If the request for relief was filed within the three years after the return was filed, the refund available is limited to the

[202]*Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989). The circuits following the Ninth are the Second, Fifth, Seventh, Eighth, and Eleventh. Rice, ''Guidance for Taxpayers,'' *supra* note 185, at note 12.

[203]*Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997), *aff'g in part and rev'g in part* T.C. Memo. 1995-572, *Doc 95-10697, 95 TNT 233-6*; *Hayman v. Commissioner*, 992 F.2d 1256, *Doc 93-5551, 93 TNT 104-15* (2d Cir. 1993), *aff'g* T.C. Memo. 1992-228, *92 TNT 85-12*.

[204]887 F.2d 959 (9th Cir. 1989).

[205]930 F.2d 585 (8th Cir. 1991).

[206]*Id.* at 588.

[207]53 F.3d 523, *Doc 95-4592, 95 TNT 90-9* (2d Cir. 1995).

[208]Treas. reg. section 1.6015-2(d).

[209]*Id.*; Rev. Proc. 2000-15, 2000-1 C.B. 447, *Doc 2000-2048, 2000 TNT 12-4, superseded by* Rev. Proc. 2003-61, 2003-2 C.B. 296, *Doc 2003-17345, 2003 TNT 143-10*.

[210]Section 6015(b)(2).

[211]Treas. reg. section 1.6015-2(3).

[212]IRS Pub. 971, *supra* note 181.

[213]*Id.*

[214]*Id.*

amount of tax paid within those three years.[215] If the request for relief was made more than three years after the return, but within two years from the payment of the tax, the refund available is limited to the amount of tax paid within the two years before the request for relief was filed.[216]

B. Separation of Liability

Separation of Liability relief is available under section 6015(c) for deficiencies attributable to erroneous items if the following five requirements are met: (1) the Innocent Spouse must be no longer married to, be legally separated from, and not be a member of the same household as the Guilty Spouse; (2) the Innocent Spouse must not have actual knowledge of the erroneous item; (3) there must be no fraudulent transfers; (4) there must be no transfers of "disqualified property" to the Innocent Spouse; and (5) there must be a basis for allocating the items that resulted in tax liabilities.

1. The spouse must no longer be married, must be legally separated, and must not be a member of the same household. The first requirement for Separation of Liability is that the Innocent Spouse show proof that, as of the time he or she requests relief, he or she is widowed, divorced, or legally separated. Alternatively, the Innocent Spouse may provide evidence that the two spouses were not members of the same household at any point during the 12-month period leading up to the day the request is filed.[217] Spouses that live in different homes may be found to be members of the same household if they are not estranged and if one is temporarily absent under certain circumstances. In those circumstances, it must be reasonable to assume that the absent spouse will return and the household must be maintained in anticipation of a return.[218] A spouse that is temporarily absent may be considered to be a member of the household if it is reasonable to assume that the spouse will return after, for example, a period of incarceration or illness or living away from the home for business, education, or military service.[219] A court considering whether spouses are members of the same household when they are living apart may consider the specific facts and circumstances of the situation. There are no definite requirements or bright-line tests for making the determination. However, one could imagine, for example, that a court would consider a spouse that is serving in the military or transacting business away from the home for a period of months to be a member of the household, whereas a spouse serving a term of several years in a federal prison is not.[220]

2. The innocent spouse did not have actual knowledge of the erroneous item. The second requirement for Separation of Liability is that the Innocent Spouse lacks knowledge of the erroneous item. Unlike a request for Innocent Spouse Relief, the burden of proof for this requirement is on the IRS. To deny a request for Separation of Liability, the IRS must show that the Innocent Spouse had *actual knowledge* of the item of omitted income or disallowed deduction that resulted in the deficiency at issue.[221] That requirement does not allow for a denial of relief if the Innocent Spouse merely should have known of the item.

The knowledge test is different for items of income and deductions. For cases involving omitted income, there must be evidence that the Innocent Spouse had knowledge of the receipt of income for a denial of relief.[222] In those cases, there is no need for proof that the Innocent Spouse knew about the underlying transaction that produced the income or the source of the income. If the IRS can show, for example, that an Innocent Spouse knows that the Guilty Spouse simply received an amount of money and did not report the payment on their joint return, that is enough to deny Separation of Liability.[223] For cases involving erroneous deductions, however, the IRS must prove that the Innocent Spouse actually knew of any fact that made the deduction disallowable, that the amount deducted was not correct, or that the deduction did not represent an expense that actually was paid.[224]

The IRS and the courts must consider all of the facts and circumstances in determining whether the Innocent Spouse had actual knowledge. As is the case for Innocent Spouse Relief, the factors that may be considered include, among others, whether the Innocent Spouse and the Guilty Spouse jointly owned the property that resulted in the erroneous item and whether the Innocent Spouse made a deliberate effort to avoid knowledge of an item.[225] It may be noted that this second factor is arguably at odds with the requirement that the IRS prove *actual* knowledge rather than constructive knowledge. In *Martin v. Commissioner*,[226] a case involving a complicated, multistep real estate transaction, the Tax Court considered the level of the Innocent Spouse's understanding of that transaction and its consequences in determining whether she had knowledge of omitted income. Because the Innocent Spouse in *Martin* did not have a full understanding of the complex transaction and how it was reported on the tax return, the court held that the Innocent Spouse did not have actual knowledge of the deficiency.

There is an exception to the knowledge requirement for cases in which the Innocent Spouse is abused by the Guilty Spouse. If an Innocent Spouse can prove that he or she was a victim of the other spouse's abuse and did not challenge the treatment of an erroneous item on the tax return as a result, the IRS may grant relief.[227]

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[215] *Id.*
[216] *Id.*
[217] Treas. reg. section 1.6015-3(a).
[218] Treas. reg. section 1.6015-3(b)(2).
[219] *Id.*
[220] *See Martin v. Commissioner*, T.C. Memo. 2000-346, *Doc 2000-28929, 2000 TNT 218-15* (granting relief to an Innocent Spouse whose husband had been in a federal prison for three years as of the date she filed for relief).
[221] Section 6015(c)(3)(C).
[222] Treas. reg. section 1.6015-3(c)(2)(i)(A).
[223] Treas. reg. section 1.6015-3(c)(2).
[224] Treas. reg. section 1.6015-3(c)(2)(i)(B).
[225] Treas. reg. section 1.6015-3(c)(2)(iv).
[226] T.C. Memo. 2000-346.
[227] Treas. reg. section 1.6015-3(c)(2)(v).

3. The spouses did not engage in fraudulent transfers of assets. If the IRS can prove that the Innocent Spouse and the Guilty Spouse engaged in transfers of assets as part of a fraudulent scheme, Separation of Liability relief will be denied.[228] A fraudulent scheme includes any plan to defraud the IRS or a third party, such as a creditor, ex-spouse, or business partner.[229]

4. There was no transfer of disqualified assets. An Innocent Spouse's liability is increased by the value of any "disqualified assets" transferred to the Innocent Spouse.[230] A disqualified asset is any property or right transferred to an Innocent Spouse if the purpose of the transfer is the avoidance of tax or of payment of tax.[231] If an asset is transferred within a year before the IRS sending a notice of deficiency, it is presumed to be a disqualified asset.[232] That presumption does not apply if the transfer was made under a divorce decree, separate maintenance agreement, or similar legal agreement.[233] To rebut the presumption, the Innocent Spouse must provide proof of a purpose for the transfer unrelated to avoiding tax.[234] When the presumption does not apply, the IRS has the burden of proving that the transfer had a tax avoidance purpose for the transferred asset to be treated as a disqualified asset.

5. There must be a basis for allocating items that resulted in tax liabilities. In general, the items giving rise to a tax deficiency are allocated in a manner as if the two spouses had filed separate returns for the tax year. The Innocent Spouse must establish the proper allocation of the erroneous items.[235] The Innocent Spouse is relieved of liability for any portion of the tax deficiency that results from items attributable to the Guilty Spouse. Erroneous items of income are generally allocated to the spouse who was the source of the income.[236] Erroneous deductions are generally allocated 50 percent to each spouse, unless the Innocent Spouse shows with clear and convincing evidence that a different allocation is appropriate.[237] If a deduction is due to a business or investment expense and only one spouse owned the business or investment, any related deductions are allocated to that spouse.[238]

If an item that would be allocated to one spouse results in a tax benefit to the other spouse, the item is allocated to the spouse who actually receives the benefit.[239] While there is little case law, if any, that addresses what is meant by benefit in this specific context, courts may look to cases that consider the concept of benefit under Innocent Spouse Relief or Equitable Relief.[240] For example, in *In re Jeremy Bearl Shafman*,[241] the court used the definition of benefit under Innocent Spouse Relief and considered whether the Innocent Spouse received a benefit above the family's level of ordinary support. The court held that when the newlywed couple purchased a home and car and the Innocent Spouse received an engagement ring, these items did not constitute a benefit for the purposes of allocating items for Separation of Liability, and the Guilty Spouse was allocated the full amount of the items in question. The IRS may allocate any item between the spouses if it establishes that the allocation is appropriate because of fraud by either or both of the spouses.[242]

6. Relief available. If the IRS grants a request for Separation of Liability, the tax deficiency generally is allocated in accordance with the allocation of the items that gave rise to the deficiency as discussed in Part III.B.5 above.[243] If an item is fully attributable to the Guilty Spouse, the Innocent Spouse is absolved of the full amount of deficiency resulting from the liability. However, even when an Innocent Spouse is allocated part or all of an item and the resulting deficiency, the Guilty Spouse remains liable for the entire amount of any deficiency on the joint return.[244] When relief is granted under Separation of Liability, refunds for any tax paid are not available to the Innocent Spouse, even if the tax paid is attributable to items that have been allocated to the Guilty Spouse.

C. Equitable Relief

Equitable Relief is granted under section 6015(f) if an Innocent Spouse can show that it is inequitable to hold him or her liable for a deficiency resulting from an *understatement* on a return. Also, Equitable Relief is available for *underpayments* of tax, whether or not there are erroneous items on the return.

1. General requirements. Rev. Proc. 2003-61 lists the following requirements that an Innocent Spouse must satisfy before the IRS will consider granting Equitable Relief:

(1) the Innocent Spouse filed a joint return for the year for which he or she is requesting relief;

(2) relief is not available under sections 6015(b) or 6015(c);

(3) no assets were transferred between the spouses as part of a fraudulent scheme;[245]

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[228]IRS Pub. 971, *supra* note 181.
[229]*Id*.
[230]Section 6015(c)(4).
[231]Section 6015(c)(4)(B).
[232]Treas. reg. section 1.6015-3(c)(3)(iii).
[233]*Id*.
[234]*Id*.
[235]Treas. reg. section 1.6015-3(d)(3).
[236]Treas. reg. section 1.6015-3(d)(2)(iii).
[237]Treas. reg. section 1.6015-3(d)(2)(iv).
[238]*Id*.
[239]Section 6015(d)(3)(B); Treas. reg. section 1.6015-3(d)(2)(i).
[240]For a discussion of benefit under Innocent Spouse Relief, see *supra* Part III.A.3 and for a discussion of benefit under Equitable Relief, see *infra* Part III.C.3.
[241]2001 Bankr. LEXIS 1092, *Doc 2001-23007, 2001 TNT 171-61* (Bankr. N.D.W.Va. 2001).
[242]Section 6015(d)(3)(C).
[243]*See* sections 6015(d)(2)-(5); Treas. reg. sections 1.6015-3(d)(2)-(6).
[244]Treas. reg. section 1.6015-6 and Rev. Proc. 2003-19, 2003-1 C.B. 371, set forth rules concerning the right of the Guilty Spouse to receive notice and to protest.
[245]*See* discussion of fraudulent transfers, *supra* Part III.B.3.

(4) the Guilty Spouse did not transfer ''disqualified assets'' to the Innocent Spouse;[246]

(5) the Innocent Spouse did not file or fail to file the return with fraudulent intent; and

(6) the income tax liability at issue is attributable to an item of the Guilty Spouse, with exceptions.[247]

In certain cases, exceptions apply and Equitable Relief may be granted even if the threshold requirements are not satisfied.[248] The first exception to the attribution rule (Item 6 above) allows for an item that is attributable, in whole or in part, to the Innocent Spouse solely because of the operation of community property laws to be considered attributable to the Guilty Spouse.[249] Thus, the operation of community property laws will not itself prevent an Innocent Spouse from meeting the threshold conditions. Second, an Innocent Spouse may offer proof to rebut the presumption that an item titled in the Innocent Spouse's name is attributable to that Innocent Spouse.[250] The revenue procedure provides an example of a retirement account fraudulently opened in the Innocent Spouse's name. If the Innocent Spouse can provide proof to rebut the presumption that the account is attributable to him or her, the Innocent Spouse can satisfy the attribution requirement. A third exception allows for relief in a situation that involves an item attributable to the Innocent Spouse if the funds that the Innocent Spouse intended to pay the resulting tax liability were misappropriated by the other spouse for the other spouse's benefit. In such a case, if the Innocent Spouse did not know and had no reason to know of the misappropriation, the IRS may consider whether to grant the Innocent Spouse Equitable Relief.[251] A final exception allows the IRS to consider Equitable Relief in certain situations of abuse that do not rise to the level of duress necessary to void the joint return[252] even when the deficiency or understatement is attributable to the Innocent Spouse. The Innocent Spouse must provide proof that he or she was the victim of domestic abuse and that as a result, he or she did not challenge the treatment of items on the tax return for fear of the Guilty Spouse's retaliation.[253]

2. Factors considered in granting Equitable Relief. The IRS will consider ''all relevant factors'' in deciding whether Equitable Relief should be granted.[254] Rev. Proc. 2003-61 lists additional factors that may be relevant to the IRS in determining whether relief will be granted for claims relating to understatements or claims relating to underpayments that do not satisfy the requirements of the safe harbor described below in Part III.C.3. The factors may weigh in favor of or against granting relief or in some cases may be neutral. There is no one factor or combination of factors that is necessarily determinative. One of those factors is the Innocent Spouse's knowledge or reason to know.[255] In evaluating the knowledge factor, the IRS will consider whether an Innocent Spouse knew or had reason to know either about an item that gave rise to a deficiency or that the Guilty Spouse would not pay a tax liability.[256] As in cases for which Innocent Spouse Relief or Separation of Liability is sought, the IRS will determine whether an Innocent Spouse had reason to know after considering the Innocent Spouse's level of education, financial expertise, involvement in the activity that generated the tax liability, involvement in business and household finances, any deceit by the Guilty Spouse, and any lavish or unusual expenditures.[257]

In *Feldman v. Commissioner*,[258] the Tax Court considered the knowledge factor among other factors in holding that an Innocent Spouse was not entitled to Equitable Relief. The Guilty Spouse handled the family's financial affairs while the Innocent Spouse was the managing partner in a law firm. In handling the financial affairs, the Guilty Spouse showed the Innocent Spouse false and inconsistent bank statements. The Innocent Spouse signed tax returns over multiple years that were prepared using outdated forms and contained obvious errors. The court held that the Innocent Spouse should have inquired further into their financial situation and that he had reason to know that the tax liabilities shown on their returns were erroneous and would not be paid. Accordingly, that negative knowledge factor weighed heavily against any positive factors in the court's determination and the Innocent Spouse was denied relief.

Another factor considered is whether the Innocent Spouse received a significant benefit from the nonpayment of a tax liability or as a result of items giving rise to a deficiency. The test is whether the spouse received a benefit above and beyond his or her level of normal support.[259] As a result, the IRS's determination is very fact-specific. For example, in *Mitchell v. Commissioner*,[260] there was an understatement of income due to the incorrect reporting of certain distributions from the Guilty Spouse's retirement plan. The Tax Court held that the Innocent Spouse received a significant benefit from the income when she used it to pay her mortgage, make improvements to her home, pay her children's expenses and establish a trust for her children, and generally enjoy a high level of spending. The funds used and expenditures made by the Innocent Spouse were above the normal level of funds available.

Another related factor that the IRS may consider is whether the Innocent Spouse will experience economic hardship as a result of being held liable for the tax liability.[261] To determine whether economic hardship exists, the IRS applies the definition found in Treas. reg.

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[246]*See* discussion of disqualified assets, *supra* Part III.B.4.
[247]Rev. Proc. 2003-61, 2003-2 C.B. 296.
[248]*Id.* at sections 4.01(7)(a)-(d).
[249]*Id.* at section 4.01(7)(a).
[250]*Id.*
[251]*Id.* at section 4.01(7)(c).
[252]*See supra* note 186 and accompanying text.
[253]Rev. Proc. 2003-61, at section 4.01(7)(d).
[254]*Id.* at section 4.03(2).
[255]*Id.* at section 4.02(2)(a)(iii).
[256]*Id.* at sections 4.02(2)(a)(iii)(A)-(B).
[257]*Id.* at section 4.02(2)(a)(iii)(C).
[258]T.C. Memo. 2003-201, *Doc 2003-16455, 2003 TNT 133-8*.
[259]Rev. Proc. 2003-61, at section 4.02(2)(a)(v).
[260]292 F.3d 800, *Doc 2002-14349, 2002 TNT 116-7* (D.C. Cir. 2002), *aff'g* T.C. Memo. 2000-332, *Doc 2000-27641, 2000 TNT 209-16*.
[261]Rev. Proc. 2003-61, at section 4.02(2)(a)(ii).

section 301.6343-1(b)(4). The test is whether paying the tax liability will prevent the Innocent Spouse from being able to pay his or her ''reasonable basic living expenses.''[262] Again, determinations depend largely on the specific facts of a case and the proof provided by an Innocent Spouse. An Innocent Spouse who wishes to establish the existence of economic hardship must provide information as to his or her age, employment history, ability to earn, reasonable and necessary expenses, cost of living, and any extraordinary circumstances.[263] In *Ewing v. Commissioner*,[264] an Innocent Spouse offered proof of the living expenses she paid for herself and her husband and the limited source of income available to her, especially in light of her husband's medical condition and lack of income. The Tax Court found that to pay the tax liability at issue, she would have to use her limited savings or to borrow against the equity in her house. As a result, the court held that this factor weighed in favor of the Innocent Spouse and ultimately granted her Equitable Relief.

Additional factors the IRS may consider in granting or denying Equitable Relief include marital status, the Guilty Spouse's legal obligation to pay the tax liability, and the Innocent Spouse's history of compliance with income tax laws.[265] Legal separation and divorce weigh in favor of the Innocent Spouse, as does a divorce decree or other legal agreement that requires the Guilty Spouse to pay the tax liability.[266] Certain other factors may be considered and weighed in favor of granting Equitable Relief but will not weigh against relief if they are not present. Those include abuse of the Innocent Spouse by the Guilty Spouse and the Innocent Spouse's poor physical or mental health.[267]

An example of the examination of factors is *Washington v. Commissioner*,[268] in which an Innocent Spouse's wages were garnished and certain refunds were applied to a tax deficiency attributable to a joint return filed in a previous year. The Innocent Spouse was no longer married to the Guilty Spouse, she was not obligated to pay the tax liability under the divorce decree, and the deficiency was attributable to the Guilty Spouse. Moreover, the court found that the Innocent Spouse would be unable to pay rent and other basic living expenses for herself and her children if she were not granted relief. The court went on to state that each factor it considered weighed in favor of the Innocent Spouse or was neutral, and as a result, the court granted Equitable Relief.

3. Safe harbor for relief from underpayments. An Innocent Spouse may be granted Equitable Relief for an underpayment of tax without weighing the factors discussed above if the Innocent Spouse can satisfy the elements of a ''safe harbor'' for relief, provided in Rev. Proc. 2003-61. It is important to note that the safe harbor applies only to *underpayments* of tax and not to *understatements* of tax on a return due to erroneous items. The safe harbor has four requirements. First, the threshold requirements discussed in Part III.C.1 above must be met.[269] Second, the Innocent Spouse must be no longer married to, legally separated from, and not a member of the same household as the Guilty Spouse at any time during the year before the request for relief.[270] Third, the Innocent Spouse must show that he or she had no knowledge or reason to know that the income tax liability would not be paid.[271] As part of that requirement, the Innocent Spouse must show a reasonable belief that the Guilty Spouse would pay the tax liability. Partial relief is available if the Innocent Spouse can show a lack of knowledge only as to a portion of the tax liability. And fourth, the Innocent Spouse must show that he or she will suffer economic hardship if the IRS does not grant relief.[272] Relief granted under the safe harbor is available only to the extent of the tax liability shown on the couple's joint return, before any adjustments the IRS may have made that increase the tax liability payable.

4. Relief available. If Equitable Relief is granted for an income tax liability, the Innocent Spouse is absolved of liability and may receive credits or refunds for certain separate payments made by the Innocent Spouse. Refunds made under Equitable Relief are subject to the same limitations applicable to Innocent Spouse Relief, as discussed in Part III.A.4 above. If a spouse would have qualified for relief under Separation of Liability, refunds may not be granted under Equitable Relief.[273]

D. Obtaining Relief for an Innocent Spouse

A spouse seeking relief from joint and several liability must file an IRS Form 8857, ''Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief''). In addition to providing the basic information on the form, a statement must be attached explaining why the Innocent Spouse qualifies for relief. Additional information may be provided on an IRS Form 12510, ''Questionnaire for Requesting Spouse,'' such as details of marital status, the Innocent Spouse's involvement with the preparation of the joint return, and the spouses' finances and employment. IRS Publication 971, *Innocent Spouse Relief*, provides a worksheet and instructions that are helpful in computing and allocating the Innocent Spouse's portion of tax, interest, and penalties.

A request for relief is timely if the Form 8857 is filed within two years after the date the IRS initiates collection

[262]Treas. reg. section 301.6343-1(b)(4).

[263]*See Albin v. Commissioner*, T.C. Memo. 2004-230, *Doc 2004-20036, 2004 TNT 198-9* (*citing* Treas. reg. section 301.6343-1(b)(4)).

[264]122 T.C. 32, *Doc 2004-1771, 2004 TNT 19-20* (2004).

[265]Rev. Proc. 2003-61, at sections 4.02(a)(i), (iv), and (vi).

[266]*Id.* at section 4.02(2)(a)(iv).

[267]Rev. Proc. 2003-61, at section 4.03(2)(b).

[268]120 T.C. 137, *Doc 2003-10149, 2003 TNT 77-10* (2003).

[269]Rev. Proc. 2003-61, at section 4.02.

[270]*Id.* at section 4.02(1)(a). For a discussion of marital status and what it means to be a member of the same household, see *supra* Part III.B.1 under Separation of Liability.

[271]*Id.* at section 4.02(1)(b).

[272]*Id.* at section 4.02(1)(c). Economic hardship for this purpose is determined under Treas. reg. section 301.6343-1. For an explanation of economic hardship, see *supra* notes 262-263 and accompanying text.

[273]Treas. reg. section 1.6015-4(b).

activities against the Innocent Spouse.[274] For that purpose, initiation of collection activities includes a notice of the right to a hearing before a levy is made, the application by the IRS of a subsequent refund to tax due, the filing of a suit against the Innocent Spouse, or a claim in which the Innocent Spouse is a party or the property involved is owned by the Innocent Spouse.[275] Although they may serve to provide notice to an Innocent Spouse of the tax liability, a notice of deficiency, notice of a tax lien, and a demand for payment of tax on notice are not considered collection activities.[276]

Filing a request for relief will prevent the IRS from commencing collection activities, including court proceedings and levies, until either 90 days after a final determination or, if a petition to the Tax Court is made, until a final decision of the Tax Court is rendered.[277] The statute of limitations for collecting tax liabilities is suspended, however, for the period of time during which collection activities are suspended and for 60 days thereafter.

An Innocent Spouse who has filed a Form 8857 request for relief may petition the Tax Court for review if the IRS has made a final determination of relief or if the IRS has not made a determination within six months of the filing of the Form 8857.[278] The petition is timely if made within six months after the request was filed or within 90 days after the date the IRS has mailed notice of a final determination of relief.[279]

IV. Charitable Organizations

Most tax-related pro bono opportunities for charitable organizations relate to procuring and maintaining tax-exempt status for the organization. The vast majority of those organizations will wish to qualify for federally exempt status under section 501(c)(3).[280] Once it is determined the substantive requirements are met,[281] the application process is easy.

A. Applying for Status as a 501(c)(3) Organization

An organization seeking exemption under section 501(c)(3) must provide notice to the IRS that it seeks recognition of exemption within 15 months from the end of the month in which the organization was organized.[282] The notice requirement is waived for churches and related groups, certain organizations with gross receipts that are normally less than $5,000 for a tax year, and subordinate organizations that are covered by a group exemption letter.[283] An organization's date of organization is the date it becomes an organization described in section 501(c)(3).[284] For those purposes, an organization formed under state law is considered organized on the date it comes into existence under that state law. For example, a corporation may be considered organized on the date it files articles of incorporation with the appropriate state official in its state.[285]

An organization seeking recognition of exemption under section 501(c)(3) must submit a completed and executed IRS Form 1023, ''Application for Recognition of Exemption.''[286] Information provided on the form includes a description of the organization's activities, financial information, and the organization's employer identification number. If the organization does not have an EIN, it must attach an IRS Form SS-4, ''Application for Employer Identification Number.'' The Form 1023 must be accompanied by a copy of the organization's organizing documents and bylaws (if any), updated to reflect any amendments and certified by an officer of the organization.[287] The form also must be accompanied by an IRS Form 8718, ''User Fee for Exempt Organization Determination Letter Request,'' and the appropriate fee.[288] The fee is currently $150 for organizations with annual gross receipts that average or are expected to average $10,000 or less.[289] For organizations with higher gross receipts, the fee is $500.[290]

A central organization with subordinate organizations, such as local chapters, posts, or units, may apply for a group exemption under section 501(c)(3). Those organizations may include, for example, church organizations, fraternities, or groups such as the Boy Scouts or Girl Scouts. Rev. Proc. 80-27[291] provides the process,

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[274]The two-year requirement is statutory in the case of Innocent Spouse Relief and Separation of Liability. *See* sections 6015(b)(1)(E), 6015(c)(3)(B). Rev. Proc. 2003-61 imposes the same two-year requirement for granting Equitable Relief.

[275]Treas. reg. section 1.6015-5(b)(2).

[276]Treas. reg. section 1.6015-5(b)(2)(i).

[277]Sections 6015(c)(1), (2).

[278]IRS Pub. 971, *supra* note 181.

[279]*Id*.

[280]Corresponding state tax exemptions may also be available.

[281]In general, to qualify for an exemption under section 501(c)(3), an organization must be organized and operated exclusively for one or more charitable purposes. These purposes may not be illegal or contrary to public policy. The organization's earnings may not benefit private individuals. Also, the organization may not attempt to influence legislation or participate in political campaigns as a substantial part of its activities. In many, if not most, cases, it will be clear whether those requirements are met. A full discussion of the requirements and restrictions is beyond the scope of this report. Several authoritative sources are available, including the text of section 501 and Treas. reg. sections 1.501(a)-1 and 1.501(c)(3)-1, IRS Publication 557, *Tax-Exempt Status for Your Organization* (revised May 2003), the IRS instructions for Form 1023 (revised October 2004), and a

(Footnote continued in next column.)

leading treatise, James J. Fishman and Stephen Schwartz, *Nonprofit Organizations: Cases and Materials* (Foundation Press 2d ed. 2000).

[282]Treas. reg. section 1.508-1(a)(2).

[283]Treas. reg. section 1.508-1(a)(3)(i). Similarly, these organizations are not required to file annual information returns that are otherwise required for exempt organizations.

[284]Treas. reg. section 1.508-1(a)(2)(iii).

[285]Rev. Rul. 75-290, 1975-2 C.B. 215.

[286]*See* IRS Package 1023, *Application for Recognition of Exemption* (revised October 2004).

[287]Rev. Proc. 90-27, 1990-1 C.B. 514.

[288]Rev. Proc. 2005-8, 2005-1 IRB 243, *Doc 2005-241, 2005 TNT 2-15*.

[289]*Id.*

[290]*Id*.

[291]Rev. Proc. 80-27, 1980-1 C.B. 677, *amplified by* Rev. Proc. 93-23, 1993-1 C.B. 939, *93 TNT 100-52*. The fee for a group exemption letter is $500, unless it includes an initial application

(Footnote continued on next page.)

requirements, and necessary information for obtaining a group exemption. An officer of each of any of the subordinate organizations must authorize the central organization to include it in the group application.[292] Instead of filing Form 1023, the central organization must submit a letter to the IRS requesting recognition of exempt status for the subordinate organizations.[293] The organizations covered in the group application must be affiliated with the central organization, subject to its supervision and control, exempt under the same section 501(c),[294] not private foundations, and on the same accounting period as the central organization if they are to file group returns.[295] Further, the application must be filed within the 15-month period after the affiliate organizations' formation dates.[296]

B. Ongoing Requirements

In addition to filing certain forms and providing information when an organization initially applies for tax-exempt status, 501(c)(3) organizations must at times provide additional information to the IRS. These organizations must file an information return annually, using IRS Form 990, ''Return of Organization Exempt From Income Tax,'' providing information relating to income, receipts, and disbursements.[297] If an information return is due while an organization's application for exemption is pending, the organization must file a Form 990 and mark ''Application Pending'' in the heading.[298] Also, section 501(c)(3) organizations may have to file information returns with the IRS for a variety of reasons, including liability for unrelated business income tax or employment taxes, receipt of charitable donations, and certain cash transactions.[299]

Section 501(c)(3) organizations must also make their annual information returns and application for exempt status available for public inspection.[300] Forms 1023 and 990 and related correspondence and certain other forms filed with the IRS are open for public inspection unless they are separately marked ''NOT SUBJECT TO PUBLIC INSPECTION'' for a reason approved by the IRS.[301] Organizations must allow members of the public to inspect the information or to receive a copy of the information on request.[302] The documents may also be posted on the organization's Web site.[303]

V. Certain Procedural Matters

Every young child knows the basics of tax procedure. Your client has issues raised on audit. The client gets a 30-day letter. You file a protest and wrestle with the IRS Appeals Division. You lose (occasionally). Your client gets a 90-day letter. You discuss whether to pay, try to settle, or fight in court. If fighting is the chosen option, you look at precedents in the possible forums and decide whether to litigate in Tax Court, federal district court, or the federal court of claims. Routine stuff.

The very same procedures apply to low-income taxpayers and the tax controversies they may become involved in. However, as one might expect, the process in practice is seldom as orderly as we are accustomed to, and also is encumbered by several additional considerations that our more typical clients don't face. The end result is that many procedural considerations arise for controversies involving low-income taxpayers that we don't encounter in day-to-day practice.

A. Small Case Status in Tax Court

When litigation is the chosen path for a low-income taxpayer, the forum choice as a practical matter seldom will include the district court or claims court, since the low-income taxpayer is quite likely to be unable to advance the disputed tax.[304] Instead, after litigation becomes the chosen route, the decision to be made is whether to follow the small case procedure in Tax Court.

Section 7463 provides for certain simplified procedures for income tax (or less likely, estate or gift tax) controversies that involve not more than $50,000 (including asserted penalties) for any calendar year. The small case procedures are also available for contesting notices of levy when the unpaid tax does not exceed $50,000,[305] and for claiming Innocent Spouse Relief when the relief sought does not exceed $50,000.[306] It is safe to assume that the amount in controversy in virtually any pro bono matter will not exceed that threshold. Access to the small case procedure is made at the election of the taxpayer with the concurrence of the Tax Court. Only rarely would the Tax Court not agree to use those procedures if requested.

The actual procedures called for in cases designated as small tax cases are set forth in Title XVII of the Tax Court Rules. Those rules differ from the normal rules for Tax

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for exemption for the central organization, in which case an additional $150 or $500 is required, depending on the central organization's gross receipts. Rev. Proc. 2005-8, *supra* note 288.

[292]*Id*.

[293]*Id*.

[294]Although all of the subordinate organizations covered by a group application must be exempt under the same paragraph of section 501(c), it is not necessary that the organizations are exempt under the same paragraph as the central organization.

[295]*Id*.

[296]*Id*. Alternatively, in the unlikely event that the other affiliate organizations agree that their exempt status will begin from the date of the application rather than formation, the group application may be filed within the 15-month period for at least one of the affiliate groups.

[297]Section 6033(a)(1). For exceptions to the filing requirement, see *supra* note 283 and accompanying text.

[298]IRS Instructions for Form 990 (revised May 2003).

[299]*See* IRS Publication 557; IRS Form 990-T; IRS Form 8300; IRS Form 941; IRS Form 8868; and IRS Form 8870.

[300]IRS Publication 557.

[301]IRS Instructions for Form 1023 (revised October 2004). Acceptable reasons include, for example, trade secrets or patents and information affecting the national defense.

[302]IRS Publication 557.

[303]*Id*.

[304]Federal court may be an option, however (indeed the only option) when a taxpayer owes no tax and is contesting the denial of an EITC claim that would have produced a refund.

[305]Section 7463(f)(2).

[306]Section 7463(f)(1).

Court cases[307] in three main respects. First, a somewhat slimmed-down version of the initial petition is called for.[308] Second, pleadings are vastly simplified. No answer to an initial petition is called for except for an issue on which the IRS has the burden of proof or as otherwise in the discretion of the court. No reply is called for unless directed by the court. Furthermore, no briefs or oral arguments are required unless the court otherwise directs. And third, the procedures for trials are reduced from a rigorous application of various procedural rules borrowed from the federal courts (with a myriad of modifications)[309] to a simple statement presented as follows:

> Trials of small tax cases will be conducted as informally as possible consistent with orderly procedure, and any evidence deemed by the Court to have probative value shall be admissible.[310]

Under those procedures, any tax attorney, no matter how unfamiliar with tax or other litigation, can proceed with a fair amount of confidence (probably without even calling on our litigation partners).

The principal theoretical drawback to using the small case procedure is that no decision of the court is appealable.[311] In most cases, the controversy will involve a factual dispute (or at least putting the taxpayer to proof of relevant facts). Thus, giving up the right to appeal is not of great practical significance.

B. Audit Reconsideration

If you have never missed a court filing deadline, you might have no reason to have heard of the procedure known as ''audit reconsideration.'' For any number of reasons, a low-income taxpayer's case may first come to your office more than 90 days after the taxpayer received a 90-day letter, perhaps only after the IRS has attempted to collect the assessed deficiency. In that common situation, the audit reconsideration procedure represents the taxpayer's best chance to recover from what may have been either neglect or mishandling of the dispute.

Unlike most of the more familiar procedures, audit reconsideration has no statutory basis. It is a creation of the IRS and its rather sensible parameters are set forth in IRS Publication 3598. Within the stated constraints, audit reconsideration is essentially a second chance for the taxpayer to go through the audit process, when the first time through produced an unsatisfactory result (most likely due to neglect). Unlike certain other things, audits are not better the second time around. There is no right to a judicial appeal of any decision the IRS may make in the audit reconsideration. That is still better than nothing. Although not technically an appeal of the audit reconsideration outcome, a second bite at the apple may still be possible, however, if the taxpayer owes no tax (such as when the only matter in dispute is the denial of an EITC refund claim). In that case, the taxpayer can still bring a refund action in federal court.

Publication 3598 states that the IRS will accept an audit reconsideration request if: (1) the taxpayer has information that the IRS had not previously considered and that might change the amount of tax owed, (2) the taxpayer filed a return after the IRS completed a return for the taxpayer, or (3) the taxpayer believes the IRS made a computational or processing error in assessing the disputed tax. However, Publication 3598 states that the IRS will not accept an audit reconsideration request if: (1) the taxpayer has already agreed in writing to pay the tax assessed (for example, by entering into a closing agreement or an offer in compromise), (2) the Tax Court or any other court has issued a final determination of the tax liability, or (3) (less-relevant to low-income taxpayer cases) the amount owed is attributable to a TEFRA partnership audit.

An audit reconsideration request is initiated through a written submission by or on behalf of the taxpayer to the IRS Service Center with which the taxpayer's return was filed. The submission must include a copy of the audit report for which reconsideration is being requested (either Form 4549 or Form 1902-B). The submission should indicate exactly which issues in the audit report that reconsideration is requested for and should contain whatever supporting documentation is available. The submission of an audit reconsideration request may, although will not necessarily, delay collection activity by the IRS.

C. The Taxpayer Advocate

The Office of the National Taxpayer Advocate (NTO) was established in 1979 and was originally known as the office of the Ombudsman. The current statutory underpinnings of the NTO were most recently enhanced and amended as part of the Internal Revenue Service Restructuring and Reform Act of 1998,[312] which also renamed the taxpayer advocate the National Taxpayer Advocate.[313] The NTO has a multifaceted mission set forth in section 7803(c)(2), which includes, most significantly for our purposes, to ''assist taxpayers in resolving problems with the Internal Revenue Service.''[314] The specific powers granted to the NTO for doing so are delineated in section 7811, which provides for the office to issue taxpayer assistance orders (TAOs.)

A TAO can be the equivalent of a wand waved over a big mess, with magical results usually reserved for the movies. Those results can include quite dramatic real-life happy endings. To issue a TAO, the NTO must first find that the taxpayer is suffering or is about to suffer a ''significant hardship'' as a result of the manner in which the tax laws are being administered.[315] Significant hardship is defined to include: an immediate threat of adverse

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[307] *See* Tax Ct. R. Tits. III (Commencement of Case; Service and Filing of Papers; Form and Style of Papers; Appearance and Representation; Computation of Time) and XIV (Trials).

[308] *Compare* Tax Ct. R. app. I, Form 1 *with* Tax Ct. R. app. I, Form 2.

[309] Tax Ct. R. No. 174(b).

[310] Tax Ct. R. Nos. 141-150.

[311] Section 7463(b).

[312] Pub. L. 105-206, section 1001.

[313] ''Taxpayer Advocate'' replaced ''Ombudsman'' in 1996. Pub. L. 104-169 section 101(b).

[314] Section 7803(c)(2)(A)(i).

[315] Section 7811(a)(1)(A).

action, a delay of more than 30 days in resolving an account problem, significant costs that the taxpayer would incur if relief is not granted, or the existence of irreparable damage or long-term adverse effect if relief is not granted.[316] The subject matter of the TAO and the relief it may grant is set forth in such broad terms that the magical metaphor is indeed apt. A TAO, among other things, may release property of the taxpayer that is levied on, require the IRS to cease collection activity, or require the IRS to cease any action or take any action under law as the taxpayer advocate may specify. (Have you ever seen a constitutional democracy grant the legal power to *anyone* of the type the last of those clauses grants?)

A TAO can be rescinded only by action of the taxpayer advocate or by the IRS commissioner or deputy commissioner. That serves as something of a check on the otherwise breathtaking power granted to the taxpayer advocate to ignore the law or the facts if she sees fit. In practice, absent a taxpayer advocate who may have run amok, the commissioner or deputy commissioner will not likely intervene where a TAO has been issued to aid a low-income taxpayer who has been tossed about by the system.

The NTO actually consists of 74 taxpayer advocates, with at least one located in each state. A taxpayer advocate is easily accessed by calling 1-877-777-4778. A list of the local physical locations of the NTO can be found in IRS Publication 1546. The process of enlisting the assistance of the NTO is as straightforward as calling the telephone number or filing IRS Form 911. (Who said the IRS does not have a sense of humor?)

D. Offers in Compromise

It is certainly not surprising that many low-income taxpayers find themselves in circumstances in which they actually owe a tax liability they cannot pay. Some cases may be more sympathetic than others, such as the all-too-frequent situation of a taxpayer defrauded into falsely claiming an EITC, only to pay the perpetrator and spend the refund, while later learning that he was not entitled to and must repay the refund. Nonetheless, in both the sympathetic and nonsympathetic cases, the need to pay off the liability is a fact that must be addressed. Section 7122 provides statutory authority for the IRS to accept less than an amount found to be owing in full satisfaction of a taxpayer's liability for one or more tax years. Regulations under that section and Rev. Proc. 2003-71[317] set forth specific substantive and procedural criteria for the IRS to accept a so-called offer in compromise.

Treas. reg. section 301.7122-1(b) describes the three circumstances that the IRS will consider grounds for compromising an established tax liability. The three circumstances are: (1) ''doubt about liability,'' (2) ''doubt about collectibility,'' and (3) ''[promotion of] effective tax administration.'' Of those, doubt about collectibility is the most frequently used criterion.

There is not a great deal of authority elaborating on how a determination of doubt about liability is determined. The regulations simply provide that doubt about liability does *not* exist when the liability has been established by a final court decision. Otherwise the IRS can exercise a great deal of discretion, and is most likely to be amenable to compromise on the basis of doubt about liability when proof of the relevant facts by the taxpayer is possible if not certain.

A determination of doubt about collectibility must take into account the taxpayer's ability to pay. The taxpayer's ability to pay is determined only after allowing for the payment of the taxpayer's basic living expenses, which is made on the basis of the individual facts and circumstances of the taxpayer as well as the IRS's published guidelines on national and local living expense standards.[318]

Compromises to promote effective tax administration are premised on an IRS determination that even if collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship[319] or that there are compelling public policy or equity considerations present.[320] The regulations provide several examples of economic hardship that comport with common sense. For example, the effective tax administration is considered to be fostered if the IRS does not take the assets of a disabled person who foreseeably will need the assets to provide for his care[321] or if the taxpayer's liability is directly attributable to incorrect information that the IRS gave to the taxpayer.[322] However, even when economic hardship is present, perhaps in the most obvious of ways, a compromise is not deemed to promote effective tax administration if the taxpayer has a history of noncompliance.[323]

That illustrates the underlying tension in the OIC process and its administration. At the same time one recognizes that personal hardship must be a factor to be considered in effective tax administration, there is a wariness that leniency will encourage indifference toward compliance. As a result, there are remarkably few compromises that are accepted on the grounds of effective tax administration, and there has been considerable

[316]Section 7811(a)(2).

[317]2003-2 C.B. 517, *Doc 2003-18674, 2003 TNT 158-11.*

[318]Treas. reg. section 301.7122-(c)(2). *See* IRS Collection Financial Standards, available at http://www.irs.gov/individuals/article/o,,id+96543,00.html; Internal Revenue Manual sections 5.8, 5.15 (revised November 2004).

[319]Economic hardship for this purpose is as defined in Treas. reg. section 301.6343-1. *See supra* notes 262-263 and accompanying text.

[320]Treas. reg. sections 301.7122-(b)(3)(i), (ii).

[321]Treas. reg. section 301.7122-(c)(3)(iii), Example 1.

[322]Treas. reg. section 301.7122-(c)(3)(iii), Example 2. The regulations are not entirely sensible regarding that issue. Treas. reg. section 301.7122-(c)(3)(i)(C) states that hardship exists if a taxpayer is unable to borrow against the equity in her assets, and liquidation of the assets would leave the taxpayer unable to meet basic living expenses. That strongly implies that there is no hardship if the taxpayer is able to borrow against the assets even though there is little practical difference between borrowing against and liquidating assets. *But see Ewing v. Commissioner*, *supra* note 264 and accompanying text (dismissing the ability to borrow against assets).

[323]Treas. reg. section 301.7122-(c)(3)(ii)(A).

criticism of the overall efficacy of the OIC program generally. In particular, the ambivalence of the underlying philosophy has led to marked differences in the approaches taken by different IRS offices in otherwise comparable circumstances.[324] Improvement in OIC administration was named as one of the chief areas for improvement in the National Taxpayer Advocate's 2004 Report to Congress.[325]

Although the OIC process is flawed, it can be a critical tool to resolve the difficulties of a low-income taxpayer. The process of seeking a compromise begins with the filing of an IRS Form 656. The form requires the taxpayer to specify which of the three bases for an OIC is being relied on and to provide a detailed explanation of why the taxpayer qualifies for a compromise on that basis. Detailed financial information must be provided, except when the chosen basis is doubt about liability. The specific terms of the proposed offer must be provided on Form 656. The offer, which must be for an amount greater than zero,[326] may be one that includes periodic payments over time.[327] Somewhat incredibly, the filing of Form 656 must be accompanied by a $150 user fee, which is waived only in the case of a taxpayer whose annual income is below the federal poverty guideline amount.[328]

The IRS must make two separate determinations following the receipt of a taxpayer's offer pursuant to the filing of a Form 656. First, the IRS must determine whether or not it will ''accept the offer for processing.'' The IRS will not accept an offer for processing if the relevant liability has been referred to the Justice Department for prosecution or defense, or if it believes the offer was submitted solely to delay collection or was otherwise nonprocessable.[329] Nor will the IRS accept an offer for processing if the taxpayer has not made all required tax filings (including estimated tax payments) or is in bankruptcy.[330]

Acceptance of the offer for processing is an important formal step because at the point of acceptance, whereon the offer is referred to as ''pending,'' the IRS generally will cease efforts to collect the liability that is the subject of the offer.[331] The IRS may, however, proceed with collection efforts despite a pending offer if it believes that: (1) collection of the liability would be in jeopardy otherwise,[332] (2) the offer as submitted did not contain sufficient information to permit evaluation of whether it should be accepted,[333] (3) the offer was submitted solely to delay collection,[334] or (4) the offer was otherwise nonprocessable.[335] During the period in which collection efforts cease, the statute of limitations on collection is suspended.[336] The IRS may ''return'' an offer that had previously been accepted for processing if it later determines that the taxpayer has not supplied additional information as requested by the IRS or that it could have initially rejected the processing of the offer (for example, because the offer was submitted solely to delay collections).[337] The return of an offer allows the IRS immediately to commence any previously suspended collection efforts.[338]

The second determination the IRS must make is whether to accept or reject the offer. If the IRS rejects the offer, the taxpayer has 30 days to appeal the decision to the IRS Office of Appeals.[339] Returns of offers for failure of the taxpayer to provide requested information, or based on a determination that the offer was submitted solely to delay collection or otherwise was nonprocessable, are not considered to be rejections of an offer that entitle the taxpayer to appeal.[340] The IRS's suspension of collection efforts ceases 30 days after the rejection of an offer and unless a timely appeal is filed, whereupon the suspension continues until the appeal is decided.[341]

If the IRS accepts the offer and a written agreement is signed, the taxpayer's liability is conclusively resolved absent a discovery that the taxpayer either provided false information in the offer process or concealed assets or other means of payment, or that there otherwise was a mutual mistake of material fact.[342] The taxpayer must comply fully with the terms of the offer, and otherwise comply with all other tax filing and payment obligations for five years. Otherwise, the accepted offer is invalidated and the IRS may immediately begin to attempt to collect the full original amount of tax.[343] The IRS may request the taxpayer to post collateral as a condition of accepting an offer.[344]

VI. Conclusion

Tax colleagues, I urge you to get involved. Give back in kind. You are better suited to the task than you think. In my opinion, you also will be better at the task than anyone else. I guarantee you will feel good at the end. Can anyone issue that guarantee about your next round of golf?

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[324]National Taxpayer Advocate, 2004 Annual Report to Congress, at 11 (June 30, 2004).

[325]*Id*. at 7-15.

[326]IRS Form 656.

[327]*Id*.

[328]*Id*.

[329]Treas. reg. section 301.7122-1(d)(2).

[330]Rev. Proc. 2003-71, at section 5.01. However, in *In Re Peterson*, 317 B.R. 532, *Doc 2004-23736, 2004 TNT 245-20* (Bankr. D. Neb. 2004), the bankruptcy court ignored Rev. Proc. 2003-71 and ordered the IRS to process an offer of a taxpayer who was in a bankruptcy proceeding.

[331]Treas. reg. section 301.7122-1(g)(1).

[332]Treas. reg. section 301.7122-1(g)(3).

[333]Treas. reg. section 301.7122-1(g)(4).

[334]*Id.*

[335]*Id.*

[336]Treas. reg. section 301.7122-1(i)(1). The IRS may condition its consideration of an offer on the taxpayer's agreement to suspend the statute of limitations on assessment. Treas. reg. section 301.7122-1(i)(2).

[337]Treas. reg. section 301.7122-1(d)(2). As a taxpayer safeguard, managerial review is required before an offer can be returned by reason of the taxpayer's failure to provide requested financial information. Treas. reg. section 301.7122-1(f)(5)(ii).

[338]Treas. reg. section 301.7122-1(g)(1).

[339]Treas. reg. section 301.7122-1(f)(5)(i). Certain procedural safeguards are provided for in connection with IRS rejections. *See* Treas. reg. section 301.7122-1(f).

[340]Treas. reg. section 301.7122-1(f)(5)(ii).

[341]Treas. reg. section 301.7122-1(g)(1).

[342]Treas. reg. section 301.7122-1(e)(5).

[343]IRS Form 656.

[344]Treas. reg. section 301.7122-1(e)(2).