Settling Tax Debt: Relief and Bankruptcy

Course #3133A

Taxes

2 Credit Hours

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SETTLING TAX DEBT: RELIEF AND BANKRUPTCY

This course covers major tools that can be used to settle tax debts with the IRS. Topics include: Relief for liability for join returns and the common forms of bankruptcy protection.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Relief from Liability for Joint Returns
Resolving Delinquent Taxes Via Bankruptcy

Study the course materials from pages 1 to 53

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify differences between the four types of relief from joint and several liability for spouses who filed joint returns.
- Recognize differences between the most common forms of bankruptcy protection.

NOTICE

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: RELIEF FROM LIABILITY FOR JOINT RETURNS

Chapter Objective

After completing this chapter, you should be able to:

- Identify differences between the four types of relief from joint and several liability for spouses who filed joint returns.

I. OVERVIEW

When a couple elects to file a joint return, both taxpayers are jointly and severally liable for the tax and any additions to tax, interest, or penalties that arise as a result of the joint return, even if they later divorce. Joint and several liability means that each taxpayer is legally responsible for the entire liability. Thus, both spouses are generally held responsible for all the tax due, even if one spouse earned all the income or claimed improper deductions or credits. This is also true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. In some cases, however, a spouse can get relief from joint and several liability.

There are four types of relief from joint and several liability for spouses who filed joint returns:

- **Innocent Spouse Relief:** This provides the innocent relief from additional tax owed by a taxpayer if his or her spouse or former spouse failed to report income, reported income improperly, or claimed improper deductions or credits;
- **Separation of Liability Relief:** This provides for the allocation of additional tax owed between a taxpayer and his or her former spouse or current spouse from whom he or she is separated because an item was not reported properly on a joint return. The tax allocated to the taxpayer is the amount for which he or she is responsible; or
- **Equitable Relief:** This type of relief may apply when a taxpayer does not qualify for innocent spouse relief or separation of liability relief for something not reported properly on a joint return and generally attributable to his or her spouse. A taxpayer may also qualify for equitable relief if the correct amount of tax was reported on his or her joint return but the tax remains unpaid.
- **Relief from Liability for Tax Attributable to an Item of Community Income:** This type of relief only applies to taxpayers who file a tax return in a community property state. A taxpayer is not responsible for the tax relating to an item of community income if certain conditions are met.

Married persons who did not file joint returns but who live in community property states may also qualify for relief. This will be discussed later in this chapter.

Generally, the IRS has ten years to collect federal taxes. This is the collection statute of limitations. By law, the IRS is not allowed to collect from a taxpayer after the 10-year statute ends. If a taxpayer requests relief for any tax year, the IRS cannot collect from the taxpayer for that year while the request is pending but interest and penalties continue to accrue. A taxpayer's request is generally considered pending from the date the IRS receives his or her Form 8857 until the date the request is resolved. This includes the time the Tax Court is considering the request. After the case is resolved, the IRS can begin or resume collection proceedings. The 10-year period will be increased by the amount of time the taxpayer's request for relief was pending plus 60 days.

II. REQUESTING RELIEF

A taxpayer seeking Innocent Spouse Relief must file Form 8857, a copy of which is provided at the end of this course. Taxpayers seeking relief for more than six tax years must file an additional Form 8857.

A. OVERVIEW

1. Innocent Spouse Relief

By requesting innocent spouse relief, a taxpayer can be relieved of responsibility for paying tax, interest, and penalties if his or her spouse (or former spouse) improperly reported items or omitted items on his or her tax return. Generally, the tax, interest, and penalties that qualify for relief can only be collected from his or her spouse (or former spouse). However, a taxpayer is jointly and individually responsible for any tax, interest, and penalties that do not qualify for relief. The IRS can collect these amounts from either spouse or former spouse.

A taxpayer must meet all of the following conditions to qualify for innocent spouse relief:

- He or she filed a joint return;
- There is an understated tax on the return that is due to erroneous items (defined later) of his or her spouse (or former spouse);
- He or she can show that when they signed the joint return he or she did not know, and had no reason to know, that the understated tax existed (or the extent to which the understated tax existed); and
- Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understated tax.

Innocent spouse relief will not be granted if the IRS proves that the taxpayer and his or her spouse (or former spouse) transferred property to one another as part of a fraudulent scheme. A fraudulent scheme includes a scheme to defraud the IRS or another third party, such as a creditor, former spouse, or business partner.

2. Separation of Liability Relief

A taxpayer may be allowed separation of liability relief for any understated tax (defined above) shown on the joint return(s) if the person with whom the taxpayer filed the joint return is deceased or the taxpayer and that person:

- Are now divorced,
- Are now legally separated, or
- Have lived apart at all times during the 12-month period prior to the date the taxpayer filed Form 8857.

If, at the time the taxpayer signed the joint return, he or she knew about any item that resulted in part or all of the understated tax, then the taxpayer's request will not apply to that part of the understated tax.

3. Equitable Relief

The taxpayer may be allowed equitable relief if both of the following conditions are met.

- The taxpayer has an understated tax (defined earlier) or unpaid tax (defined next), and
- Taking into account all the facts and circumstances, the IRS determines it would be unfair to hold the taxpayer liable for the understated or unpaid tax.

Equitable relief is the only type of relief available for an unpaid tax.

B. WHEN TO FILE

A taxpayer seeking relief should file Form 8857 as soon as he or she becomes aware of a tax liability for which he or she believes that only his or her spouse or former spouse should be liable. There are a variety of ways a taxpayer could become aware of such a liability, including the following:

- The IRS is examining his or her tax return and proposing to increase his or her tax liability; or
- The taxpayer receives a notice of assessment from the IRS.

1. Two-Year Rule

Form 8857 must generally be filed no later than two years after the date on which the IRS first attempted to collect the tax.[1] For this reason, a taxpayer should not delay filing because he or she does not have all the required documentation.

Collection activities that may start the 2-year period are:

- The IRS offsets a taxpayer's income tax refund against an amount owed on a joint return for another year and the IRS informed the taxpayer about his or her right to file Form 8857;

1. If a taxpayer is requesting relief based on community property laws, a different filing deadline applies.