# HEARING

BEFORE THE

# COMMITTEE ON WAYS AND MEANS
# HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

## H.R. 3475

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO SIMPLIFY AND IMPROVE THE TAX LAWS

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Thank you for the opportunity to testify. I congratulate Representatives Rostenkowski and Conable for taking this initiative. I urge the Ways and Means Committee to move as quickly as possible toward enactment of this important legislation.

**STATEMENT OF GAIL M. HARMON, COUNSEL, ON BEHALF OF THE WOMEN'S LEGAL DEFENSE FUND AND THE WOMEN'S EQUITY ACTION LEAGUE**

Mr. PEASE. Ms. Harmon, you may proceed.

Ms. HARMON. Thank you. My name is Gail Harmon. I am testifying on behalf of the Women's Legal Defense Fund and the Women's Equity Action League in favor of the proposed revisions to the so-called innocent spouse rule.

Prior to 1971, the general rule was that when a husband and wife filed a joint income tax return, each would be jointly and severally liable for any deficiencies, interest, or penalties. A claim of innocence of the wrongdoing would not even be considered. In 1971, subsection (e) was added to section 6013 of the code. This so-called innocent spouse provision grants relief in those rare cases in which the following five requirements are met: One, a joint return was filed; two, there was an omission from gross income attributable to the guilty spouse; three, the omission constituted an amount in excess of 25 percent of the amount stated in gross income; four, the innocent spouse established that he/she neither had knowledge of the omission nor reason to know of it; and five, considering all the facts and circumstances—most notably, whether the innocent spouse significantly benefitted from the omission, it would be inequitable to hold the innocent spouse liable.

The legislative history of this section makes clear that Congress intent was to bring Government tax collection practices into accord with basic principles of equity and fairness. However, the change enacted did not go far enough, and basic inequities still exist.

The proposed bill now before you will increase the instances in which the courts are able to achieve the equitable results Congress originally intended. Relief would be available in all cases of substantial understatement of tax whether the understatement is due to omitted income or inflated deductions. Substantial understatement would be broadly defined to allow an increased amount of innocent spouse taxpayers to qualify. In addition, special rules would provide equal treatment for innocent spouse taxpayers in community property States.

The proposal substitutes the broader category of substantial understatement of tax for understatements of gross income, correcting the problem that current law ignores cases involving errors in deductions or credits. It is just as unfair to impose liability on an innocent spouse for underpaid taxes due to overstated deductions as it is to impose liability for underreported gross income.

In Spaulder, a wife was denied relief when an erroneous deduction in a joint return improperly reflected losses on the sale of securities as ordinary rather than capital losses. In Resnick, the coin-dealer husband overstated the cost of goods sold. Again relief was denied because the understatement of income was held attributable to an erroneous deduction rather than to unreported income.

The present statute usually applies to the rare case of an innocent nonworking spouse of a criminal who fails to report his illegal

income to the IRS. This new formulation is better adapted to the current reality of two income families. In the case of a dual professional household, each spouse is responsible for his/her individual business accounts and would contribute only the final figures for inclusion on the joint return. Each spouse would have no reason to doubt the information from the other spouse and probably little access to the raw data provided in the information.

Second, the bill provides relief for more innocent taxpayers since it will apply to all understatements of tax exceeding the lesser of 10 percent or $500. Too often the Federal tax law provides relief only to the very rich. This proposal provides relief to innocent spouses up and down the income scale.

Third, the proposed amendment would eliminate the provision requiring that the innocent spouses prove that they did not benefit directly or indirectly. The significant benefit doctrine has proven to be a vague concept that will become worthless when applied to understatements of tax as opposed to omitted income.

Finally, this amendment provides relief for the particular problems faced by innocent spouses in a community property State. The property law of these States provides that the income of one spouse is attributable to the other spouse even though separate Federal tax returns are filed. Under the present Federal statute, relief is not available when separate returns are filed. Take, for example, the case of Mary Lou Galliher, who resited in the community property State of Texas. She met all of the other tests of the statute but she was denied relief of section 6013(e) because she had filed a separate return. It seems only fair that innocent spouses in community property States should have the same rights as those residing in noncommunity property States.

Congress attempted to remedy existing inequities in the area of joint and several liability by enacting the innocent spouse provisions. However, many injustices still exist and many innocent spouses are denied relief. The bill that you are looking at today will insure the relief that Congress originally intended.

[The prepared statement follows:]

STATEMENT OF GAIL M. HARMON ON BEHALF OF THE WOMEN'S LEGAL DEFENSE FUND AND THE WOMEN'S EQUITY ACTION LEAGUE

Good morning. My name is Gail Harmon. I am a practicing tax attorney here in Washington and a partner in the law firm of Harmon & Weiss. I am testifying on behalf of the Women's Legal Defense Fund and the Women's Equity Action League. I would like to thank the committee for the opportunity to comment today on the proposed revisions to section 6013(e) of the Internal Revenue Code, the so-called innocent spouse rule.

Prior to 1971, the general rule was that when a husband and wife filed a joint income tax return each would be jointly and severally liable for any deficiencies, interest or penalties. A claim of innocence of the wrongdoing would not even be considered. In 1971, subsection (e) was added to section 6013 of the Code. This so called innocent spouse provision grants relief in those rare cases in which the following five requirements are met: (1) a joint return was filed; (2) there was an omission from gross income attributable to the "guilty" spouse; (3) the omission constituted an amount in excess of 25 percent of the amount stated in gross income; (4) the innocent spouse established that he/she neither had knowledge of the omission or "reason to know of it"; and (5) considering all the facts and circumstances (most notably, whether the innocent spouse "significantly benefited" from the omission), it would be inequitable to hold the innocent spouse liable.

The legislative history of this section makes clear that Congress's intent was to bring government tax collection practices into accord with basic principles of equity

and fairness. However, the change enacted did not go far enough, and basic inequities still exist.

The proposed bill now before you will increase the instances in which the courts are able to achieve the equitable results Congress originally intended. Relief would be available in all cases of "substantial understatement of tax," whether the understatement is due to omitted income or inflated deductions. "Substantial understatement" would be broadly defined to allow an increased number of innocent spouse taxpayers to qualify. In addition, special ruels would provide equal treatment for innocent spouse taxpayers in community property states.

The proposal substitutes the broader category of "substantial understatement of tax" for understatements of gross income, correcting the problem that current law ignores cases involving errors in deductions or credits. It is just as unfair to impose liability on an innocent spouse for underpaid taxes due to overstated deductions as it is to impose liability for underreported gross income.[1]

The present statute usually applies to the rare case of an innocent non-working spouse of a criminal who fails to report his illegal income to the I.R.S. This new formulation is better adapted to the current reality of two income families. In the case of a dual professional household, each spouse is responsible for his/her individual business accounts and would contribute only the final figures for inclusion on the joint return. The other spouse would have no reason to suspect that the information provided was not accurate. He/she would have no knowledge of underestimated business income or inflated deductions claimed by the other spouse.

Second, the bill provides relief for more innocent taxpayers since it will apply to all understatements of tax exceeding the lesser of ten percent or $500. Too often the federal tax law provides relief only to the very rich. This proposal provides relief to innocent spouses up and down the income scale. The original Senate report on section 6013(e) indicates that one of the primary purposes for the current 25 percent requirement was to establish a clear standard and to assure judicial economy. The proposal substitutes another precise standard and meets the desire for judicial economy through forces of the market place, namely the high cost of legal representation, which will deter insubstantial claims. More important, the proposed lower threshold would be consistent with the remedial nature of the original statute.[2]

Third, the proposed amendment would eliminate the provision requiring that the innocent spouses prove that they did not benefit directly or indirectly. The "significant benefit" doctrine has proven to be a vague concept that will become worthless when applied to understatements of tax as opposed to omitted income. When the tax fraud relates to failing to report substantial amounts of embezzeled funds or gambling winnings, one may be able to show that the innocent spouse never received the benefit of these funds. However, when the error relates to inflated deductions there is no hidden income from which to benefit. In addition, if the focus is upon understatements of tax, the lack of substantial benefit can be proved only in those cases in which the marriage has already broken down and the parties are separated.

Finally, this amendment provides relief for the particular problems faced by innocent spouses in a community property state. The property law of these states provides that the income of one spouse is attributable to the other spouse even though separate federal tax returns are filed. Under the present federal statute, relief is not available where separate returns are filed. Take for example, the case of *Mary Lou Galliher,* who resided in the community property State of Texas. She met all of the other tests of the statutes but she was denied relief of section 6013(e) because she had filed a separate return. It seems only fair that innocent spouses in community property states should have the same rights as those residing in noncommunity property states.

Congress attempted to remedy existing inequities in the area of joint and several liability by enacting the innocent spouse provisions. However, many injustices still exist and many innocent spouses are denied relief from liability. To the extent these

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[1] Two instances of the unjust denial of relief follow. In Spaulder, (TCM 1972-144) a wife was denied relief when an erroneous deduction in a joint return improperly reflected losses on the sale of securities as ordinary rather than capital losses. In *Resnick,* [63 TC 524 (1975)], the coin-dealer husband overstated the cost of goods sold. Again relief was denied because the understatement of income was held attributable to an erroneous deduction rather than to unreported income.

[2] The case of *Estate of Klein* v. *Commissioner* demonstrates the inequities in the 25 percent of gross income test. There, the husband reported $91,000 in net partnership income but $45,000 of miscellaneous income in dividends, interest and the like. However, because the husband's gross income was based upon his distributive share of partnership income before partnership deductions, it was quite large and prevented the spouse from meeting the 25 percent test.