

# INITIAL DISCUSSION FOR ISSUE PAPER

## Equitable Relief Under Regulation 1705.1, Innocent Spouse Relief from Liability

### Issue

Should Regulation 1705.1, *Innocent Spouse Relief from Liability*, be amended to 1) clarify that relief generally does not generally apply to spouses still married to and living with a spouse who has been attributed with a sales and use tax liability, and 2) include provisions concerning equitable relief for spouses?

### Background

Regulation 1705.1 (Exhibit 1), effective December 5, 1997, interprets and explains the provisions of Revenue and Taxation Code (RTC) section 6456 (Exhibit 2). Section 6456 authorizes the Board to grant innocent spouse relief to persons who meet certain criteria. It was originally enacted by AB 1288, Stats. 1993, Ch. 181 and subsequently amended by SB 1827, Stats. 1996, Ch. 1087. The purpose of section 6456 is to conform the Sales and Use Tax Law to Internal Revenue (IRS) Code and Franchise Tax (FTB) Code provisions concerning relief for innocent spouses.

During the year 2000 legislative session, AB 2898, Stats. 2000, Ch. 1052 added subdivision (f) to section 6456, effective January 1, 2001. This subdivision further conforms the Sales and Use Tax Law with the FTB and IRS provisions concerning equitable relief. Subdivision (f) authorizes the Board, when appropriate, to grant equitable relief to spouses not eligible for innocent spouse relief. It provides:

Under procedures prescribed by the board, if, taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under subdivision (a), the board may relieve the other spouse of that liability.

Staff proposes two amendments to Regulation 1705.1. First, staff proposes an amendment to subdivision 1705.1(c) to clarify that a spouse who is still married to and living with a spouse who is liable for sales and use tax will generally not qualify for innocent spouse relief. The current regulation does not specifically address the granting of relief in such a situation. Second, staff proposes to add language concerning “equitable relief” to Regulation 1705.1 through the addition of subdivision 1705.1(h). This amendment incorporates subdivision 6456(f) into Regulation 1705.1. The proposed amendments are shown in Exhibit 1.

Discussion of this proposal is on the agenda for the Business Taxes Committee scheduled for March 28, 2001.

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#### Discussion of Innocent Spouse Relief

##### Regulation 1705.1

The relief of liability provided by Regulation 1705.1 applies to a limited class of taxpayers. The taxpayer must be a spouse who has a liability and the liability must result from the activities of a business co-owned by both spouses, or from a dual determination issued because the spouse has been active in a business operated by the other spouse.

In subdivision (a), Regulation 1705.1 provides that a spouse meeting these basic criteria may file a claim for relief from liability if all the following requirements are met:

- The liability is incurred under the Sales and Use Tax Law.
- The liability is attributable to the non-claiming spouse. “Attribution” is defined in subdivision (c) and is determined on the basis of which spouse rendered substantial services as a retailer or, if an erroneous deduction or credit is claimed, which spouse caused the deduction or credit to be entered on the return. If individual attribution cannot be established, then both spouses are held to be the retailers.
- The spouse claiming relief can establish that he or she did not know of the liability and a reasonably prudent person in the spouse’s position would not have reason to know.
- When taking into account the significant direct or indirect benefit to the spouse and taking into account all other facts and circumstances, it would be inequitable to hold the spouse liable. “Significant benefit,” discussed in subdivision 1705.1(b), does not include support payments that allow the spouse to maintain a normal standard of living.

Subdivision 1705.1(d) provides that a spouse must submit a relief request in writing. The written request must include the seller’s permit number, the period for which relief is requested, and the specific grounds on which the claim is based.

In subdivision 1705.1(e), the regulation provides for a statute of limitations on the period within which a claim may be filed for liabilities not yet paid. A spouse may claim relief for all quarters included in a liability if the relief request is filed no later than one year after the Board’s first contact with the spouse. If the spouse files a claim more than one year after first contact, it will not apply to any calendar quarter that is more than five years from the due date for a nonpayment on a return or more than five years from the finality date on the Board-issued determination, whichever is later. Calendar quarters that have been closed by res judicata, that is, by court action, are not eligible for relief.

These limitations do not apply to innocent spouse claims for refunds on liabilities that have already been paid. Subdivision 1705.1(f) provides that a refund of any amounts is subject to the

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requirements of RTC sections 6901 through 6908. On a sales and use tax return, section 6902 limits refund claims to three years from the last day of the month following the close of the quarterly period for which the overpayment was made. With respect to determinations issued by the Board, a claim must be filed within six months of the date of determination or within six months of the date of payment on the determination or within the three year statute of limitation for a quarter included in the determination, whichever period expires the later. An innocent spouse claim seeking a refund must adhere to the statute of limitations provided by section 6902.

#### Administration of Claims Made under Regulation 1705.1

Written requests for relief as an innocent spouse must be filed with the Board's Offers in Compromise Section (OIC). If an initial review finds that the request is timely, the OIC will determine whether the request meets the substantive criteria of attribution, benefit, and knowledge. The OIC makes this determination based on the explanation included in the request and the documentation provided by the claimant. In general, the claimant must document that:

- The underpayment is attributable to the other spouse. This includes a failure to file a return, the understatement of amounts reported, or an erroneous claim of a credit or deduction.
- No significant benefit was received because of the underpayment.
- He or she had no knowledge of the underpayment.

Because each case is unique, there are no standard types of documentation. In general, the documentation submitted by the claimant must demonstrate that, during the period of the liability, the claimant:

- Had no direct involvement with the business, such as being included on the business checking account, keeping the books, signing checks, managing employees, or signing returns.
- Had separate assets, such as wages, bank accounts, or real property; or maintained a separate household because of separation or divorce.
- Filed separate federal and state income tax returns and the claimant's returns took no depreciation for the business assets and showed no income or loss from the business.

The claimant must also document that there were no subsequent joint bankruptcy filings that included the liability and that any support received from the other spouse during the period of liability helped only to maintain a "normal" lifestyle.

The documentation that a claimant may provide in support of his or her position is not restricted to the items listed above. A claimant may provide any documentation that will help support the claim of innocent spouse status.

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Subdivision 1705.1(a) provides that all requirements must be met. Failure to adequately document any one requirement: attribution, lack of knowledge, or lack of significant benefit, will result in denial of the request. To date, a claimant whose request for innocent spouse relief has been denied has no other recourse for relief of the liability.

#### Discussion of “Attribution”

Under RTC section 6456, relief from a liability as an innocent spouse is dependent on whether the liability is “attributable” to the other spouse. “Attributable” means that the Board determines the other spouse as wholly responsible for the sales and use tax liability. Subdivision 6456(b) states that attribution to a spouse “shall be made without regard to community property laws.” That is, the responsibility for the liability is determined against one spouse even though, under community property laws, the spouses would be jointly liable. Subdivision 6456(e) states that a liability may be determined to be “attributable to one spouse” when a spouse renders substantial services as a retailer. If neither spouse renders substantial services as a retailer, the attribution of applicable understatements will be treated as community property. That is, both spouses will be liable. Subdivision 6456(e) also states that an erroneous deduction or credit is attributable to the spouse who caused the error to be entered on a return.

The “attribution” provisions of 6456 are restated in Regulation 1705.1, subdivision (c):

Attribution. The determination of the spouse to whom items of liability are attributable shall be made without regard to community property laws. With respect to a liability incurred as a result of a failure to file a return or an omission of an item from the return, attribution to one spouse may be determined by whether a spouse rendered substantial services as a retailer of taxable items related to the liability. If neither spouse rendered substantial services as a retailer, then the attribution of the liability shall be treated as community property. A liability incurred as a result of an erroneous deduction or credit shall be attributable to the spouse who caused that deduction or credit to be entered on the return.

Although the current language of subdivision 1705.1(c) is an accurate paraphrase of the statute, staff is of the opinion that it does not, as stated in Regulation 1500, *Foreword*, sufficiently “implement, interpret or make specific” the “attribution” provisions of RTC section 6456. In particular, staff feels that the regulation does not clearly address the issue of whether a sales and use tax liability can be “attributed” to one spouse in the case of spouses who are still married and living together.

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The lack of clarity stems from the community property law statutes in California's Family Code. In general, the California Family Code provides that property owned by a husband and wife is owned in common, that is, the property qualifies as community property. Community property includes not only assets owned in common, but also wages earned by a spouse. In addition, a spouse is generally liable for any debt generated by the other spouse; that is, the debt qualifies as community debt. Community debt includes, but is not limited to, mortgages, consumer debt, and tax liabilities. Debt incurred by one spouse is the legal liability of the other spouse and the creditor can collect the debt through a levy of community property, including the wages earned by the other spouse.

Consequently, a spouse who is still married to and living with the other spouse generally cannot qualify for innocent spouse relief under the provisions of Regulation 1705.1 because the sales and use tax liability is not solely attributable to the other spouse. Under the community property statutes, the requesting spouse is jointly liable for the unpaid sales or use tax. Even if a spouse is found to be innocent, the Board can still levy against community property owned by the spouses, including wages earned by the innocent spouse.

To clarify the application of innocent spouse relief to intact unions, staff suggests the following amendments to subdivision 1705.1(c):

Attribution. The determination of the spouse to whom items of liability are attributable shall be made without regard to community property laws. A spouse who requests innocent spouse relief but is still married to and living with the other spouse generally will not qualify for such relief. With respect to a liability incurred as a result of a failure to file a return or an omission of an item from the return, attribution to one spouse may be determined by whether a spouse rendered substantial services as a retailer of taxable items related to the liability. If neither spouse rendered substantial services as a retailer, then the attribution of the liability shall be treated as community property. A liability incurred as a result of an erroneous deduction or credit shall be attributable to the spouse who caused that deduction or credit to be entered on the return.

### Discussion of Equitable Relief

The addition of subdivision (f) to RTC section 6456 authorizes the Board to grant equitable relief to a claimant who does not meet the strict criteria of the innocent spouse provisions in section 6456 and Regulation 1705.1. Rather, staff must consider all facts and circumstances presented by the claimant. If, on balance, it appears inequitable to hold the claimant liable, staff may recommend relief of the liability.

Examples of when equitable relief may apply include cases where:

- The spouse/claimant knew of the liability when it was incurred and was involved with the business at the time of the liability, but was unable to correct the understatement and/or

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underpayment and was unable to discontinue business involvement because of abusive coercion by the other spouse.

- The spouse/claimant was active in the business and knew of the liability, but had no control over payments or return filings.

These examples do not cover all possibilities for making claims for equitable relief. In general, the facts and circumstances underlying relief requests are different for each case.

Staff recommends that equitable relief be considered only after a taxpayer has been denied relief as an innocent spouse. This recommendation is based on the language of 6456(f), which provides that equitable relief should be considered for “any item for which relief is not available under subdivision (a),” that is, under the innocent spouse provision of section 6456. In the staff’s opinion, this language implies that a spouse must first apply for and be denied innocent spouse relief prior to requesting equitable relief.

Staff is of the opinion that the statute of limitations provided for in subdivision 1705.1(e) also applies to requests for equitable relief. That is, requests filed within one year of first contact may include all quarters included in a liability. Requests filed more than one year after first contact are limited to calendar quarters that are less than five years from the due date for a nonpayment on a return or from the finality date on the Board-issued determination, whichever is later. Calendar quarters that have been closed by court action (res judicata) are not eligible for relief. This opinion is based on the strict language of subdivision 6456(f). This subdivision provides that equitable relief may apply only if relief is not available under 6456(a), that is, the innocent spouse provisions. Subdivision 6456(f) does not exclude equitable relief from the statute of limitations provided for in subdivision 6456(c).

#### Summary

Adoption of Regulation 1705.1 provided guidelines for granting innocent spouse relief to qualified spouses. The amendments proposed by staff will 1) clarify the application of innocent spouse relief to a spouse still married to and living with the other spouse, and 2) incorporate the equitable relief provision in 6456(f) that was passed by the Legislature during the year 2000 legislative session. Enactment of the equitable relief provision and its inclusion in Regulation 1705.1 will allow staff to consider all the relevant facts and circumstances of a case and recommend relief where appropriate.

Prepared by the Program Planning Division, Sales and Use Tax Department

Current as of 11/20/2000

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Regulation 1705.1. Innocent Spouse Relief from Liability.

(a) In General. A spouse claiming relief from liability for any sales or use tax, interest, penalties, and other amounts shall be relieved from such liability where all the following requirements are met:

(1) A liability is incurred under the Sales and Use Tax Law;

(2) The liability is attributable to the nonclaiming spouse;

(3) The spouse claiming relief establishes that he or she did not know of, and that a reasonably prudent person in the claiming spouse's circumstances would not have had reason to know of, the liability; and

(4) It would be inequitable to hold the claiming spouse liable for the liability, taking into account whether the claiming spouse significantly benefited directly or indirectly from the liability, and taking into account all other facts and circumstances.

(b) ~~Definition of~~ "Benefited." Whether a claiming spouse has benefited directly or indirectly from the liability will be determined by a review by the Board of all of the available evidence. Normal support payment is not a significant benefit for purposes of this determination. Normal support is measured relative to each family's standard of living. The claiming spouse will not be deemed to have benefited directly or indirectly from the liability solely as a result of normal support unless his or her lifestyle significantly improved during the periods of liability. Gifts received by the claiming spouse, or lavish or luxury purchases made by either spouse may be evidence that the claiming spouse benefited directly or indirectly from the liability. Evidence of direct or indirect benefit may consist of transfers of property, including transfers which may be received several years after the calendar quarter in which the liability occurred. For example, if a claiming spouse receives from the other spouse an inheritance of property or life insurance proceeds which are traceable to the liability, the claiming spouse will be considered to have benefited from that liability. Other factors considered may include desertion of the claiming spouse by the other spouse or that the spouses have become divorced or separated subsequent to the periods of liability.

(c) Attribution. The determination of the spouse to whom items of liability are attributable shall be made without regard to community property laws. A spouse who requests innocent spouse relief but is still married to and living with the other spouse will generally not qualify for such relief. With respect to a liability incurred as a result of a failure to file a return or an omission of an item from the return, attribution to one spouse may be determined by whether a spouse rendered substantial services as a retailer of taxable items related to the liability. If neither spouse rendered substantial services as a retailer, then the attribution of the liability shall be treated as community property. A liability incurred as a result of an erroneous deduction or credit shall be attributable to the spouse who caused that deduction or credit to be entered on the return.

(d) Written Request for Relief. To seek relief under these provisions, a claiming spouse may submit a written request for relief setting forth the seller's permit number, the period for which relief is requested, and the specific grounds upon which the request for relief is based.

(e) Statute of Limitations. These provisions shall apply to all calendar quarters for claims made no later than one year after the board's first contact with the spouse making the claim.

Claims made after one year from the board's first contact with the spouse making the claim shall not apply to any calendar quarter that is more than,

Five years from the return due date for nonpayment on a return, or  
Five years from the finality date on the board-issued determination,

whichever is later.

No calendar quarters shall be eligible for relief under this regulation that have been closed by res judicata.

(f) Refunds. A refund of any amounts under these provisions shall be subject to the requirements as set forth in Revenue and Taxation Code sections 6901 through 6908, inclusive.

(g) This regulation shall apply retroactively to liabilities arising prior to January 1, 1994.

(h) Effective January 1, 2001, a spouse may be relieved of liability for any unpaid tax or deficiency under the Sales and Use Tax Law if, taking into account all the facts and circumstances, it is inequitable to hold the spouse liable for such amount attributable to any item for which relief is not available under subdivisions (a) through (d). A spouse may file a written claim for equitable relief under this subdivision only after a written claim for relief has been filed pursuant to subdivision (d) and that claim has been denied by the Board.

**Revenue and Taxation Code Section 6456  
As Amended by AB 2898 (Chap. 1052) Stats. of 2000**

SECTION 1. Section 6456 of the Revenue and Taxation Code is amended to read:

6456. (a) Under regulations prescribed by the board, if:

(1) A tax liability under this part was understated by a failure to file a return required to be filed under this part, by the omission of an amount properly includable therein, or by erroneous deductions or credits claimed on a return, and the understatement of tax liability is attributable to one spouse; or any amount of the tax reported on a return was unpaid and the nonpayment of the reported tax liability is attributable to one spouse,

(2) The other spouse establishes that he or she did not know of, and had no reason to know of, that understatement or nonpayment, and

(3) Taking into account whether or not the other spouse significantly benefited directly or indirectly from the understatement or the nonpayment and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax attributable to that understatement or nonpayment, then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) to the extent that the liability is attributable to that understatement or nonpayment of tax.

(b) For purposes of this section, the determination of the spouse to whom items of understatement or nonpayment are attributable shall be made without regard to community property laws.

(c) This section shall apply to all calendar quarters subject to the provisions of this part, but shall not apply to any calendar quarter that is more than five years from the final date on the board-issued determination, five years from the return due date for nonpayment on a return, or one year from the first contact with the spouse making a claim under this section; or that has been closed by res judicata, whichever is later.

(d) For purposes of paragraph (2) of subdivision (a), "reason to know" means whether or not a reasonably prudent person would have had reason to know of the understatement or nonpayment.

(e) For purposes of this section, with respect to a failure to file a return or an omission of an item from the return, "attributable to one spouse" may be determined by whether a spouse rendered substantial service as a retailer of taxable items to which the understatement is attributable. If neither spouse rendered substantial services as a retailer, then the attribution of applicable items of understatement shall be treated as community property. An erroneous deduction or credit shall be attributable to the spouse who caused that deduction or credit to be entered on the return.

(f) Under procedures prescribed by the board, if, taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under subdivision (a), the board may relieve the other spouse of that liability.