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Tax Law 101 for the Legal Aid Practitioner

BY JOHN YOUNG

If the topic of conversation at social gatherings with other lawyers turns to what type of law I practice, I can get some curious looks. Private attorneys are surprised to learn that a lawyer for poor people practices tax law. You can almost hear them thinking, “How can a person with no money have tax problems? They don’t pay tax.” Much to my clients’ dismay, that is not true. Those living in poverty can have as many, if not more, tax problems as anyone else.

Here I share a primer for legal aid lawyers on the tax issues most frequently encountered by those in poverty. I often train new lawyers at my office on basic tax questions that may surface when they represent our clients. I do this so that new attorneys can spot issues, seek out advice, and refer clients to me and our office’s low-income taxpayer clinic.

The Legal Aid Society in Louisville, Kentucky, was awarded a low-income taxpayer clinic grant from the Taxpayer Advocate Service to represent low-income taxpayers in disputes with the Internal Revenue Service (IRS). The Taxpayer Advocate

Service, an independent organization within the IRS, is dedicated to resolving tax issues where the taxpayer is undergoing a hardship and the issue cannot be resolved through normal IRS channels. Low-income taxpayer clinics are found in 49 states and the District of Columbia.¹ As of 2016, there were 138 organizations receiving these

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funds to represent low-income taxpayers in tax controversies. Many of the grantees are legal aid organizations, but grantees also include universities and nonprofit entities.² If a legal aid attorney encounters a client with a tax problem, a low-income taxpayer program is very likely nearby, if not in-house, to which that client can be referred.

Given the priorities and areas of practice for a legal aid organization, legal

1 [Internal Revenue Service, Pub. 5066, Low Income Taxpayer Clinics Program Report 3](#) (Jan. 2017).

2 See [Internal Revenue Service, Pub. 4134, Low Income Taxpayer Clinic List](#) (Jan. 2017).

aid attorneys often see clients with tax problems related to family law, debt, and social security benefits.

Family Law

The tax law questions that often arise in family law cases are (1) which filing status an individual should use when the individual has separated from a spouse in the past year but has not yet divorced, (2) whether a divorce court has the power to divide the tax credits and deductions associated with children, (3) whether parents can agree to divide tax benefits between themselves, and (4) how to deal with joint tax debt between married or formerly married people.

“CAN I CLAIM MY KIDS?”

Clients often ask this simple question, “Can I claim my kids?” The answer is a lot more complicated than the question would indicate. Six different potential benefits are associated with children whom one can claim on an income tax return.³

The most important benefit to low-income clients is often the Earned Income Tax Cred-

3 Those benefits are head of household filing status (which allows for a larger standard deduction), dependent exemption, child tax credit, additional child tax credit, earned income tax credit, and child and dependent care credit.

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it. For clients living in poverty, the Earned Income Tax Credit is a way to buy or make a down payment on a car or get caught up on past-due bills. For tax year 2016, the Earned Income Tax Credit was worth up to \$6,269 for a single filer with three qualifying children.⁴ The Earned Income Tax Credit is a refundable credit, that is, the taxpayer can receive this money as a refund even if the taxpayer owes no tax.

For clients who are recently separated from their spouse and are trying to regain their financial footing, the Earned Income Tax Credit can be a lifeline. However, those who have separated from their spouse cannot claim the Earned Income Tax Credit for their children if the taxpayer’s filing status is married filing separately.⁵ To claim the credit if a client is married, the client must file as married filing jointly or as head of household.⁶ To file as head of household, the client can still be married but must have been separated from the spouse for the last six months of the tax year.⁷ If the client was still living with the spouse during the final six months of the year, the client will need to make the difficult decision either to give up the Earned Income Tax Credit or to file the tax return jointly with the estranged spouse.

The latter option can open up a can of worms. The estranged spouse often wants a portion of the refund generated in whole or in part by the Earned Income Tax Credit.

Whether this situation presents a problem for the client varies. Sometimes clients are happy to get a portion of a refund with the Earned Income Tax Credit if the other option would be getting much less or nothing. But clients must trust their estranged spouse to report all income and deductions on the tax return honestly. If the IRS later audits the return and finds a debt due and owing, it could be the responsibility of your client. Take care to advise your client on the potential benefits and consequences of filing a joint tax return.

CAN PARTIES IN A DIVORCE AGREE TO ALLOCATE DEPENDENT EXEMPTIONS?

Legal aid clients going through a divorce often face the question of how to divide dependents in a divorce settlement. If the clients do not resolve the issue in a divorce

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settlement, then the Internal Revenue Code will determine who claims a child as a dependent in a given tax year. Generally, a person may claim a dependent if (1) the person is a parent who is related by blood or marriage or who has legal custody of a child, (2) the child is 19 or younger at the end of the calendar year or is a student and under 24 before the end of the calendar year, (3) the person funded more than half of the financial support

for the child, and (4) the person lived with that child for more than half of the year.⁸

Often, however, as part of a divorce settlement, parents divide who can claim children as dependents for a particular tax year. The Internal Revenue Code allows parents to divide dependents and thus allows noncustodial parents to claim their children as dependents.⁹ Claiming a child as a dependent can reduce the tax owed by the parent. It can also make the parent eligible to claim the Child Tax Credit or the Additional Child Tax Credit or both for that tax year.¹⁰

If your divorcing client decides to divide dependents with a spouse, the best practice is to execute Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, at the time your client signs the divorce settlement agreement or soon thereafter.¹¹ Parents can allocate dependents without executing Form 8332, but the settlement must contain all of the elements in Form 8332, and the settlement agreement may

even need to be physically affixed to the tax return when filed.¹² Just executing the IRS form is much easier. When dividing

⁸ *Id.* § 152. The definition of a dependent includes not only children but also siblings, stepbrothers, stepsisters, any descendant of a sibling, parents, and even people who are not related by blood, marriage, or legal placement as long as they lived all year with the taxpayer. Here I discuss only children, being the most commonly claimed dependents.

⁹ *Id.* § 152(e).

¹⁰ See *id.* § 24(a).

¹¹ See Internal Revenue Service, Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent (Jan. 2010).

¹² See *Armstrong*, 139 T.C. 468, 479–81 (Goeke, J., concurring).

⁴ Internal Revenue Service, Pub. 596, Earned Income Credit (EIC) 30–36 (Dec. 21, 2016).

⁵ 26 U.S.C. § 32(d) (2015).

⁶ *Id.*

⁷ *Id.* § 7703(b).

dependents in a divorce settlement, a best practice is for the attorney to incorporate IRS Form 8332 into the standard divorce settlement agreement. Reference the form in the settlement agreement. Advise your client to keep a copy of the Form 8332 with the client's other important documents. Your client can avoid future problems with the IRS—and an ex-spouse—by doing so.

A number of U.S. Tax Court cases deal with the issue of parents dividing dependents in a divorce settlement but not executing Form 8332. The IRS's position in these cases has been that the agency does not want to get involved in policing divorce settlement agreements to see which parent gets to claim which child in a particular tax year.¹³ Moreover, the IRS does not want to monitor whether a parent has been paying child support when that has been a condition upon which that parent is able to claim a child as a dependent.¹⁴

CAN A DIVORCE COURT ALLOCATE DEPENDENT EXEMPTIONS?

As discussed above, the Internal Revenue Code allows custodial and noncustodial parents to allocate dependent exemptions between themselves. What happens when the parties cannot agree to allocate dependent exemptions and the divorce court must decide? Is the IRS required to respect the decision of a divorce court? Not necessarily. However, while state courts cannot determine issues of federal tax law, “state law may allocate claims and property rights in the dissolution of a marriage.”¹⁵ In a majority of states, courts have ruled that they have the authority to allocate

dependent exemptions.¹⁶ Only seven states have ruled that courts cannot.¹⁷ A majority of state courts have gone further and held that they have the authority to require a custodial parent to execute Form 8332.¹⁸

CAN THE IRS GRANT RELIEF FROM JOINT AND SEVERAL LIABILITY ON INCOME TAX DEBT?

Dealing with joint debt in a divorce can be difficult. For parties with very little or no income and assets in a divorce case, dealing with joint debt can be very difficult because there is often not a satisfactory way to deal with the debt once it is assigned to one party or the other. Family courts have the power only to assign responsibility to pay the debt to one of the parties. Family courts do not have the power to make a creditor rewrite a contract to make only one party responsible for a debt. If one spouse does not pay a debt on which that spouse has been assigned responsibility in a divorce decree, the remedy is to go back to court with a contempt motion or to obtain a judgment against the noncompliant party or both. This can be time-consuming, costly, and ultimately frustrating when the noncompliant party likewise has little to no money.

When dealing with joint income tax debt, however, another remedy may be available

to spouses or former spouses. The Internal Revenue Code lays out administrative remedies, with judicial review, for individuals who are jointly liable for a tax debt and who have a good reason to justify their not being held liable. There are three types of this relief from the joint and several liability of a joint tax return: innocent spouse relief, separation of liability, and equitable relief. All three are informally referred to as “innocent spouse relief,” even though the law separates them into different types.¹⁹ Here I briefly discuss each type of relief.²⁰

Innocent Spouse Relief. Traditional innocent spouse relief is available to individuals where (1) a joint return has been filed; (2) there is an understatement of tax on the return attributable to erroneous items of the nonrequesting spouse; (3) in signing the return, the requesting spouse did not know or have reason to know that there was such an understatement; and (4) all of the facts and circumstances having been taken into account, holding the requesting spouse liable for the deficiency in tax is inequitable.²¹ The important prong to be considered in traditional innocent spouse relief is that the innocent, or requesting, spouse must have had no knowledge of the misrepresented item on the tax return.

An example of innocent spouse relief under Internal Revenue Code § 6015(b) is where a married couple files jointly, one spouse conceals income from the other and does not report it to the IRS, and the concealed income results in a joint tax debt. The spouse who was misled about the income can make a request for innocent spouse relief.

16 See 29 A.L.R. 7th Art. 3 (2017) (listing Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Vermont, Washington, West Virginia, Wisconsin, and Wyoming as states holding that courts have authority to allocate dependent exemptions).

17 *Id.* (listing Georgia, Indiana, Michigan, Nevada, South Dakota, Texas, and Utah as states having adopted view that courts cannot allocate dependent exemptions).

18 *Id.* (listing Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Tennessee, Utah, Washington, West Virginia, Wisconsin, and Wyoming as states that can order custodial parent to execute Form 8332 in favor of noncustodial parent).

19 Even the IRS form to request any of the three types is called Request for Innocent Spouse Relief (see [Internal Revenue Service, Form 8857, Request for Innocent Spouse Relief](#) (Jan. 2014)).

20 For an excellent, in-depth manual on the subject, written by a legal aid attorney, see ROBERT NADLER, A PRACTITIONER'S GUIDE TO INNOCENT SPOUSE RELIEF: PROVEN STRATEGIES FOR WINNING SECTION 6015 TAX CASES (2d ed. 2017).

21 26 U.S.C. § 6015(b).

13 See [Armstrong v. Commissioner of Internal Revenue](#), 139 T.C. 468, 475 (2012), *aff'd*, 745 F.3d 890 (8th Cir. 2014).

14 See [Thomas v. Commissioner of Internal Revenue](#), T.C. Memo. 2010-11 (2010).

15 [Armstrong](#), 745 F.3d 890, 895.

The statute of limitations to file a request for innocent spouse relief under § 6015(b) is two years from the date the IRS began collection of the tax against the individual requesting relief.²²

Separation-of-Liability Relief. Separation-of-liability relief provides for the allocation of additional tax owed when an item was not properly reported on a tax return and the requesting spouse did not have actual knowledge of the item not reported.²³ Separation-of-liability relief is different from traditional innocent spouse relief under § 6015(b) in that, if granted, it treats the spouses as if they had filed their tax returns separately. The facts underlying the relief are different from those required for traditional innocent spouse relief in that the requesting spouse must show that the requesting spouse is no longer with the spouse, either legally through divorce or legal separation or by living apart. The statute of limitations to request this type of relief is also two years from the date the IRS began collection.²⁴

Equitable Relief. Equitable relief is available to individuals who do not qualify for traditional innocent spouse relief or separation-of-liability relief. Importantly, equitable relief may be available to individuals who have missed the two-year statute of limitations to request the other two types of relief. The statute of limitations to request equitable relief is the ten-year period that the IRS has to collect a tax debt.²⁵ Also, and very important to legal aid clients, in looking at whether to grant equitable relief, the IRS can place weight on domestic violence being a significant factor when the requesting spouse may have even had knowledge of a fraudulent

or concealed item on a tax return.²⁶ The Request for Innocent Spouse Relief form inquires about domestic violence history. While the IRS must notify the requester's spouse of a Request for Innocent Spouse Relief, the agency will not disclose the requesting spouse's current name, address, phone number, or employer.

"CAN I GET BACK A TAX REFUND THAT WAS INTERCEPTED TO PAY MY SPOUSE'S DEBT?"

If you have a client who filed jointly with a spouse and the federal income tax refund was, or is expected to be, intercepted by the IRS to pay a debt of the spouse, your client may be eligible for injured-spouse relief. Normally if joint filers are eligible for a tax refund, but one spouse owes a state or federal income tax debt—namely, a child support debt, an unemployment compensation debt, or a federal nontax debt such as a student loan—the refund may be applied toward that debt.²⁷ The state or federal agency must notify the debtors

the refund went toward a tax debt.³¹ The statute of limitations is six years if the refund was applied to a nontax debt.³²

Debt

When a legal aid client is represented on debt issues, the tax law scenario most likely to arise involves a prior home foreclosure with the mortgage company later canceling the debt on the mortgage deficiency. But debt cancellation can also occur by having credit card debt or auto loans canceled or by having a mortgage modified. Clients may then wonder if the canceled debt counts as income.

Generally, if a person has a debt and that debt is later forgiven or discharged, the debt is deemed canceled. Canceled debt is considered to be income under the Internal Revenue Code.³³ The individual whose debt has been canceled is to report that as income in the year it was canceled.³⁴ Canceled debt is reported on Form 1099-

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before the refund is intercepted.²⁸ Federal regulation allows the spouse who is not the debtor to petition to have the nondebtor's portion of the refund not intercepted or returned if the refund has already been intercepted.²⁹ A person can file for the injured-spouse allocation when filing the tax return or after the refund has been intercepted.³⁰ A person has three years to file for the injured-spouse allocation if

C.³⁵ Clients often do not understand what the 1099-C is and that they may need to report the income on their tax return. In my experience, many clients do not receive the Form 1099-C for one reason or another. They learn of the 1099-C only when the IRS sends a letter asking why they did not report their canceled debt or they have been assessed tax on the unreported income.

22 *Id.* § 6015(b)(1)(E).

23 *Id.* § 6015(c).

24 *Id.* § 6015(c)(3)(B).

25 *Id.* § 6502.

26 See *Rev. Proc. 2013-34*, I.R.B. 2013-43.

27 See *26 U.S.C. § 6402(a)*.

28 *31 C.F.R. § 285.3(c)(4)*.

29 *Id.* § 285.3(c)(4)(ii).

30 See *Internal Revenue Service, Form 8379, Injured Spouse Allocation* (Nov. 2016).

31 *26 U.S.C. § 6511(a)*.

32 *28 U.S.C. § 2401(a)* (2015).

33 *26 U.S.C. § 61(a)(12)*.

34 See *Jelle v. Commissioner of Internal Revenue*, 116 T.C. 63 (2001).

35 See *Internal Revenue Service, Form 1099-C, Cancellation of Debt* (2017).

Legal aid clients frequently are able to exclude the canceled debt from their income in a couple of ways. First, if the debt is due to a foreclosure on the client's primary residence, the client may be able to exclude the income from the canceled debt under the Mortgage Debt Forgiveness Relief Act of 2007.³⁶ This exception to the rule of counting canceled debt as income expires at the end of 2017.³⁷ Understand that if a client chooses to exclude the canceled debt from income under this exception, the client may still need to deal with a state taxing authority because state law may not have a corresponding exception.

Second, if your client was insolvent immediately before the debt was canceled, then the canceled debt can be excluded from gross income.³⁸ Determining insolvency is as simple as setting up a balance sheet with assets on one side and debts on the other.³⁹ The relevant date is the day before the debt was canceled; when recreating the client's assets and debts, be sure to include the canceled debt in the debt column. If the debt outweighs the assets, the client was insolvent. The canceled debt can be excluded from gross income for the tax year. The client should file IRS Form 982, indicating that the client was insolvent, with the client's tax return.⁴⁰

Social Security Benefits

In social security matters, tax questions can surface when clients receive back-payment awards from

the Social Security Administration. Two problems stand out in particular.

“IF I RECEIVE PRIVATE DISABILITY INSURANCE AND LATER RECEIVE SOCIAL SECURITY BENEFITS, WHAT HAPPENS WHEN I PAY BACK THE PRIVATE DISABILITY?”

Clients who receive private disability insurance and who are later awarded social security benefits can be required to return their private disability payouts. This can be tricky for people because they likely have already declared the private disability insurance as taxable income in the previous tax year or years and now must account for returning the money. Individuals have the choice of dealing with this situation in one of two ways. First, in the current tax year, an individual can simply deduct the returned income as an itemized deduction, thereby reducing taxable income.⁴¹ Second, the individual can claim a tax credit for the current year on the money repaid.⁴² To do this, the individual must figure the individual's tax for the current year without deducting the amount repaid. Then the individual re-figures the tax from the earlier year or years without including in income the amount returned. Next the individual subtracts the tax in the refigured amount from the amount of tax from the previous year. This is the amount of the tax credit. The tax credit is then subtracted from the amount of tax actually figured for the current year. Although individuals' circumstances vary, tax credits tend to be better than itemized deductions for legal aid clients.

“WHY AM I BEING MADE TO PAY TAX ON MY SOCIAL SECURITY BACK PAY?”

If an individual receives a lump-sum social security back-payment award, the rule is that the individual must include a relatively large portion of the back-payment award in the individual's gross income, depending

upon filing status and other income.⁴³ The exception to this rule is that the individual can elect to have taxed the compensated payments attributed to the prior years as though they were properly received in those years, if doing so lowers the tax paid on those social security benefits.⁴⁴ To make this election, the taxpayer does not need to amend prior tax returns. The income document received by an individual and showing social security benefits paid is called Form SSA-1099.⁴⁵ Box 3 of the Form SSA-1099 will list the amount paid in the current tax year. Box 3 will also indicate if the amount received in the current tax year includes amounts that would have been awarded in the prior tax years had they been awarded in the earlier years. Detailed instructions on how to make this election are found in IRS Publication 915.⁴⁶ Often, clients present this problem years after having received the lump-sum back payment. The problem can be fixed with an amendment to their tax return.

Legal aid attorneys will likely encounter clients with tax problems during representation on matters other than tax cases. To prevent tax problems down the road, family law attorneys should seek out the advice of attorneys in low-income taxpayer clinics in the beginning of divorce representation, in settling cases, and in preparation for final hearings. Attorneys who are in other practice areas and identify tax issues related to debt and social security payments should make an appropriate referral to the nearest low-income taxpayer clinic.

36 See Mortgage Debt Forgiveness Relief Act of 2007 § 2(a), [26 U.S.C. § 108\(a\)\(1\)\(E\)](#).

37 See [26 U.S.C. § 108\(a\)\(1\)\(E\)\(i\)](#).

38 See *id.* § 108(a)(1)(B).

39 See [Internal Revenue Service, Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments \(for Individuals\)](#) 6 (Feb. 1, 2017) (insolvency worksheet).

40 See *id.*, [Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness \(and Section 1082 Basis Adjustment\)](#) (Jan. 2016).

41 See [26 U.S.C. § 1341\(a\)\(2\)](#).

42 See *id.* § 1341(b)(1).

43 *Id.* § 86(a)(1).

44 See *id.* § 86(e).

45 See [Social Security Administration, Form SSA-1099, Social Security Benefit Statement](#) (Jan. 2017).

46 See [Internal Revenue Service, Pub. 915, Social Security and Equivalent Railroad Retirement Benefits](#) (Dec. 30, 2016).

AUTHOR'S ACKNOWLEDGMENTS

I thank Nick Maraman for his time reviewing and editing this article. I thank all of my colleagues at the Legal Aid Society for their friendship and help over my career. I also thank the Low-Income Taxpayer Clinic community for its advocacy and work on behalf of taxpayers across the United States.

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