Report From Counsel

Insights and Developments in the Law **Summer 2004**

Innocent Spouse Tax Relief

For most married couples, filing federal income taxes jointly rather than separately results in a lower tax bill. However, this "all for one, one for all" approach can have a downside if questions arise about the accuracy of the return. The general rule is that both taxpayers will be responsible, individually as well as collectively, for any taxes, interest, and penalties owed, even if only one spouse was earning the income. It may be that in a couple's division of labor only one spouse is in fact responsible for understating income or erroneously claiming deductions, but by law each spouse can be made to answer to the IRS.

It is always good advice for anyone signing a tax return to do so only after carefully reviewing and understanding every line of it. But even such common-sense measures cannot prevent mistakes and/or deception from happening. To avoid unfairness in such circumstances, the Tax Code has provisions designed to protect "the innocent spouse."

Under this general heading, there are three kinds of relief: innocent spouse relief, relief by separation of liability, and equitable relief. To request relief, a taxpayer must file the appropriate form with the IRS no later than two years after the IRS first tries to collect the tax. An attached statement must explain why the taxpayer believes he or she qualifies for relief. If the IRS rejects the claims for the first two types of relief, it will automatically determine whether equitable relief is warranted.

Innocent Spouse Relief

An innocent spouse must meet the following conditions to qualify for relief: (1) a joint return understated taxes because of erroneous claims by the requesting party's spouse, such as unreported or underreported income, or unjustified deductions or credits; (2) when the return was signed, the innocent spouse did not know or have reason to know that there was an understatement of tax. If the spouse knew, or should have known, that there was an understatement, but did not know by what amount, partial relief may be given; and (3) in light of all of the

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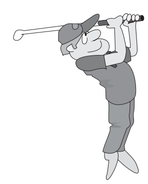
Rough Day at the Golf Tournament



More than most athletic endeavors, golf is known for being a setting for the mixture of business and pleasure. Many business relationships have been formed or strengthened, and many deals have been closed, somewhere between the first tee and the eighteenth green. That aspect of the game played a part in a recent court decision in which an employee was held to be entitled to workers' compensation benefits based on injuries he sustained while taking part in a golf tournament.

Kenneth worked as a shipping supervisor for a furniture manufacturer. A trucking company invited Kenneth and some other managers to play in its annual golf tournament, free of charge. Participation was voluntary, but you do not need to twist a golfer's arm to get him to play golf on what otherwise would have been a regular workday. Unfortunately, the fun stopped abruptly for Kenneth when the golf cart in which he was riding struck a tree and he was injured.

When Kenneth tried to get workers' compensation benefits, his employer challenged his claim. Its argument was

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Family and Medical Leave Act Update

Margaret worked in a clerical position for a hospital. During the first three years of her employment, she was disciplined several times for unexcused absences, and she risked termination if her absenteeism continued. Then, Margaret slipped and fell while at work, fracturing her elbow and ankle and aggravating an existing wrist condition. Over the next 10-day period, she worked only one complete workday. Margaret missed parts of the remaining workdays because she had medical appointments, or was not feeling well, or both.

The FMLA provides that an eligible employee can take up to 12 workweeks of leave during any 12-month period because of a "serious health condition."

The hospital, seeing these absences as the straw that broke the camel's back, fired Margaret for excessive absenteeism. Margaret sued her ex-employer, contending that her absences after her fall were protected leave under the federal Family and Medical Leave Act (FMLA). A federal court ruled that the hospital was free to fire Margaret without running afoul of the FMLA.

The outcome in Margaret's case turned on a fine distinction about language in the FMLA and a regulation issued under it. The FMLA provides that an eligible employee can take up to 12 workweeks of leave during any 12-month period because of a "serious health condition" that makes the employee unable to perform the functions of the employee's job. After taking such leave, an employee must be reinstated to the position held before the leave. Part of the statute's definition of "serious health condition" is a condition that involves "continuing treatment by a health care provider." That phrase is not defined in the FMLA itself, but a Department of Labor regulation describes it as including "a period of incapacity . . . of more than three consecutive calendar days." Incapacity refers to the inability to work or perform other regular daily activities.

Margaret argued to no avail that she had been incapacitated for more than three consecutive calendar days, and that she therefore had taken only protected leave for a "serious health condition." The problem was that she missed work for only a part of all but one of the days in question. The court reasoned that a "calendar day" is commonly understood to mean a whole day, from midnight to midnight. Thus, to be afforded protection under the FMLA, the period of incapacity must last for more than 3 whole days, that is, 72 consecutive hours. In addition to parsing the language from the regulation, the court ruled that the incapacity either extends for over 72 straight hours, or it does not. By contrast, under the interpretation argued for by Margaret, more issues would arise about how much incapacity on a given day is enough for that day to count toward the requirement in the regulation. The court was "loathe to adopt a strained interpretation of a regulatory provision that would result in employers, employees, and courts facing an uncertain and ever-shifting legal landscape."

Development Ditched

Developers bought 12 acres in a hilly, rural area, with plans to build homes on the property. Because surface water pooled on a large central part of the land after heavy rains, the owners channeled the excess water into a roadside ditch. The roadside ditch was connected to a series of waterways that eventually reached a river eight miles away.

The developers' plan hit a major snag when they were sued by the United States Army Corps of Engineers. The Corps contended that the roadside ditch was a waterway of the United States that fell under the protection of the Clean Water Act and the jurisdiction of the Corps. With that premise, the developers first needed a permit from the Corps before digging the drainage ditch on their property.

While the Corps exercises no control over isolated wetlands, it has jurisdiction over wetlands that are adjacent to navigable waters and their tributaries. In particular, the Clean Water Act requires a permit from the Corps for the discharge of fill material into waters that are in the Corps' jurisdiction. When the contractors piled the excavated dirt on each side of the 1,100 foot-long drainage ditch, this constituted the "discharge" of fill material into wetlands without a permit.

A federal court took the side of the Corps in holding that a permit was required. First, the court deferred to the Corps' interpretation of the regulation under which the tract to be developed was regarded as having wetlands. Second, the adjacent roadside ditch was a tributary of navigable waters, even though water from the ditch flowed through several other nonnavigable watercourses before reaching the river and later the Chesapeake Bay. The court accepted the Corps' interpretation of "tributary" as encompassing

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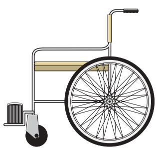
Medicaid and Nursing Home Benefits



Medicaid is a governmental program that provides health insurance coverage for low-income children, seniors, and people with disabilities. As the baby boomers age, Medicaid's other role, as a source of nursing home benefits, is getting more attention. Each of the states operates its own Medicaid program, subject to some overriding rules set up by Congress and the federal Centers for Medicare and Medicaid Services. The following is an overview of some of those rules. Be aware that the specific requirements can vary from state to state, and must be checked *before* making decisions.

Asset Rules

An individual may have no more than $2,000 in "countable" assets to be eligible for Medicaid nursing home benefits. Assets that are not counted in this calculation include personal possessions, one motor vehicle (valued up to $4,500 for an unmarried recipient and of any value for the resident's spouse), a principal residence in the same state where benefits are sought, prepaid funeral plans and a small amount of life insurance, and assets deemed to be inaccessible. To promote the independence of the nursing home resident's healthy spouse, usually referred to as the "community" spouse, that spouse may keep one-half of the couple's countable assets, up to a maximum of $92,760 in 2004. The least that a state may allow the community spouse to retain in 2004 is $18,552. The couple's assets are totaled as of a "snapshot date," which is when a spouse enters a long-term facility in which he or she then stays for at least 30 days.

Transfer Penalty

To avoid giving benefits to those who present a false picture of poverty, there is a transfer penalty that is imposed when people transfer assets without receiving fair value in return. The Government divides the amount so transferred by the average monthly cost of a nursing home in the state in question. The person is then ineligible for Medicaid during the resulting number of months. Several provisions limit the impact of the transfer penalty. First, Medicaid officials can consider only transfers made during the 36-month "look-back period" preceding the application for Medicaid (or 60 months for transfers made to certain trusts). As a result, it is prudent not to apply for benefits in the three years after a large transfer. Second, the transfer of assets to particular categories of individuals, such as spouses and blind or disabled children, will not bring about a penalty. Finally, a penalty can be completely wiped away, or "cured," if the transferred asset is returned, or the penalty may be reduced to the extent that the asset is partially returned.

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Treatment of Income

The starting point for dealing with income under Medicaid is that nursing home residents pay all of it, less certain deductions, to the nursing home. The types of deductions are as follows: a $60 per month allowance (subject to some variations among the states) for the resident's personal needs; a deduction for any uncovered medical costs, including premiums for medical insurance; for married applicants, an allowance for the spouse at home if he or she needs income support; and a deduction for any dependent children living at home. Income attributable solely to the community spouse is off-limits. It is not taken into account in determining eligibility and the community spouse will not have to use his or her income to support the spouse receiving Medicaid benefits in a nursing home.

Development Ditched

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all of the streams whose water eventually flows into navigable waters.

The court required the developers to fill in the drainage ditch on their property and restore their wetlands to their pre-violation condition. It rejected the developers' argument that a more reasonable remedy would have been to allow the ditch to stay by removing the fill to a nonwetlands part of the property.

Developers are well advised to carefully evaluate whether any existing ditches or drainage swales are linked to navigable water, however indirectly, before dredging or filling what might appear to be an isolated wetland beyond the jurisdiction of the United States Army Corps of Engineers.

Reverse Piercing of Corporate Veil

Generally, business entities such as corporations or limited partnerships are legally separate and distinct from the shareholders and members who compose them. When justice requires it, however, courts have ignored the separation of the business and the individual and have allowed a creditor of the business to satisfy the debt from the assets of an individual closely connected to the business. This concept is known as "piercing the corporate veil." A variation on the idea, called reverse piercing of the corporate veil, allows someone to reach the assets of the business entity to satisfy a claim or judgment obtained against a corporate insider. In both instances, a court disregards the normal protections given to a business structure in order to prevent abuses of that structure.

There must be such a blurring of the lines between a business and an individual that the separate personalities of the two no longer exist.

Neither type of "piercing" is done lightly. There must be such a blurring of the lines between a business and an individual that the separate personalities of the two no longer exist. Moreover, while a court's analysis is highly dependent on the facts of each case, typically the party seeking to disregard the distinction between a business and an individual associated with it must show that the individual controlled or used the business so as to evade a personal obligation, perpetrate a fraud or a crime, commit an injustice, or gain an unfair advantage.

Recently, a state supreme court approved the use of "reverse piercing" to allow two creditors of an individual to use the assets of a limited partnership controlled by that individual to satisfy his personal debts. The businessman owned or controlled various business entities. The creditors showed that revenue from the largest of these, a limited partnership, was transferred to a corporation owned by the same individual. Then the funds were used to pay for the businessman's lavish lifestyle, including such items as a second home, a country club membership, a luxury vehicle, credit card bills, and college tuition for the businessman's son. Under these circumstances, the legal distinction between the partnership and the person controlling it had become a fiction to be ignored in the interests of justice.

Golf Tournament

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that Kenneth was taking part in a voluntary recreational activity that made him ineligible for benefits. There is such an exclusion in the law, but it did not apply to bar Kenneth's claim. The golf tournament was voluntary, but it was not "recreational," in the sense of being unrelated to Kenneth's employment. Under the "mutual benefit doctrine," even an activity that is generally regarded as recreational will fall within the workers' compensation laws if some advantage to the employer results from the employee's conduct.

Kenneth's participation in the golf tournament was at least equal parts business and pleasure. His employer benefited because Kenneth was able to meet with and establish better relationships with the trucking company representatives whom he had previously only talked with by telephone.

Innocent Spouse

Continued from page one.

surrounding circumstances, it would be unfair to hold the requesting party liable for the understatement of tax. Among the factors taken into account by the IRS are whether the taxpayer benefited from the erroneous return in the form of a higher standard of living and whether the joint filers later were divorced or separated.

Separation of Liability

Separation of liability means an allocation between the spouses of unpaid liabilities resulting from the understatement of taxes owed. Either of the following requirements must be met: The parties filing the joint return are no longer married or are legally separated, or the joint filers were not members of the same household at any time during the 12-month period before the relief is sought. This relief is not available if spouses transfer assets between themselves to avoid tax or as part of a fraudulent scheme. Another disqualifying factor is actual knowledge of the other spouse's erroneous items on a return that gave rise to the deficiency.

Equitable Relief

As a last resort, equitable relief may be available when there has not been any fraud and, all things considered, it would be unfair to hold the spouse seeking relief liable for the understatement or underpayment of tax. A broad range of "fairness" factors may be considered by the IRS. There is no exhaustive list, but some examples include separation or divorce, economic hardship if relief is not granted, and the fact that the tax for which relief is sought is attributable to the other spouse. Weighing against equitable relief would be factors such as knowledge of the items causing the understated tax, receiving a significant benefit from that understatement, or not making a good-faith effort to comply with federal income tax laws for the tax year in question.