What if it's Not Better than Nothing?

A standard feature in many divorce settlements is a tax indemnification, typically given by the primary income earner (especially if one is involved in his/her own business) to the lesser earner. Especially where one of the spouses has a business, it is fairly routine for that spouse to indemnify the other ("non-business" spouse) from any tax complications arising from that person's wrongdoing, lack of doing, or otherwise. As stated, it's routine, it happens many times, and basically it's also generally reasonable to at least have each spouse indemnify the other for that spouse's transgressions.

As we expect our readers know, that indemnification is merely an agreement between two people (in this case, a soon-to-be ex-husband and ex-wife). To put it in other words, it is not an agreement with a taxing authority – for instance, the IRS, or any state. Indeed, it would be highly unusual (probably nearly impossible) to get a taxing authority to join in as a party and agree to any such indemnification. Thus, all such an indemnification does is give the spouse who is being indemnified a degree of protection, a degree of comfort, that if there is a tax problem, the indemnifying spouse will be responsible for same, will assume all of the tax, penalty and interest obligations. However, that only binds the spouses – the taxing authorities are not a party to this agreement, and are not bound by same. Typically, the taxing authorities, when they have a problem, will go after both parties (the assumption here is of course that joint returns were filed), and grab what they can from whomever they can. Many times we refer to that as the IRS going after the lower hanging fruit. By the way, again, just to make sure that our readers understand, with perhaps rare exception, an indemnification is only needed where joint returns were filed. A spouse is responsible for the other (from a tax point of view) only when they filed a joint return.

With the above in mind, it's reasonable and logical to assume that, certainly for the spouse being indemnified, there's no downside to the indemnification, and it's certainly better than nothing. We won't disagree that there is no downside, but in some cases, perhaps it isn't better than nothing. And that of course is the focus of this article. Let's assume that the spouse giving the indemnification is truly a deadbeat, someone who doesn't care too much about who's chasing him/her, what taxing authorities are trying to get; someone who has, in a sense, made him/her self judgment proof, etc. You get the idea – someone who could stand up and say "Take your best shot – I've got nothing you can get". How do you handle a situation like that, how do you (can you) protect your client, and what can you do about all of this?

After understanding the limitations of a tax indemnification clause, as well as accepting the truism that at least a tax indemnification is better than nothing (no matter what the title of this article says), the first thing that's critically important to do is to have a good, frank, discussion with your client, to make sure that he/she understands the limitations of a tax indemnification agreement. The client must understand this, not just because it's factually true, but also because the client should be aware of the situation, should not be proceeding under any false assumptions – and ultimately, if things go really bad, it probably is also important in terms of protecting yourself from a malpractice claim. Make sure your client understands that essentially all the indemnification agreement does is give that client the right to go after that ex-spouse if your client gets tagged by the taxing authorities. And, if the IRS, with all of its powers, finds it easier to get money from your client than from the indemnifier, what makes your client think that he/she will fare any better?

If indeed the indemnifier is worthless, perhaps you should augment this "discussion" with an explicit letter advising that while the indemnification agreement is routine and something that your client would want (as we say, why not, there's no downside), it is probably worthless under the specific circumstances of with whom you are dealing. We say this because perhaps it's important to dissuade your client from any false comfort that, in a case like this, the indemnification agreement is worth anything. We are not suggesting there's anything better to do, that anything else can be done – but this type of disclosure may be important in order to dispel any client misconceptions.

What if the worst happens, and the IRS goes after the now ex-spouses for unpaid taxes (or perhaps for unreported income or other nefarious activities), and because your client is more accessible, he/she gets tagged by the IRS? Certainly, your client now has recourse against his/her ex-spouse – but, as pointed out above, if the IRS can't get money out of that ex-spouse, what chance does your client have? Assume for the moment that you didn't give your client all the warning flags, all the bells and whistles of the shortcomings of an indemnification agreement. Now perhaps you've got an angry client (ex-client?), one making utterances along the lines of, had you done your job better, he/she wouldn't now have income/assets attached by the IRS. Likely, that is a specious argument – and certainly, you hope so. Our point here is that putting aside disclosure and comfort, what would or could have been different, and where are your client's damages now, as compared to where they would have been with all of that so-called full disclosure?

The odds are the answer is your client hasn't been hurt at all by anything that you did or didn't do. After all, so what if you had made it clear that the indemnification agreement may be worthless, and that the ex-spouse is a bum and probably untouchable by the taxing authorities? What difference would any of that have made in terms of your client's exposure to the IRS? Perhaps one argument your client might raise is that he/she might have taken steps to protect him/her self from the IRS had that person realized the extent of exposure. Of course, that sounds like something along the lines of looking to hide assets, or otherwise disguise the truth. I's unclear how far that type of defense goes – something about unclean hands. However, perhaps there is the possibility that had your client realized the extent of exposure and worthlessness of the tax indemnification, your client may have looked for some greater security. Perhaps there is some exposure if that bad ex-spouse had something that your client could have liened or otherwise attached.

The issue then of course is full disclosure – which is generally a good idea in almost any case and for almost anything. Also, it is important to creatively look forward as to how valuable is that indemnification agreement, what does it truly mean on a case specific basis. And, where it is probably worthless or nearly so, what else, if anything, can be done to protect your client?