

**Innocence is Bliss**  
**Qualifying for Innocent Spouse Relief**  
**Under Federal Income Tax Law**

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## I. The Basics – Code Section 6015

### A. Relief Available to all Taxpayers (Innocent Spouse) - § 6015(b)

1. **Definition:** An *understatement* of tax attributable to an *erroneous item* of one spouse; the other spouse *did not know* or *had no reason to know* of the understatement; and considering all of the circumstances it would be *inequitable* to hold the other spouse liable and the other spouse makes an election within 2 years of the *first collection action* of the IRS. Code section 6015 was enacted in the IRS Restructuring and Relief Act of 1998 and follows the previous innocent spouse provision of former section 6013(e) except it eliminated the requirements of the former provision that there be a “substantial understatement” of tax attributable to a “grossly erroneous” item.
2. **Understatement** is a deficiency (the excess of tax required to be shown on return over the tax actually shown). This relief is not applicable for situations involving failure to pay the tax shown or for non-filers.
3. **Erroneous Item** refers to underreported or omitted income, incorrectly claimed deduction, or incorrect or erroneous credit.
4. **Actual Knowledge** means knowledge that an item existed, not that the item was erroneously reported, omitted, or incorrectly treated. The final regulations issued on Jul. 18, 2002 illustrate this by a spouse who knows the other spouse received interest income. If the income is omitted the spouse is charged with actual knowledge even if she believed (erroneously) that the interest was tax exempt, or believed that the item had been included on the return. Thus, a spouse who signs a return prepared by the other spouse without careful review is charged with knowledge that an item was not reported, unless she can show duress. This formulation of the actual knowledge standard is consistent with the pre-regulation case law. See *Cheshire*, 115 T.C. No. 15 (2000); *Wiksell v. Comm.*, 215 F.3d 1335 (9 Cir. 2000).
5. A spouse **Had Reason to Know** of an item if a reasonable person in similar circumstances would have known. The circumstances considered include the couple’s financial condition and the requesting spouse’s education level and business experience.
6. A **collection action** occurs when the first of the following happens:
  - (a) IRS levy or seizure of assets
  - (b) Offset of overpayment against owed tax

- (c) Filing of suit by the U.S.
- (d) Filing of a claim by the U.S. in a bankruptcy or similar action.

**B. Divorced or Separated Spouses (Equitable Apportionment) - § 6015(c)**

1. **Definition:** Available as an *election* to *apportion* tax liability attributable to a *deficiency* assessed against a joint return for an item which the electing spouse lacked *actual knowledge* of if at the time of the election the couple has divorced or legally separated or not lived together at any time during the 12 months preceding the filing of the election.
2. The election must be made not later than two years after the first collection action of the IRS. It can, however, be made *before* any collection action is undertaken or even before a deficiency is determined.
3. Apportionment. In general, items of income and expense are allocated between the joint return filers in the same manner as if separate returns had been filed. Items of income and expense attributable to a business are allocated to the spouse owning the business. For this purpose, community property laws are ignored and ownership is determined based on whose names appear on the legal documents establishing the business. Personal expenses and income from joint accounts is usually allocated equally to the parties. Tax credits and additional taxes (such as self-employment tax and additional tax on premature withdrawals from qualified plans) are handled separately, with the tax liability net of credits and before additional taxes first being allocated to the parties in the ratio of their individual items of income and deduction and adjustment for credits and additional taxes being made next.

**Example:** H and W file a joint return in 2000. On June 30, 2001, H and W obtain a decree of divorce. Also on that date, W makes the election to apportion tax liability. On April 1, 2002 the IRS notifies H and W that it has determined a deficiency of \$6,000 based on (1) failure to report \$3,000 of interest on a joint account; (2) understatement of H's net income as a dentist of \$6,000; (3) understatement of W's commissions as a stockbroker of \$3,000; (4) failure to report a penalty for premature withdrawal from W's IRA of \$500; and (5) understating H's self-employment tax in the amount of \$1,500. Neither spouse had any knowledge of the understatement of the other's income.

**Step 1:** The \$6,000 deficiency is adjusted by subtracting the specially treated items (penalty on IRA and self-employment tax) to \$4,000.

**Step 2:** The ratio of income and expense items is determined. In this case, \$6,000 is attributable to H, \$3,000 to W and \$3,000 to both. The ratios are 50% for H, 25% for W and 25% for both.

**Step 3:** The adjusted tax of \$4,000 is apportioned \$2,000 to H, \$1,000 to W and \$1,000 to both.

**Step 3:** The specially treated items are added back with the final allocation of the \$6,000 deficiency being \$3,500 to H (\$2,000 + \$1,500 STI); \$1,500 to W (\$1,000 + \$500 STI); and \$1,000 to both. The result is the IRS can collect up to \$4,500 from H and \$2,500 from W (but not more than \$6,000 from both). This is because H and W remain jointly and severally liable for the joint deficiency of \$1,000.

4. Items will not be allocable to only one spouse if the other spouse received a tax benefit from the erroneous treatment of the item.
5. The election is not available unless the IRS assesses a deficiency. Thus, if H and W had properly reported their income and other items but lacked funds to pay the tax, neither innocent spouse nor apportionment of liability would be available.
6. **Actual knowledge** of an item will preclude a spouse from separately allocating tax attributable to that item. However, the IRS must demonstrate actual knowledge and not rely on circumstances which indicate the spouse *should have known* of the item. In the example above, if W knew H was not keeping accurate books but lacked more specific knowledge (even though, with inquiry, she could have found out), the tax attributable to H's dental practice income would remain his sole responsibility. However, if W knew of a specific instance of H taking a \$2,000 payment "under the table", she would remain jointly liable on tax attributable to \$2,000 of H's \$6,000 under-reporting.
7. To qualify, the spouses must be legally separated, divorced, or been a member of the same household for any period during the 12 months preceding the election. The regulations state that the separation must be for reasons of marital discord and not for reasons such as vacation or business travel.

**Deleted:** have lived apart

**Deleted:** Thus, if, because of a marital dispute, H moves out of the marital house to live with a friend but reconciles and moves back in two days later, either spouse can make the election.

8. The IRS may invalidate the election to the extent that the spouses transferred assets among themselves in a scheme to defeat the collection of tax.

### C. Equitable Relief - § 6015(f)

1. **Definition:** The IRS *may* relieve a spouse of joint liability with a spouse or former spouse for an *underpayment* of tax if the spouse does not qualify for relief under § 6015(b) or (c) and, under all of the circumstances, it would be *inequitable* to charge that spouse with liability for the tax.
2. Use of the word may in the statute indicates that the relief provided by this subsection is *discretionary* with the IRS. Consequently, appeals to court from an IRS denial of relief will be very difficult to win because the taxpayer will have to demonstrate an abuse of discretion.
3. This is the only provision by which a spouse can be relieved of liability from an underpayment of tax which is properly shown on a return.
4. The determination by the IRS of whether it would be inequitable to hold one spouse liable for underpaid tax on a joint return is, at present, guided by Rev. Proc. 2000-15. This revenue procedure states that equitable relief will normally be granted if *all* of the following factors are demonstrated:
  - a. The tax liability is unpaid when the return is filed;
  - b. The spouse claiming relief is divorced or legally separated at the time of the application for relief;
  - c. The spouse applying for relief has not shared a household with the other spouse *at any time* during the 12 months preceding the application;
  - d. The applying spouse did not know *or have reason to know* the tax would not be paid; and
  - e. The applying spouse would suffer substantial *economic hardship* if relief were denied.
5. Failure to meet all of the above is not necessarily fatal. The IRS can still grant relief from joint and several liability if, based on all the factors listed and considered in the application, it believes it would be inequitable to hold the spouse liable. Rev. Proc. 2000-15 lists the following factors as weighing *in favor* of relief:

- a. Applicant is divorced or separated from other spouse;
- b. Applicant would suffer economic hardship if relief were denied;
- c. Applicant has suffered abuse from the other spouse;
- d. Applicant did not know or have reason to know that tax would not be paid;
- e. The non-applicant spouse is liable for the tax under the terms of a divorce decree or agreement;
- f. The unpaid liability is solely attributable to the non-applicant spouse.

Factors weighing *against* granting relief include the reverse situation from those listed above, as well as:

- g. Applicant has significantly benefited from the underpayment; and
- h. Applicant has not been in full compliance with his/her tax obligations in the year(s) since the year at issue.

6. Unlike relief under § 6015(b) or (c), equitable relief under § 6015(f) will not toll the statute of limitations on collection activity nor prevent the IRS from pursuing collection activity against the spouse.

#### **D. Considerations Common to All Forms of Relief.**

1. **Method of Electing.** All of the available relief described above can be elected by filing form 8857.
2. **Notification to other spouse.** In all applications, the IRS will notify the other spouse of the application and allow the other spouse to participate in proceedings. Upon request, the IRS will take steps to maintain the confidentiality of the applicant spouse's current residence. In a recent pronouncement, the IRS said that the spouse of the spouse requesting relief may file a protest and receive a conference at appeals if the other spouse is granted full or partial relief.
3. **Tax Court Jurisdiction.** The U.S. Tax Court is provided with jurisdiction to hear appeals from denial of relief under § 6015.

## **II. Some Recent Cases Interpreting § 6015.**

- A. Actual Knowledge.** A husband had actual knowledge of constructive dividends received by his wife in the form of personal expenses paid for by corporations controlled by the husband. The fact that the husband was a tax attorney did not help his case. Grossman v. Comm'r, 182 F.3d 275 (4 Cir. 1999).

A retired schoolteacher received a \$666,500 distribution from a retirement plan in 1991, \$629,000 of which was taxable. The recipient husband also received a letter, which was not disclosed to his wife, stating that the distribution was taxable and not eligible for rollover to an IRA. The recipient invested the funds in U.S. Treasury securities. The recipient died early the next year. The spouse went to an accountant to prepare the 1991 return and the accountant fraudulently altered the 1099s to reflect a smaller taxable amount and claimed rollover treatment for all but \$700. The wife did not know of the accountant's actions and signed the return. When she applied for innocent spouse relief from the subsequent assessment, it was denied. The courts affirmed the IRS decision, holding that the wife knew of the receipt of the distribution and had benefited from it; and that mere ignorance of the tax treatment of the item was not a factor in showing lack of knowledge. Mitchell, 80 TCM 590 (2000); *aff'd* 292 F.3d 800 (D.C. Cir. 2002).

- B. Equitable Relief.** Considering that the petitioner wife benefited from her husband's tax evasion by purchasing antiques, financing her son's business and building an expensive and luxurious home with her husband, it was not inequitable to deny her innocent spouse relief under §§ 6015(b) and (f). Alt, 119 T.C. No. 19 (2002).

The IRS abused its discretion in denying relief under § 6015(f) to a spouse for underpayment of tax on a jointly filed return with her ex-husband. The circumstances included (1) all of the income giving rise to the unpaid tax was attributable to the ex-husband's business; (2) the wife was divorced from her husband prior to the collection action by the IRS; (3) the wife had a history of mental illness and drug abuse and had only an 8<sup>th</sup> grade education; (4) while married she was completely dependent on her husband for filing returns and paying taxes; (5) at the time of the collection action, she was unemployed, had no assets, and was living on \$1,000 of monthly public assistance income. The ex-husband participated in and opposed the granting of relief to the wife. August, T.C. Memo 2002-201.

Husband paid all bills and prepared income tax returns. He fraudulently hid income in various corporations he controlled and avoided taxes. The wife signed returns without reviewing them and had no actual knowledge of the fraudulent nature of the returns; however, she benefited from her husband's purchase of six properties, some of which were transferred to her name, and from a lifestyle which included substantial expenditures beyond basic living expenses. After husband's conviction of tax evasion, IRS denied the wife innocent spouse relief under § 6015(b) and (f) and the

Tax Court held this was not an abuse of discretion, considering that the actual income was 670% of the income reported on the returns. Barranco, T. C. Memo 2003-18.

Wife handled all of a couple's finances. In 1995, she inherited two IRA's from her late father. Husband, a police officer with no financial education, believed based on conversations with his wife, counsel for the estate, and a retired IRS employee, that the distributions were not taxable. The wife used the proceeds to make improvements to their house and on new cars. The couple divorced in 1996 with the wife keeping the sales proceeds from the house. On these facts, the Tax Court held the IRS abused its discretion in denying innocent spouse relief to the husband. Husband's knowledge of the receipt of the inheritance did not amount to knowledge or reason to know within the meaning of § 6015(b) because he did not know that the inheritance was from his father-in-law's IRAs. Braden, T.C. Memo 2001-69.

- C. **Relief from Penalty.** A husband received a large distribution from a retirement plan and used it to pay off their home mortgage. The husband assured his wife that their had CPA advised him that using the retirement distribution to pay off the mortgage would make it non-taxable. Although actual knowledge of the distribution precluded wife's qualification for relief under § 6014(f) on the tax deficiency, she was entitled to equitable relief from the accuracy-related penalty imposed as a result. Cheshire, 115 T.C. No. 15 (2000).

### III. Liability of Jointly-Held Property For Federal Tax Debts of One Spouse.

- A. **Problem.** This situation is really the reverse of the innocent spouse complex. In the innocent spouse area, we are concerned with the joint and several liability of spouses for tax arising on a joint return. In this section, we consider tax obligations that arise on a *separate* return, typically filed before the taxpayers are married, and the ability of the IRS to enforce them after the tax debtor is married against property jointly held with the spouse.
- B. **IRS Lien.** When an assessed tax liability is unpaid, the IRS will generally file a notice of tax lien after due notice to the taxpayer. The notice attaches to "all property and rights to property." IRC § 6321. If the lien attaches to rights in property owned by the tax debtor, how do they attach when the property has its legal character changed under state law? It is now clear that although state law governs what rights arise, it is federal law that controls the definition of "property" and the ability of the IRS to attach property.
1. **Homestead.** In a Texas homestead, the tax-debtor was a husband who died owning a homestead with his wife, who was not responsible for the husband's tax. Upon the husband's death, the wife remarried

and continued to occupy the property as a homestead under Texas law with her new husband. The U.S. Supreme Court held that the lien attached to the property during the husband's life and continued to attach after his death, so that the IRS could file suit under IRS § 7403 to force sale of the home and partition the proceeds. U.S. v. Rodgers, 461 U.S. 677 (1983).

- 2. Community Property.** Where a tax debtor marries subsequent to the tax assessment and owns property as community property with his spouse, the lien attaches to the property, subject to the non-debtor spouse's interest. U.S. v. Overman, 424 F.2d 1142 (9 Cir. 1970). Further, the U.S. Supreme Court has held that a renunciation of community property under state law pursuant to a divorce is not effective against the United States in seeking to collect tax on community income from the renouncing spouse. Mitchell v. U.S., 403 U.S. 190 (1971).
- 3. Disclaimer.** A properly filed disclaimer of inherited property is ineffective to prevent attachment of the lien for the disclaiming person's tax liability. Thus, when a man disclaimed an inheritance which then went to a trust for the benefit of his daughter, the IRS could levy on the money for the man's tax debts, despite the fiction under state law that the disclaimer relates back to the date of death of the decedent. Drye v. U.S., 528 U.S. 49 (1999).
- 4. Tenancy by the Entireties.** The separate tax of one spouse gives rise to a lien which attaches to property held as tenancy by the entireties despite the state law concept that neither husband or wife have a separate interest in such property. U.S. v. Craft, 535 U.S. 274 (2002).