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Revised Innocent Spouse Rules Offer Greater Tax Relief

By *Linda M. Johnson and Bruce Clements*

When a married couple files a joint tax return, both spouses become jointly and severally liable for the income taxes due, including any additional taxes, interest, and penalties determined at a later date. In the event of an underpayment of income tax, the IRS can proceed against either spouse to collect the entire tax deficiency. This places a spouse in a precarious position in situations where the other spouse deliberately omits income or overstates deductions on a jointly filed income tax return, even if the spouse is totally unaware of the other's transgressions.

Although Congress attempted to correct for these possible injustices by enacting innocent spouse relief provisions in IRC section 6013(e), over the years it became apparent that many deserving spouses were being denied relief. The IRS Restructuring and Reform Act (IRSRA) of 1998 replaced IRC section 6013(e) with section 6015; in addition to eliminating many of the eligibility requirements, section 6015 provides additional avenues for obtaining relief from joint and several liability.

Relief from joint and several liability is available to spouses that signed and filed a joint return for the year in which an income tax deficiency is assessed and who satisfy the requirements under one of the following three areas:

- Innocent spouse relief under section 6015(b)
- Separate liability relief under section 6015(c)
- Equitable relief under section 6015(f).

Three conditions must exist to be eligible for innocent spouse relief under IRC section 6015(b):

- The understatement of tax must be attributable to erroneous items of the nonrequesting spouse.

- The requesting spouse cannot have actual or constructive knowledge of the understatement at the time the joint return is signed.
- It would be inequitable to hold the requesting spouse liable for the income tax deficiency.

Erroneous Items Attributable to the Nonrequesting Spouse

Erroneous items that result in an understatement of income tax include omitting gross income, overstating deductions or credits, and improperly characterizing income or deductions. Erroneous items can occur when an amount that was never paid or incurred is deducted on the tax return, or when an expenditure is deducted without support. When the erroneous items are attributable to the nonrequesting spouse, that satisfies the first condition for obtaining innocent spouse relief.

An erroneous item is attributable to the spouse whose activities or investments resulted in the item, without regard to community property laws. Therefore, wage income is allocated to the spouse who earned it, and dividend income is allocated to the spouse who owned the stock. Erroneous items of income or deduction attributable to jointly owned property are allocated evenly, unless evidence supporting a different allocation is presented.

No Knowledge of the Understatement

This condition may be the most difficult to satisfy because it requires the requesting spouse to demonstrate the lack of both actual and constructive knowledge of the item that resulted in the understatement.

Knowledge of the source of the erroneous item is not sufficient to establish actual knowledge of the understatement. The requesting spouse, however, cannot deliberately avoid learning about the item and expect to be protected from joint and several liability. The fact that the requesting spouse was unaware of the tax consequences of the erroneous item is irrelevant if the spouse was aware that the erroneous item existed at the time the joint return was signed. In addition, the requesting spouse's ownership interest in the property that results in the erroneous item supports a determination that the requesting spouse has actual knowledge of the understatement. For spouses living in community-property states, however, the requesting spouse is deemed to have an ownership interest in property only if the requesting spouse's name appears on the ownership documents.

Even though the spouse may lack actual knowledge of the item that caused the understatement, innocent spouse relief will be denied unless the requesting spouse can also show that no constructive knowledge of the understatement existed at the time the return was signed. In making this determination, the IRS examines whether a reasonable person in the same situation would have been aware of the item that led to the understatement. Treasury Regulations section 1.6015-2(c) provides factors that the IRS will consider when determining whether constructive knowledge existed at the time the joint return was signed:

- The nature and relative amount of the erroneous item
- The couple's financial situation
- The requesting spouse's educational background and business experience
- The extent of the requesting spouse's participation in the activity that resulted in the erroneous item
- Whether the requesting spouse failed to inquire about the erroneous item
- Whether the erroneous item represented a departure from a recurring pattern reflected on prior years' returns.

These factors are consistent with those used by the courts. In *Charlton* [114 TC 333 (2000)], a husband prepared Schedule C for his wife's business using summarized information she provided. When the IRS later assessed additional taxes, interest, and penalties stemming from omitted business income, the husband sought innocent spouse relief under IRC section 6015(b). The Tax Court concluded that although the husband had no control over his wife's business, he had reason to know of the omission because he had complete access to its financial records.

The Tax Court has also ruled that when the requesting spouse fails to inquire about the legitimacy of a deduction, constructive knowledge of the understatement may be inferred. In *Kalinowski* [81 TCM 1081 (2001)], a husband purchased partnership interests without his wife's knowledge. After the IRS assessed a tax deficiency stemming from erroneous partnership losses reported on the couple's tax return, the wife sought relief under IRC section 6015(b). The Tax Court concluded that even though the wife did not review the return prior to signing it, she was nonetheless responsible for its contents. The court ruled that the size of the losses claimed from the tax shelters should have alerted her.

For the purposes of determining whether constructive knowledge exists, the requesting spouse's knowledge of the source of the transaction has been considered sufficient to infer constructive knowledge. For example, the Tax Court has concluded that when the spouse has actual knowledge of the underlying transaction that produced the omitted income, the spouse possessed constructive knowledge of the understatement. The fact that the wife had questioned the tax treatment and been falsely informed that the item had been handled correctly was irrelevant for purposes of determining whether she had constructive knowledge of the understatement [*Cheshire*, 115 TC 183 (2000) *aff'd* by CA-5, 2001-1 USTC para. 50, 222]. When a spouse demonstrated that he was unaware of the source of the underlying transaction that led to the understatement, however, the Tax Court held that constructive knowledge did not exist [*Braden*, 81 TCM 1380 (2001)].

The requesting spouse can apply for partial relief if, at the time the joint return was filed, the requesting spouse knew (or had reason to know) that there was an understatement of tax due to the other spouse's erroneous items, but was not aware of the full extent of the understatement. Therefore, complete relief is not available if the requesting spouse had actual or constructive knowledge of the erroneous items, but partial relief is still available for any portion of the understatement that the requesting spouse had no actual or constructive knowledge of at the time the return was signed.

Inequitable to Hold the Requesting Spouse Liable

The final condition for innocent spouse relief under IRC section 6015(b) is that it be inequitable to hold the requesting spouse responsible for the tax deficiency. A significant factor in this determination is whether the requesting spouse significantly benefited, directly or indirectly, from the understatement. A transfer of property to the requesting spouse, even several years later, may indicate that the requesting spouse received a significant benefit from the understatement.

Usually a spouse who receives no more than normal support during the years at issue will not be considered to have significantly benefited from the understatement. Although what constitutes normal support differs among households, it is important to consider whether the spouse's lifestyle increased significantly during those years.

Separate Liability Relief

Separate liability relief under IRC section 6015(c) was introduced by the IRSRRA. Eligibility hinges on satisfying the following conditions:

- At the time the election for separate liability relief is filed, the requesting spouse is either no longer married to or legally separated from the nonrequesting spouse. Alternatively, the requesting spouse can show that she has not been a member of the same household as the nonrequesting spouse during the 12 months prior to filing the election.
- The requesting spouse had no actual knowledge of the erroneous item at the time the joint return was signed. In this case, the burden of proving that the requesting spouse had actual knowledge of the erroneous item rests with the IRS.

Accordingly, separate liability relief may be available to spouses who have constructive knowledge of the erroneous item. For example, the spouses in *Charlton*, *Kalinowski*, and *Cheshire* were each denied innocent spouse relief because of their constructive knowledge of the understatement. Because no actual knowledge of the erroneous item was shown to exist, these spouses would be eligible for separate liability relief, if they also met the first requirement above.

Apportionment of Erroneous Items

If the requirements for separate liability relief are met, the requesting spouse can elect to have the erroneous items allocated between the spouses as if they had filed separate tax returns. Erroneous items are allocated to the spouse who earned the income or owned the property that produced the erroneous item, without regard to community property laws. In the case of joint ownership, deductions and credits are allocated evenly between the spouses unless the requesting spouse can provide evidence otherwise.

IRC section 6015(d)(3) provides two exceptions to the general rule for allocating erroneous items between the spouses. First, an erroneous item that normally would be allocated to the nonrequesting spouse will be allocated to the requesting spouse to the extent that the requesting spouse received a tax benefit from it. Second, the IRS can allocate items as it deems appropriate in situations where fraud by one or both spouses exists.

Allocation increased by disqualified asset transfers. IRC section 6015(c)(4) increases the allocation of erroneous items to the requesting spouse by the value of any “disqualified assets” transferred to such spouse. A disqualified asset is any property or right to property transferred to the requesting spouse for the principal purpose of tax avoidance. The principal purpose of any transfer made within one year of the date that the IRS first issues a letter proposing a deficiency is presumed to be for tax avoidance. This presumption does not apply to transfers pursuant to a divorce decree, separate maintenance, a written instrument incident to such a decree, or to transfers wherein the requesting spouse establishes that the principal purpose of the transfer was for another reason.

Equitable Relief

Equitable relief, created by the IRSRRA, is available not only for proposed and assessed deficiencies, but also for liabilities that were properly reported on the joint tax return but never paid. To be eligible, the requesting spouse must satisfy the following threshold conditions:

- The requesting spouse filed a joint return for that taxable year.
- The requesting spouse is not eligible for innocent spouse or separate liability relief.
- The requesting spouse files a timely election with the IRS.
- The liability remains unpaid at the time the request is filed.
- No assets were transferred between the spouses filing the joint return as part of a fraudulent scheme.
- No disqualified assets were transferred to the requesting spouse by the nonrequesting spouse (otherwise relief is available only to the

extent that the liability exceeds the value of such disqualified assets).

- The requesting spouse did not file the joint return with fraudulent intent.

Provided all of these threshold conditions are met, the IRS will ordinarily grant relief—if the following conditions are also met:

- The requesting spouse is no longer married to, is legally separated from, or has lived apart from the nonrequesting spouse for the past 12 months.
- The requesting spouse did not know and had no reason to know that the tax would not be paid, and had reason to believe the nonrequesting spouse would pay the tax.
- The nonrequesting spouse could suffer undue hardship if relief is not granted.

Even if all three circumstances are not satisfied, the IRS will still consider granting equitable relief if, after weighing all the facts and circumstances, it is determined that it would be inequitable to hold the requesting spouse liable for such liability. Revenue Procedure 2000-15 (2001-1 CB 447) lists eight factors the IRS uses when evaluating claims for equitable relief. No one factor is indicative of whether equitable relief will be granted. The [Exhibit](#) lists eight factors and describes the situations where support for granting relief can be found.

Filing a Request

To apply for relief under IRC section 6015, the requesting spouse must timely file Form 8857, “Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief).” Requesting spouses can ask to be considered for both innocent spouse and separate liability relief. If the IRS determines that such relief is not warranted, only then will it automatically consider whether relief is warranted under the equitable relief provisions.

If a request for relief under section 6015 has been denied, the Tax Court can be petitioned to have the requests for innocent spouse and separate liability relief reconsidered. The petition must be filed with the Tax Court anytime more than six months after filing Form 8857 but within 90 days from when the IRS mails the notice denying the request for relief under Sections 6015(b) and (c). Treasury Regulations section 1.6015-7 extends this reconsideration for relief by the Tax Court to equitable relief as well.

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