How to Educate Your Clients About Innocent Spouse Relief and Be the Hero

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Robert V. Boeshaar
Attorney at Law, LL.M., PLLC
1000 Second Avenue, Suite 3000
Seattle, WA 98104
(206) 623-0063
www.boeshaarlaw.com

ROBERT V. BOESHAAR is committed to helping individuals and small businesses who are facing problems with the Internal Revenue Service. He has a Master of Laws in Taxation degree (LL.M.) from the University of Washington and fourteen years of experience as an attorney with the IRS Office of Chief Counsel. He represented the IRS in over 40 litigated cases in the United States Tax Court. Robert is active in the legal community and has served as President of the Washington State Bar Association Taxation Section. He volunteers with the University of Washington Low-Income Federal Tax Clinic and is an active member of Seattle Rotary #4.

I. Introduction

Joint and Several Liability is imposed when spouses file a joint tax return, but a spouse may be able to obtain relief from joint and several liability ("Innocent Spouse Relief") if they have filed a joint tax return.

This presentation will show you how you may be able to save your clients from the Internal Revenue Service – what some have called the worst collection agency in the world. You will discover the four kinds of relief from joint and several liability and learn how to determine which of your clients might be eligible to wipe out their tax debt with innocent spouse relief. When your clients use the innocent spouse defense to legally avoid paying their taxes, you will look like a hero to them, strengthen your bond with them and they will enthusiastically refer their family and friends to you.

A. Hypothetical – David and Diane

David and Diane were married for ten years and have two young children. David worked at an architectural firm and Diane works for a large construction company. Two years ago, David was convicted of embezzling $2 million from his employer. Diane did not find out about this until David was arrested. She also found out that David had used most of the funds to support his gambling habit. David put the funds in a separate account and transferred $10,000 each month to their joint checking account from which Diane paid their household expenses. None of the $2 million was included on their federal tax returns. They separated, and after a few months, Diane filed for divorce. The divorce was final last year. Diane has just received a notice from the Internal Revenue Service stating that two of their joint income tax returns are under audit.

This hypothetical is based on the Example in Treas. Reg. § 1.6015-2(e).

II. Joint and Several Liability for Taxes

A. Who is Responsible for the Taxes after a Divorce?

When two spouses file a joint income tax return, the general rule is that they are jointly and severally liable for any tax that is due for that year. I.R.C. § 6013(d)(3). Even after a divorce, each spouse remains responsible for the tax due (plus interest and penalties) for any year for which they have filed a joint tax return. The Internal Revenue Service will hold a taxpayer liable for these taxes even though a divorce decree may state that the other spouse will be responsible for any federal taxes that are owed for the years during which they were married. In the hypothetical above, both David and Diane are jointly and severally liable for the 2012 and 2013 taxes because they filed joint tax returns for those years.

B. Spouses' Filing Status is Determined as of the Last Day of the Tax Year

When filing a tax return, a taxpayer must choose a filing status such as single, head of household, qualifying widow(er); or if married, married filing a joint return or married filing a separate return.

Whether a taxpayer is married or unmarried is determined as of the last day of the year. I.R.C. § 7703(a). When a couple is divorced, their filing status for the year is determined by the status of their marriage under state law on the last day of the year. I.R.C. § 7703(a). If a person is divorced under state law as of the last day of the year, the IRS treats them as being unmarried for that whole year. I.R.C. § 7703(a)(2). However, a married person will be considered to be unmarried if he or she files as married-filing-separately, lives in a separate household for which he or she provides more than half of the cost of maintaining, supports a child who lives there during more than one-half of the year, and his or her spouse does not live there during the last six months of the year. I.R.C. § 7703(b).

If spouses file as married filing separately, each is entitled to half the basic standard deduction allowed on a joint return. If one spouse itemizes deductions, the other spouse cannot claim the standard deduction. I.R.C. § 63(c)(6)(A).

C. May You File an Amended Return to Change your Filing Status?

If spouses file separate returns, they may later file a 1040X amended joint return within three years after the due date of the tax returns. I.R.C. § 6013(b). But if spouses file a joint return, and wish to later file separate amended returns, the amended returns must be filed before the due date of the joint return. After the due date of the filed joint tax return, spouses cannot file amended separate returns. Treas. Reg. § 1.6013-1(a)(1). However, if one spouse dies, the surviving spouse may, within one year of the due date of the return, elect to file a separate return for the decedent. Treas. Reg. § 1.6013-1(d)(5).

VI. Relief from Joint and Several Liability

A. Joint and Several Liability

Since 1918, married couples have been able to file one joint return and compute their tax on their aggregate income. However, in 1938 spouses became jointly and severally liable for the tax owed on a joint return. I.R.C. § 6013. Joint and several liability means that the IRS may collect the entire liability from either spouse, or may collect a portion of the liability from each spouse.

Your client may have been unfairly stuck with a tax bill from a failed marriage. Perhaps your client, like Diane in the above hypothetical, found out that their former spouse was embezzling money from their business and did not report this income on the tax returns. Or, your client's former spouse used the money that was to pay the joint tax liabilities for themselves and told your client that the taxes had been paid. After the divorce, your client may find themselves with large tax bills for prior years. In these situations, you should consider whether your client could qualify for innocent spouse relief.

B. What Kinds of Relief Are Available?

There are four kinds of relief from joint and several liability that are available. The relief available depends on whether or not a joint tax return has been filed by the spouses. The kinds of relief are:

1. Innocent Spouse Relief under I.R.C. section 6015(b)
2. Allocation of Liability Relief under I.R.C. section 6015(c) and (d)
3. Equitable Relief under I.R.C. section 6015(f)
4. Community Property Income Tax Relief under I.R.C. section 66(c)

If a joint tax return has been filed by spouses, a spouse may elect to seek relief from joint and several liability on such return under Internal Revenue Code section 6015. Relief is available if the IRS has determined that the tax was understated on the tax return, the spouse did not know, or have reason to know, of the understatement, and it is inequitable to hold the spouse liable for the tax.

If spouses are no longer married, legally separated, or have not been members of the same household for the last twelve months, it may be possible to obtain an allocation of an understatement of tax attributable to one of spouse's incomes.

If spouses have filed a joint return but relief is not available under I.R.C. section 6015(b) or (c) because the IRS has not determined that there is an understatement of tax, equitable relief may be available under I.R.C. section 6015(f). Relief is available from an item attributable to a spouse or former spouse if the tax liability is understated or if the tax is not paid and taking into account all the facts and circumstances, it would be unfair to hold the spouse liable for the understatement of tax.

If spouses did not file a joint tax return, relief may still be available. Under Internal Revenue Code section 66(c), an individual who lives in a community property state, such as Washington State, may be able to obtain relief if he or she did not know about the income attributable to the other spouse.

C. Innocent Spouse Relief under Section 6015

I.R.C. section 6015 was enacted as part of the IRS Restructuring and Reform Act of 1998. As previously discussed, when spouses file a joint tax return, they become jointly and severally liable for the tax owed for that tax year.

To be eligible for relief from joint and several liability under section 6015, spouses must file a joint income tax return for the year in issue. Generally, a joint income tax return must be signed by both spouses to be valid. However, an income tax return may qualify as a joint return if the spouses intended to file a joint return. Under the tacit consent doctrine, where spouses have a history of filing jointly for many years with one spouse signing the tax returns for both spouses, courts have held that the other spouse tacitly consented to filing a joint return. Federbush v. Commissioner, 34 T.C. 740, 757 (1960), aff'd, 325 F.2d 1 (2nd Cir. 1963); Estate of Campbell v. Commissioner, 56 T.C. 1 (1971); but see Reifler v. Commissioner, T.C. Memo. 2015–199 (no joint return where spouse did not sign and usually did sign tax returns).

When spouses have filed a valid married-filing-joint tax return, there are three kinds of relief that are potentially available to a spouse under I.R.C. section 6015:

1. Innocent Spouse Relief

The first kind of relief is generic innocent spouse relief and provides relief from additional tax the Internal Revenue Service has determined that a person owes that is attributable to their spouse (from whom they are separated) or their former spouse. I.R.C. § 6015(b). There are five requirements to qualify for this relief:

First, a spouse must have filed a joint tax return.

Second, the IRS must determine that the tax return understated their joint tax liability. An understatement of tax is generally the difference between the total amount of tax that should have been shown and the amount of tax actually shown on the return. I.R.C. § 6211(a). For instance, if there is $2,500 total tax reported and the IRS later determines in an audit that the total tax is actually $3,000, this results in a $500 understatement. This understatement must be due to an erroneous item of a spouse or former spouse. An "erroneous item" can be income the spouse received and failed to report on the joint return, or any deductions or credits that were incorrectly reported on the joint return. I.R.C. § 6015(b).

Third, a spouse must establish that at the time he or she signed the joint return they did not know, or have reason to know, of the understatement of tax.

The United States Tax Court considers four factors when considering whether a spouse had reason to know of an understatement. These factors are:

(1) the spouse's level of education;

(2) the spouse's involvement in the family's business and financial affairs;

(3) any substantial unexplained increases in the family’s standard of living; and

(4) the nonrequesting spouse's evasiveness or deceitfulness about the family's finances.

Price v. Commissioner, 887 F.2d 959, 965 (9th Cir. 1989); Resser v. Commissioner, 74 F.3d 1528 (7th Cir. 1996). No single factor is controlling. Id.

There are many scenarios under which a spouse may not know of the understatement of tax. These scenarios could include withdrawals from an IRA, income from the exercise of stock options, or compensation or bonuses deposited into the non-requesting spouse's personal account. Another scenario is outlined in Internal Revenue Service Treas. Reg § 1.6015-2(e)(1) – it says that if a wife was only aware of a small portion of their spouse's embezzled income, the wife could obtain relief from the tax on the portion of the unreported embezzlement income of which she knew and had reason to know. Treas. Reg. § 1.6015-2(e)(1).

In Santa v. Commissioner, Mr. and Mrs. Santa owned a joint bank account but Mr. Santa primarily used his own separate account. Mrs. Santa withdrew $95,392 from a profit-sharing account and deposited it into the joint bank account. The Tax Court gave relief from the tax deficiency to Mr. Santa because he did not know of Mrs. Santa's profit-sharing account withdrawal and did not benefit from it. He also had had limited or no use of the joint account and was unaware of their finances, as Mrs. Santa often hid their bills from Mr. Santa and he often did not know they were unpaid until bill collectors called him at work. Santa v. Commissioner, T.C. Memo. 2013-178.

A case which illustrates the four factors to use when considering whether a spouse had reason to know of an understatement is Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989). Mr. Price, an investment broker, sold shares in a Columbian gold mining operation.

Mrs. Price knew of the venture and that they purchased shares in it. Mr. Price told her he had flown to Columbia to check on the mine's development, show her pictures of it, and told her that it was a viable investment.

They filed a joint tax return in 1981 which was prepared by a local CPA firm with which Patricia was familiar. They reported about $103,000 of income and claimed a $90,000 deduction for exploration and development expenses allegedly incurred by the mining operation. The only tax they reported was $391 in self-employment tax.

Mrs. Price cursorily reviewed their tax return on the filing due date. She saw the $90,000 deduction taken for the mining expenses and thought it "was a bit much." But she asked Mr. Price about it and he assured her that the CPA would not have prepared and signed the return if there had been any problems with the deduction. So, she signed the return.

The IRS audited their return and found that they had understated their tax by $40,120. Mrs. Price requested innocent spouse relief and the IRS and the Tax Court both denied her request. So, she appealed to the Ninth Circuit.

The Ninth Circuit reviewed the four factors to consider in analyzing whether the a spouse had "reason to know" of the substantial understatement: (1) the spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (4) the nonrequesting spouse's evasiveness and deceit concerning the couple's finances.

Mrs. Price had studied as a sociology major at a junior college for two years and worked as a branch manager at a car-pooling agency. She had limited involvement in the financial affairs of her marriage and was not involved in the mining investment. Mr. Price was an investment broker and used a separate checking account for his investments. They had no unusually lavish expenditures during this time period when compared to their past levels of income, standard of living, and spending patterns. Finally, Mr. Price took advantage of Mrs. Price's lack of understanding of their financial affairs and misled her about the nature of the mining investment. So, the Ninth Circuit found that a reasonably prudent person in Mrs. Price's position at the time she signed the return could not be expected to know that the return contained a substantial understatement.

However, even though Mrs. Price did not have reason to know that the mining deduction would give rise to a substantial understatement, the Ninth Circuit said that if she knew enough that a reasonably prudent taxpayer in her position would be led to question the legitimacy of the deduction, she could be held to have constructive knowledge of the understatement. Her knowledge of the facts created a duty of inquiry.

Mrs. Price was aware of sufficient facts to give her reason to know of the substantial understatement, she knew enough to question the legitimacy of the deduction. The size of the $90,000 deduction compared to the total income on the return and her knowledge of the existence of the rather unusual mining investment was enough to put her on notice. So, she did have a duty of inquiry. But she satisfied this duty. She did not ignore the deduction – she questioned Mr. Price about it and agreed to sign it only after Mr. Price’s assurances that a reputable CPA had prepared it. So, the Ninth Circuit found that she had satisfied her duty of inquiry. Price v. Commissioner, 887 F.2d 959, 966 (9th Cir. 1989).

The fourth requirement for innocent spouse relief under I.R.C. section 6015(b) is that, in light of all the facts and circumstances it would be unfair to hold the spouse liable for the understatement of tax.

Finally, in order to obtain relief, you must request relief from the IRS within two years after the IRS takes collection action. For instance, you may file a Form 8857, Request for Innocent Spouse Relief, assert innocent spouse relief as a defense in a Collection Due Process hearing, or raise innocent spouse relief as a defense in a Tax Court proceeding. Collection action for the purposes of I.R.C. section 6015(b) and 6015(c) is defined as (1) the issuance by the IRS of a Collection Due Process levy notice under I.R.C. section 6330, (2) the offset of an overpayment of the requesting spouse against a tax liability (See McGee v. Commissioner, 123 T.C. 314 (2004)), (3) the filing of a lawsuit against the requesting spouse by the United States to collect the joint liability, or (4) the filing of a claim by the United States in a court proceeding in which the requesting spouse is a party or which involves the requesting spouse's property, such as a bankruptcy case. Treas. Reg. § 1.6015-5(b)(2). Collection action does not include a mere demand for payment of the tax, the issuance of a notice of deficiency by the IRS, or the filing of a Notice of Federal Tax Lien. Id.

2. Separation of Liability Relief – I.R.C. section 6015(c)

The second kind of relief is separation of liability relief and provides for an allocation of the additional tax owed because an item attributable to a spouse or former spouse was not properly reported on the joint return. I.R.C. § 6015(c).

There are four requirements to qualify for separation of liability relief.

First, a spouse must have filed a joint tax return which the IRS has determined understated their joint tax liability.

Second, at the time of requesting relief, the spouses must be divorced, legally separated, or have not been members of the same household for the past twelve months.

Third, the spouse must not have had actual knowledge of the item causing the understatement of tax when they signed the joint tax return.

Fourth, the spouse must elect relief within two years after the IRS has begun collection activities against the spouse.

In Gonce v. Commissioner, Mr. and Mrs. Gonce decided to supplement their income by delivering newspapers. They both worked separate newspaper routes in 1998 and 1999. Mrs. Gonce stopped in 1999, but Mr. Gonce continued his route in 2000 and 2001. The IRS assessed an understatement of tax attributable to income from Mr. Gonce's route in 2001. They divorced in 2004 and Mrs. Gonce requested relief from the joint liabilities for 1999, 2000 and 2001. One significant reason the Tax Court denied relief was that she had actual knowledge of the payments she and Mr. Gonce received for maintaining their respective newspaper routes. She had her own newspaper route in 1998 and 1999 and was familiar with the payments and procedures associated with maintaining those routes. She also had the opportunity to review the joint tax returns for those years to ensure that all of her and her ex-spouse's income was reported accurately before she signed those returns, but she failed to do so. Gonce v. Commissioner, T.C. Memo. 2007-327.

Actual Knowledge and Tax Shelter Cases

The third requirement is that when the requesting spouse signed the joint tax return, they must not have had actual knowledge of the item causing the understatement of tax.

In the early 1980s, in Eastern Oregon, there was a rancher named Walter J. Hoyt III. He was well-known for raising high-quality shorthorn cattle. However, he began promoting a scheme in which he sold partnership units to investors which allowed them to take large, unjustified tax losses. Mr. Hoyt organized, promoted, operated, and served as the general partner of more than 100 livestock breeding limited partnerships from 1971 through 1998. The Hoyt partnerships purchased livestock from related Hoyt entities for no money down and a promissory note. The investors in the Hoyt partnerships assumed personal liability for the partnerships' promissory notes, made payments on the notes to the Hoyt partnerships, and, in return, deducted large partnership losses related to the purchase, management, and sale of livestock. When Mr. Hoyt prepared the investors' tax returns, these losses generated huge tax refunds for the investors. As his organization grew, Mr. Hoyt continued inflating the number of cattle and the expenses and continued to mislead investors, claiming that the IRS would respect these partnerships as legitimate.

As can be expected, the IRS eventually investigated the operation and found that there was an insufficient number of cattle to sustain the partnership deductions claimed on the tax returns. In fact, eventually it was discovered that the Hoyt Cattle Partnerships owned only 7,903 cows, whereas investors were led to believe they owned over 38,000 cows. Ultimately, Mr. Hoyt sold over $103 million in illegitimate deductions. He was later convicted of tax fraud.

In the context of innocent spouse cases, the Tax Court has held that when the Internal Revenue Service disallows a deduction claimed by a taxpayer, the actual knowledge standard in I.R.C. section 6015(c)(3)(C) requires the IRS to prove that the requesting spouse had actual knowledge of the factual circumstances which made the item unallowable as a deduction. King v. Commissioner, 116 T.C. 198, 204 (2001). If the IRS cannot prove this, the requesting spouse will meet the actual knowledge requirement. Id.

In many of the Tax Court cases, the IRS was unable to show that the requesting spouse had actual knowledge of the facts giving rise to the disallowance of the losses, so the requesting spouse was able to obtain relief. See, eg., Mora v. Commissioner, 117 T.C. 279, 288 (2001). However, in other cases, the Tax Court held that the requesting spouse should have known that the deductions were not allowable. A spouse may be put on notice of an understatement of their tax liability when their tax return contains large deductions, such as tax shelter losses which offset other income and substantially reduce the couple's tax liability. Also, a spouse may be held liable if both spouses knew about the investments but mistakenly believed they were legitimate, the requesting spouse did not question the tax benefits provided by the investment, and both spouses benefited by enjoying their financial security and lifestyle. Doyel v. Commissioner, T.C. Memo. 2004-35.

Section 6015(c) – Relief Available

If relief is granted under I.R.C. section 6015(c), the understatement is allocated between the spouses pursuant to I.R.C. section 6015(d)(3). Items giving rise to the deficiency are allocated in the same manner as they would have been allocated if the spouses had filed separate returns for the taxable year. Estate of Capehart v. Commissioner, 125 T.C. 211, 215 (2005). Tax benefit items are allocated to the spouse who benefited. Items attributable to the nonrequesting spouse must be allocated to the requesting spouse to the extent of any tax benefit but can be reallocated to nonrequesting spouse to the extent the nonrequesting spouse received a tax benefit and the requesting spouse did not receive a tax benefit. I.R.C. § 6015(d)(3)(B); Treas. Reg. § 1.6015-3(d)(2)(i); Hopkins v. Commissioner, 121 T.C. 73 (2003).

3. Equitable Relief

The third kind of relief is equitable relief and provides for relief from an item attributable to a spouse or former spouse if the tax liability is understated or if the tax is not paid, and taking into account all the facts and circumstances, it would be unfair to hold the spouse liable for the understatement of tax. I.R.C. § 6015(f). Requests for equitable innocent spouse relief are evaluated by the IRS under IRS Revenue Procedure 2013-34; 2013-2 C.B. 397 (See https://www.irs.gov/pub/irs-drop/rp-13-34.pdf for a copy of this Revenue Procedure).

Threshold Requirements

To qualify for equitable relief, a spouse can have either an understatement of tax (the IRS has imposed a deficiency) or an underpayment of tax (the tax reported on the tax return has not been paid). This is unlike relief under I.R.C. section 6015(b) or (c) which is only available for understatements. Seven threshold requirements must first be met. Rev. Proc. 2013-34; Section 4.01. A spouse must (1) file a joint tax return, (2) not qualify for "Innocent Spouse Relief" or "Separation of Liability Relief," (3) timely file a claim for relief before the expiration of the collection statute or the period for credit or refund, (4) not transfer assets to their spouse as part of a fraudulent scheme, (5) not transfer assets to their spouse to avoid taxes, (6) not knowingly participate in filing a fraudulent tax return, and (7) (with a few exceptions) the tax liability must be attributable to the other spouse's unreported income or erroneous deduction. If a portion of the tax liability is attributable to the requesting spouse's income, the IRS may only grant partial relief – for the portion of the liability attributable to the other spouse's income.

Streamlined Determinations (Rev. Proc. 2013-34, Section 4.02)

The IRS will ordinarily make a streamlined determination granting equitable relief under I.R.C. sections 66(c) and 6015(f) if the requesting spouse meets three criteria:

First they must be no longer married to the requesting spouse, which means they are (a) divorced, (b) legally separated, (c) a widow or widower and not an heir to the nonrequesting spouse's estate which has sufficient assets to pay the liability, or (d) not a member of the same household as the nonrequesting spouse at any time for 12 months before requesting relief;

Second, they would suffer economic hardship if relief were not granted.

Third, they did not know or have reason to know that there was an understatement on the joint return or that the nonrequesting spouse would or could not pay the tax liability when the joint return was signed. However, if the nonrequesting spouse abused the requesting spouse or maintained exclusive control over the household finances so that the requesting spouse was not able to challenge the treatment of any items on the joint return or to question the payment of the taxes, then this factor will be satisfied even if the requesting spouse had knowledge or reason to know of the items giving rise to the understatement or that the nonrequesting spouse would not pay the tax liability.

In Gonce v. Commissioner, supra, the spouses reported underpayments on their 2000 and 2001 Federal tax returns of $1,188 and $2,528, respectively. When the returns were signed by Mrs. Gonce and filed, she knew that her husband always bought on credit and that she and her husband spent more than they made. Therefore, the Tax Court held that she did not show that it was reasonable to rely on her husband to pay the tax due for those years. Id.

Equitable Factors

The IRS looks at a number of factors when determining whether or not to grant equitable relief. These factors are listed in IRS Revenue Procedure 2013-34. The factors are:

1. The spouses' marital status. The spouses must be:

    a. Divorced;

    b. Legally Separated;

    c. The spouse is a widow or widower and not an heir to the other spouse's estate and this estate has sufficient assets to pay the liability; or

    d. The spouses are not members of the same household at any time during the 12 months before requesting relief;

2. Whether the spouse requesting relief will suffer economic hardship so as to be unable to pay his or her reasonable living expenses if relief is not granted;

a. The IRS will compares the requesting spouses' income to the Federal poverty guidelines in making this determination.

b. If the denial of equitable relief will cause an economic hardship, this factor will favor relief, but it will not weigh against relief if denying relief will not cause the requesting spouse to suffer economic hardship.

3. Whether the spouse had knowledge or reason to know of the unreported income or the erroneous deduction or that the other spouse would not pay the liability on the tax return. This factor will weigh in favor of relief even if the requesting spouse knew or had reason to know of the item or nonpayment if:

a. The other spouse abused the requesting spouse or maintained control over the household finances by restricting access to financial information, and

b. this caused the requesting spouse to be unable to challenge the treatment of any items on the joint return, or to question the assurance that the taxes were paid for fear of retaliation.

To prove abuse, the Tax Court requires documentation, or at least specificity in testimony alleging abuse. A generalized claim of abuse is not sufficient. See Nihiser v. Commissioner, T.C. Memo. 2008–135; Heydon-Grauss v. Commissioner, T.C. Memo. 2018-209. In establishing abuse, documentation and pleadings from your client's divorce proceedings, if available, can be very helpful.

Thomassen v. Commissioner is an example of a case in which the petitioner provided sufficient evidence of psychological abuse to allow relief even though the liability may be attributable to her own income. Thomassen v. Commissioner, T.C. Memo. 2011–88. The Tax Court held that even though petitioner would not be eligible for relief under I.R.C. section 6015(c) because she could not prove what portion of the deficiencies was attributable to her income earned as a professional cellist, she was entitled to equitable relief under I.R.C. section 6015(f). The evidence included testimony from a third party, specific incidents in which others witnessed abuse and the impact of the abuse on Mrs. Thomassen and the children, and the fact that Mrs. Thomassen sought help from her priest. Thomassen v. Commissioner, T.C. Memo. 2011–88.

4. Whether a divorce decree makes the requesting spouse or the nonrequesting spouse liable to pay the outstanding tax liability;

a. The IRS is not bound by any written agreements between the spouses, but a spouse who is not to be held responsible pursuant to a court agreement can sue the former spouse in state court.

b. The IRS can collect from either spouse since they are jointly and severally liable for the tax.

5. Whether the spouse significantly benefited by not paying the tax;

a. A significant benefit is something beyond normal support, such as owning luxury assets and taking expensive vacations.

b. The presence of abuse will mitigate this factor so that it is neutral.

c. The case Marzullo v. Commissioner is an example of a significant benefit received by a spouse requesting innocent spouse relief. Marzullo v. Commissioner, T.C. Memo. 2013-120. In this case, there was an underpayment of tax – the taxpayers filed their returns but did not pay the taxes owed – so relief was not available under I.R.C. section 6015(b) or (c). Mr. Marzullo was a pharmacist, and the Marzullos owned a drug store. Upon Mr. Marzullo's death Mrs. Marzullo received his 100% ownership interest in the drug store along with $1,300,000 of life insurance proceeds paid to the drug store. The Marzullo's had failed to file returns for six years and instead of paying their tax liabilities, they used funds they withdrew from their IRAs to pay living and business expenses. The Tax Court held that since she received property from Mr. Marzullo which was beyond normal support and traceable to the funds they should have used to pay their taxes, Mrs. Marzullo received a significant benefit from not paying the taxes and purchasing life insurance so was not entitled to equitable innocent spouse relief. <u>Marzullo v. Commissioner</u>, <u>supra</u>.

6. Whether the spouse has made a good faith effort to comply with Federal income tax laws in later years; and

7. Whether the spouse was in poor mental or physical health when he or she signed the tax return.

In the past the IRS considered abuse as a separate factor, but now the IRS considers whether the spouse requesting relief was abused by the other spouse or denied access to the couple's finances as part of its evaluation of the above factors. <u>Compare</u> Rev. Proc. 2003-61, 2003-2 C.B. 296, with Rev. Proc. 2013-34, 2013-2 C.B. 397. In addition, the IRS may look at other factors it considers to be relevant to a specific case.

<u>Thomassen v. Commissioner</u>, <u>supra</u>, in which Mrs. Thomassen was granted relief due to Dr. Thomassen's psychological abuse, is a good illustration of the interplay between section 6015(b), (c) and (f).

Dr. Thomassen was a successful orthopedic surgeon. Mrs. Thomassen was a homemaker, a mother to eight children, and a part-time professional cellist. She played summer festivals and starting in 1971 she played with the Disneyland Orchestra. However, Dr. Thomassen was extremely controlling and subject to fits of rage with almost weekly outbursts. Mrs. Thomassen tried to please him to avoid his outbursts.

Although his practice was successful, Dr. Thomassen inflated his expenses to avoid paying taxes. In one of the years in issue, 1971, he earned Schedule C income of $172,417 and deducted business expenses totaling $222,661. He believed that the Government had no authority to investigate his finances or to impose an income tax. During the court proceedings, he refused to provide documentation or other evidence of the expenses incurred in his medical practice for which he claimed deductions. He said that it would violate his constitutional rights and religious beliefs to provide these records to the Government.

As the troubles with the IRS increased, many process servers came to their door. To avoid them, Dr. Thomassen told his children not to answer the telephone or the door. If they accidentally did so, they would face his rage.

Eventually, the Tax Court dismissed his case and entered a default judgment against the Thomassens. Dr. Thomassen died in April 2004. When the Government obtained an order to evict Mrs. Thomassen and sell the house, she filed a Form 8857, Request for Innocent Spouse Relief, dated May 10, 2006.

The Tax Court first evaluated Mrs. Thomassen’s request for relief under I.R.C. section 6015(b). She maintained that she did not know or have reason to know of the understatements on the Thomassen’s joint returns because she did not review them before signing and their spending patterns and standard of living during the years for which she sought relief were not lavish or unusual when compared to their past expenditures and standard of living. The Court did not agree. Petitioner knew that Dr. Thomassen had a successful medical practice which paid for their mortgage on the Newport Beach house and household expenses. They were also able to support eight children, pay for them to attend private Catholic schools, purchase a new motorhome, and take regular vacations and trips overseas. Dr. Thomassen also was able to purchase four parcels of real estate for investment purposes. Despite this substantial income, the Thomassen's tax returns consistently reported no tax owed. Mrs. Thomassen was college educated and even though she had little experience with tax or financial matters, she should have realized that they should have been paying tax on their substantial income. She failed to meet her duty of inquiry, so the Tax Court found that she had reason to know of the understatements on the tax returns.

The Tax Court next evaluated Mrs. Thomassen's request for relief under I.R.C. section 6015(c). She requested an allocation of the liabilities and to pay tax only on the portion attributable to her income. She did earn income from playing the cello. However, although she testified that she did earn this income, there was no evidence of the amount of cello income she earned each year and she could not show the amount, if any, they reported on their joint tax returns. She did make $18,000 in a year after the years for which she requested relief, so the Tax Court held that the amount was not de minimis. Also, there was other income they received that was not attributable to Dr. Thomassen's medical practice and Mrs. Thomassen could not show that it was not attributable to her. So, the Tax Court held that since Mrs. Thomassen could not show which portions of the deficiencies were allocable to her, she was not eligible for relief under section 6015(c).

The Tax Court held that even though petitioner would not be eligible for relief under I.R.C. section 6015(c) because she could not prove what portion of the deficiencies was attributable to her income earned as a professional cellist, she was entitled to equitable relief under I.R.C. section 6015(f).

The Tax Court reviewed the seven equitable factors. First, Mrs. Thomassen met the marital status factor. Dr. Thomassen died in April 2004, before the Tax Court trial in November of 2007. Second, Mrs. Thomassen died after the trial, but before the Tax Court issued its opinion in April 2011. Since she was deceased, there could be no economic hardship to her personally if equitable relief was denied, so that factor weighed against relief. See Jonson v. Commissioner, 118 T.C. 106, 126, aff'd 353 F.3d 1181 (10th Cir. 2003).

The third factor is whether the spouse had knowledge or reason to know of the unreported income or erroneous deductions. The Tax Court noted that even if the deficiency is attributable to the income of the requesting spouse, relief may be granted where the requesting spouse establishes that he or she was a victim of abuse. The Tax Court pointed to specific facts in evidence that demonstrated psychological abuse. There was testimony about Dr. Thomassen's treatment of his daughter who accidentally answered the door and accepted service on her father from a process server. There was also testimony about another daughter's college friends who were so appalled after witnessing Dr. Thomassen's behavior over a weekend, that they advised Mrs. Thomassen to find shelter for herself and the younger children elsewhere. Also, Mrs. Thomassen consulted her priest regarding her husband's behavior, although the priest just told her to persevere in the marriage.

The Tax Court found that since due to years of psychological abuse, Mrs. Thomassen was unable to meet her ordinary duties to investigate and challenge any unusual items on the tax returns. Therefore, this factor was neutral.

The fourth factor is whether the nonrequesting spouse had a legal obligation to pay the taxes. Since Mr. and Mrs. Thomassen remained married until his death, this factor was neutral.

The fifth factor is whether the spouse significantly benefited from the failure to pay taxes. The Tax Court held that due to Dr. Thomassen's abuse, Mrs. Thomassen did not significantly benefit. First, Dr. Thomassen controlled the family's finances and allowed petitioner very little access to his earnings. He gave Mrs. Thomassen an allowance to pay household expenses, but since she was afraid to ask him for more when this would not cover the expenses, she had to supplement this with her cello earnings and even borrowed from her mother or sold personal items. Second, the real properties did not provide a significant benefit because they were sold to pay tax liabilities. Third, the payments for the children's education were not a significant benefit. The Tax Court said that the decision to send the children to Catholic schools was undoubtedly Dr. Thomassen's choice since he was so controlling and was a devout Catholic, whereas Mrs. Thomassen converted to Catholicism after her marriage to Dr. Thomassen. So, the significant benefit factor favored relief.

The sixth factor is whether the spouse has made a good faith effort to comply with Federal income tax laws in later years. The Internal Revenue Service did not produce any evidence of any significant noncompliance by petitioner in later years, so the Tax Court held that this factor was neutral.

The seventh factor is whether the spouse was in poor mental or physical health when he or she signed the tax return. Since Mrs. Thomassen died after the trial factor, the Court held that her death made this factor irrelevant.

The Tax Court granted relief under I.R.C. section 6015(f). It said that Dr. Thomassen's abuse weighed very heavily in favor of relief, since it rendered her incapable of challenging her spouse regarding the positions taken on the joint returns. It also prevented her from significantly benefiting from the unpaid taxes.

D. Relief from Tax on Community Property Income

In community property states, such as Washington State, a spouse is taxable on half of the community income, including the other spouse's income. However, a spouse may be relieved of liability for taxes on their spouse's income if (1) they did not file a tax return, (2) the spouse did not include the income attributable to the other spouse on their own return, (3) they did not know, and had no reason to know of, the income, and (4) it would be unfair to tax them on their spouse's income in light of all the facts and circumstances. To determine whether it would be inequitable to tax the spouse on the other spouse's income, the Internal Revenue Service will use the equitable factors in Revenue Procedure 2013-34 that were discussed in the last section. Rev. Proc. 2013-34, Section 4.01.

A good example of a case in which the Tax Court granted relief from taxation on community property income is Hiramaneck v. Commissioner, T.C. Memo. 2011-280. In this case, from California, the first question that had to be answered by the Tax Court was whether the taxpayers' tax return was a valid married-filing-joint tax return. They held that it was not a valid return because Mrs. Hiramaneck had signed it under duress. Mrs. Hiramaneck demonstrated a pattern of abuse. It led up to the night she refused to sign the joint return given her by Mr. Hiramaneck, when he became violent. The Tax Court held that since Mrs. Hiramaneck was unable to resist his demand to sign the joint return and would not have signed the return if he had not threatened her, the return was signed under duress and was not a valid joint return. Since the return was not a joint return under I.R.C. section 6013 and Mrs. Hiramaneck was not jointly and severally liable for any deficiency arising from that return, relief was not available to her under I.R.C. section 6015.

Next, the Tax Court reviewed the factors used by the Internal Revenue Service in granting equitable relief. It held that Mrs. Hiramaneck did not significantly benefit from the community property income and would suffer economic hardship if relief from the tax on the community property income was not granted. Therefore, the Tax Court granted equitable relief under I.R.C. section 66(c) meaning that Mrs. Hiramaneck did not have to include her one-half share of her ex-husband's wages in her own taxable income. Hiramaneck v. Commissioner, T.C. Memo. 2011-280.

E. Injured Spouse Relief

A person may be entitled to relief as an injured spouse if

a) they filed a joint tax return;

b) they and their spouse were entitled to a refund;

c) they made and reported tax payments, such as federal income tax withholding or estimated tax payments, or claimed a refundable tax credit on the joint return, such as the earned income credit or additional child tax credit;

d) the IRS used the refund to pay a legally enforceable past-due debt(s) owed only by their spouse such as Federal tax, State income tax, State unemployment compensation, Child support, Spousal support, or Federal nontax debt (such as a student loan); and

e) they are not legally obligated to pay this past-due debt.

To claim injured spouse relief, one must file a Form 8379, Injured Spouse Allocation, with the Internal Revenue Service.

F. How Do I Get Relief for my Client?

1. Form 8857 (See https://www.irs.gov/pub/irs-pdf/f8857.pdf)

To get innocent spouse relief, one must file a Form 8857, Request for Innocent Spouse Relief, with the Internal Revenue Service. Generally, the IRS will make a determination as to whether or not a spouse qualifies for relief within 6 months. However, if the IRS does not respond to the request within 6 months, you can file a petition with the United States Tax Court to ask the Tax Court to determine that your client qualifies for relief from joint and several liability.

You can also make a claim that your client is entitled to innocent spouse relief in response to a notice of deficiency from the IRS asserting that your client owes additional taxes or in response to a notice of lien or levy. You will still need to submit a Request for Innocent Spouse Relief to enable the IRS to evaluate your client's case.

2. Is There Anything I Can Do to Strengthen My Client's Case Before Filing a Form 8857?

There are things you can do to strengthen your client's case. You should make sure that your client is divorced or has been living in a separate household for the last twelve months before filing Form 8857. You can also make sure that your client is current with filing their tax returns and paying the taxes due. It is also a good idea to obtain as much evidence of abuse or financial control as possible. If pleadings from a divorce proceeding are available, they may be useful in establishing abuse or financial.

3. Form 8379 (See https://www.irs.gov/pub/irs-pdf/f8379.pdf)

To claim injured spouse relief, to claim a spouse's proper share of a tax refund, a Form 8379, Injured Spouse Allocation, must be filed with the Internal Revenue Service.

4. When Must One Request Relief?

For "Innocent Spouse Relief" and "Separation of Liability Relief" relief one must request relief within two years after the IRS takes action to collect the tax liability. See Treas. Reg. § 1.6015-5(b)(2). For "Equitable Relief" a claim must be filed before the expiration of the time the IRS has to collect the tax. Rev. Proc. 2013-34; Section 4.01(3)(a). To get a refund one must file before the expiration of the period of limitations for claiming a credit or refund. Rev. Proc. 2013-34; Section 4.01(3)(b).

5. What Happens if the IRS Rejects the Claim?

When a Form 8857 is filed, it is reviewed by IRS Cincinnati Centralized Innocent Spouse Operation (aka “CCISO”). If the IRS rejects the innocent spouse claim, you will have the opportunity to dispute the disallowance with the IRS Office of Appeals. If Appeals also rejects your client’s claim, a petition may be filed with the United States Tax Court to dispute this. The Tax Court will review the evidence presented to the Internal Revenue Service, as well as your client’s testimony, and any additional evidence submitted at trial.