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The Innocent Spouse Provision Under Section 6013(e) of the Internal Revenue Code: Relief or Refuse?

Michael F. Lax*

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I. Introduction

When a husband and wife file a joint income tax return each is generally jointly and severally liable for the tax.¹ A primary policy reason for such joint and several liability is administrative convenience.² Although the rationale for imposing joint and several liability

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¹ I.R.C. § 6013(d)(3) (1986) provides, in pertinent part: "If a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several." Joint and several liability also exists with respect to penalties and additions to tax: e.g., the 50% fraud penalty determined to be due as a result of the fraud of either spouse. H.R. Rep. No. 1734, 91st Cong., 2d Sess. (1970). The requirements for when a husband and wife may file a joint return are set forth in I.R.C. § 6013(a) (1986).

² Since a joint return does not show the respective incomes and deductions of a husband
where a joint return is filed has been questioned, it is firmly entrenched in both statutory and judicial law.

The primary goal of this article is to provide a critical analysis of section 6013(e) of the Internal Revenue Code of 1986 and the cases interpreting and applying this statute as it has evolved through the years. This provision sets forth the circumstances under which an individual who signs a joint return with his or her spouse may be relieved of liability for tax by qualifying as an "innocent spouse." Although the statute sets forth specific requirements that must be satisfied before innocent spouse relief will be granted, this article will address the arbitrariness of the limitations of this provision and question the purpose of these restrictions. This article will further note that although the courts have articulated standards to help taxpayers apply this statute to their particular situation, these standards have been so inconsistently applied that any certainty as to the applicability of this provision today is questionable. The article also will review the recent changes made by the Technical and Miscellaneous Revenue Act of 1988 and comment on what impact this legislation has on the continued viability of I.R.C. section 6013(e) today. Further, the article will propose modifications for reform of existing law and offer planning suggestions for advising clients in view of current law.

In the final analysis, the underlying theme will be to form an opinion about whether the provision actually serves its purpose of providing relief to deserving innocent spouses or whether it is laden with so many problems that it should be deposited in the nearest "dipsy dumpster."

II. PURPOSE AND ANALYSIS OF STATUTE
A. Legislative History and Changes

Prior to 1971 there was no provision in the Internal Revenue and wife, and since the statute imposes a tax on the aggregate income, administrative simplicity makes it necessary that the filing of such a return create a liability that is joint and several. H.R. REP. NO. 1734, 91st Cong., 2d Sess. 2 (1970).

5. See infra notes 56-64 and accompanying text.
6. See infra notes 92-102 and accompanying text.
7. See infra notes 104-69 and accompanying text.
9. See infra notes 175-83 and accompanying text.
10. See infra notes 184-213 and accompanying text.
Code to ameliorate the harsh effects of joint liability where the acts of one spouse, unknown to the other, resulted in an increased joint and several tax liability.\textsuperscript{11} Several instances in which joint liability was asserted by the Internal Revenue Service in similar circumstances resulted in court decisions. Although courts expressed sympathy for the innocent spouse, they stated that the clear role of the statute, imposing joint and several liability, did not permit any decision other than the one holding the innocent spouse liable for the taxes and penalties.\textsuperscript{12}

In 1971 section 6013(e) was enacted by Congress to relieve an "innocent spouse" from joint liability to the extent the tax liability was attributable to an omission from gross income by the other spouse.\textsuperscript{13} As originally enacted, taxpayers had to satisfy the following

\textsuperscript{11} A typical situation might be one in which a husband embezzles funds (which are taxable income) and omits the proceeds from gross income. If the wife of the embezzler filed a joint return with her husband for the year in which the income should have been reported, the Internal Revenue Service could, under then existing law, hold the innocent spouse liable for the tax liability resulting from the underpayment and for the 50\% fraud penalty due as a result of the fraudulent omission of the embezzled funds from income. This liability could be imposed upon the spouse even though she had no knowledge of her husband's activities and the resulting omission from income, and did not benefit in any way from the use of the funds. H.R. REP. No. 1734, 91st Cong., 2d Sess. 2 (1970).

\textsuperscript{12} H.R. REP. No. 1734, 91st Cong., 2d Sess. 2 (1970). Some of the judicial decisions carried pleas for legislative relief. See, e.g., Scudder v. Commissioner, 48 T.C. 36 (1967). In Scudder the court observed:

Although we have much sympathy for petitioner's unhappy situation and are appalled at the harshness of this result in the instant case, the inflexible statute leaves no room for amelioration. It would seem that only remedial legislation can soften the impact of the rule of strict individual liability for income taxes on the many married women who are unknowingly subjected to its provisions by filing joint returns.

\textit{Id.} at 41.

\textsuperscript{13} Pub. L. No. 91-679, 84 Stat. 2063 (1971) states:

\textit{Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 6013 of the Internal Revenue Code of 1954 (relating to joint returns of income tax by husband and wife) is amended by adding at the end thereof the following new subsection:}

\textit{“(e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—

“(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, if—

“(A) a joint return has been made under this section for a taxable year and on such return there was omitted from gross income an amount properly includable therein which is attributable to one spouse and which is in excess of 25 percent of the amount of gross income stated in the return, 

“(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and}

“(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income and taking into account all other facts and circumstances, it is inequitable
three conditions to qualify for relief from joint tax liability (including interest, penalties, and other amounts): (1) a joint return had to be filed from which there was an omission from gross income attributable to one spouse amounting to more than twenty-five percent of the total gross income stated on the return; (2) the innocent spouse had to establish that in signing the return he or she did not know of, and had no reason to know of, the omission from income; and (3) taking into account whether or not the spouse significantly benefitted from the items omitted from gross income and all other facts and circumstances, it would be inequitable to hold the spouse in question liable for the deficiency in tax.  

Although the enactment of this provision was certainly a step in the right direction, the original statute fell short of fully achieving its remedial purpose. It failed to provide relief to an innocent spouse where the assessment of a deficiency was based upon the disallowance of deductions claimed under circumstances similar to which relief under section 6013(e) would otherwise be granted. For example, in *Ketchum v. Commissioner* innocent spouse relief was denied where the deficiency resulted from the Commissioner's disallowance of deductions taken by the husband. While acknowledging that the wife was the victim of her ex-husband's irresponsible conduct, the court relied on the legislative history of the statute in reluctantly determining that she could not qualify under the innocent spouse provision because the statute did not extend relief to overstated deductions, but

14. I.R.C. § 6013(e) (1986). See also H.R. REP. No. 1734, 91st Cong., 2d Sess. 3 (1970). This provision applies to an omission from gross income for any reason and is not limited to embezzlement, theft or similar activities. See also Sanders v. United States, 509 F.2d 162 (5th Cir. 1975). This provision was adopted to prevent hardships which resulted when one spouse did not report income, thereby leaving the "innocent spouse" to pay the deficiencies. *Id.* at 166.  


16. 697 F.2d 466 (2d Cir. 1982).  

17. *Id.* at 468.
rather only omissions from income.\(^8\)

The original statute also failed to provide relief where the omission from gross income fell short of the required twenty-five percent benchmark,\(^9\) even though all other statutory requirements were satisfied. Strict interpretation of the statute has led to some very harsh results.\(^2\) Commentators have criticized this approach,\(^2\) particularly in view of the underlying policy of this legislation.\(^2\) The courts, however, have been mindful of the underlying policy for allowing the filing of joint returns,\(^2\) and have looked to Congress for reform.\(^2\)

In 1984 Congress significantly broadened section 6013(e) to provide relief to an innocent spouse for "grossly erroneous items" resulting in a "substantial understatement" of tax attributable to the other

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18. *Id.* This provision grants relief from the imposition upon innocent spouses of large liabilities for taxes and penalties attributable to income omitted from a joint return by the other spouse. *S. Rep. No. 1537, 91st Cong., 2d Sess. 1 (1970), reprinted in 1970 U.S. Code Cong. & Admin. News 6089, 6090.* When Congress enacted the innocent spouse provision in 1971, it restricted the provision’s applicability to omissions that are greater than 25% of gross income to insure that this special relief would extend only "to those cases where the income omitted represents a significant amount relative to the reported income." *Id.* at 6091.


20. *See* Fields v. Commissioner, 50 T.C.M. (P-H) ¶ 81,652 (1981), where the taxpayer argued that the court should round the 24.96% omission from gross income up to the 25% threshold so that taxpayer could avail himself of innocent spouse relief. The court rejected taxpayer's argument stating "[N]either the statute, case law, nor any sound reasoning we can think of calls for such a result. Accordingly, the taxpayer is not entitled to relief as an innocent spouse under § 6013(e)." *Id.*


22. *See* Sanders v. United States, 509 F.2d 162 (5th Cir. 1975). "Congress intended the [innocent spouse] exception to remedy a perceived injustice, and we should not hinder that praiseworthy intent by giving the exception an unduly narrow or restrictive reading." *Id.* at 166-67.

23. *See* Sonnenborn v. Commissioner, 57 T.C. 373 (1971) where the court stated:

It is important that these provisions be kept in proper perspective. The filing of a joint return is a highly valuable privilege to husband and wife since the resulting tax liability is generally substantially less than the combined taxes that would be due from both spouses if they had filed separate returns. The circumstances give particular emphasis to the statutory rule that the liability with respect to tax is joint and several, regardless of the source of income or of the fact that one spouse may be less informed about the contents of the return than the other, for both spouses ordinarily benefit from the reduction in tax that ensues by reason of the joint return. * * * But it must be kept in mind that Congress still regards joint and several liability as an important adjunct to the privilege of filing joint returns, and that if there is to be any relaxation of that rule the taxpayer must comply with the carefully detailed conditions set forth in section 6013(e).

*Id.* at 380-81. *See also* Gorman v. Commissioner, 55 T.C.M. (P-H) ¶ 86,344 (1986); Wayne Johnson v. Commissioner, 49 T.C.M. (P-H) ¶ 80,569 (1980).

spouse.\textsuperscript{25} A substantial understatement of tax means "any under-


SEC. 424. INNOCENT SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.

(a) General Rule.—Subsection (e) of section 6013 (relating to spouse relieved of liability in certain cases) is amended to read as follows:

"(e) Spouse Relieved of Liability in Certain Cases.

"(1) In General.—Under regulations prescribed by the Secretary, if—

"(A) a joint return has been made under this section for the taxable year,

"(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

"(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and,

"(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement, then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

"(2) Grossly Erroneous Items.—For purposes of this subsection, the term 'grossly erroneous items' means, with respect to any spouse—

"(A) any item of gross income attributable to such spouse which is omitted from gross income, and

"(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

"(3) Substantial Understatement.—For purposes of this subsection, the term 'substantial understatement' means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

"(4) Understatement Must Exceed Specified Percentage of Spouse's Income.—

"(A) Adjusted Gross Income of $20,000 or Less.—If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.

"(B) Adjusted Gross Income of More Than $20,000.—If the spouse's adjusted gross income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting '25 percent' for '10 percent'.

"(C) Preadjustment Year.—For purposes of this paragraph, the term 'preadjustment year' means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.

"(D) Computation of Spouse's Adjusted Gross Income.—If the spouse is married to another spouse at the close of the preadjustment year, the spouse's adjusted gross income shall include the income of the new spouse (whether or not they file a joint return).

"(E) Exception for Omissions from Gross Income.—This paragraph shall not apply to any liability attributable to the omission of an item from gross income.
... which exceeds $500."26 Basically, "grossly erroneous items" include any items of income that are omitted from gross income, regardless of the basis for the omission.27 Additionally, "grossly erroneous items" include "any claim of a deduction, credit, or basis by such other spouse in an amount for which there is no basis in fact or law."28 Although the statute does not define "no basis in fact or law," the committee report29 as well as the courts30 have provided some guidance in interpreting this language.

In Douglas v. Commissioner31 the court reviewed the statute and its legislative history, and held that a deduction has no basis in fact when the expense for which the deduction is claimed was never in fact made. The court further held that "[a] deduction has no basis in law when the expense, even if made, does not qualify as a deductible expense under well-settled legal principles or when no substantial legal

"(5) Special Rule for Community Property Income.—For purposes of this subsection, the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws."

(c) Effective Dates.—

(1) In General.—Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies. Corresponding provisions shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to all taxable years to which such Code applies.


The committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered.

Id.


31. 86 T.C. 758 (1986).
argument can be made to support its deductibility.\textsuperscript{32}

Two other significant changes made by the 1984 Tax Reform Act severely limit the availability of innocent spouse relief where the understatement of tax is attributable to grossly erroneous items of the other spouse. First, such relief is only available where the amount of tax liability in issue exceeds a specified percentage of the innocent spouse's adjusted gross income.\textsuperscript{33} This percentage varies depending on the amount of the adjusted gross income of the individual claiming innocent spouse relief.\textsuperscript{34} Second, the adjusted gross income of the innocent spouse includes the income of such individual's spouse, if any, for the most recent taxable year ending before the date the deficiency notice is mailed.\textsuperscript{35} The most incredible part of this second limitation is that it requires inclusion of each spouse's income, even if a joint return is not filed.\textsuperscript{36}

Another change made by the 1984 amendments was the elimination of the specific statutory inquiry into whether the innocent spouse benefitted from the omission.\textsuperscript{37} The primary focus of this provision today is whether imposing the tax would be inequitable under all the facts and circumstances.\textsuperscript{38} Although this change in the statute appeared to be a significant one, its practical effect involved nothing more than a different phraseology of the same analysis.\textsuperscript{39}

Even though the amendments made by the 1984 Tax Reform Act\textsuperscript{40} denote some liberalization of the innocent spouse provisions, the application of the statute by the courts reveals a need for further legislative reform.\textsuperscript{41}

\textsuperscript{32} Id. at 763. See also Shenker v. Commissioner, 54 T.C.M. (P-H) \textsuperscript{3} 85,301 (1985), where the court held that ordinarily, a deduction having no basis in fact or in law can be described as frivolous, fraudulent, or to use the word of the committee report, phony.

\textsuperscript{33} See infra notes 57-59 and accompanying text.

\textsuperscript{34} Id.

\textsuperscript{35} See Borison, \textit{supra} note 3.

\textsuperscript{36} Id.

\textsuperscript{37} I.R.C. \textsuperscript{(1)} § 6013(e)(1)(D) (1986). See \textit{supra} note 13 for the text of the statute prior to amendment by Pub. L. No. 98-369.

\textsuperscript{38} Shea v. Commissioner, 780 F.2d 561 (6th Cir. 1986). See \textit{supra} note 25.

\textsuperscript{39} See infra notes 76-77 and 87-88 and accompanying text.

\textsuperscript{40} Section 6013(e) was amended by the Tax Reform Act of 1984, Pub. L. No. 98-369, Sec. 424(a), 98 Stat. 801, with retroactive application to all taxable years to which the I.R.C. of 1954 and 1939 applies. H.R. REP. No. 432, 98th Cong., pt. 2, at 1503, \textit{reprinted in} 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1144.

\textsuperscript{41} Borison, \textit{supra} note 3. Although there were further amendments made by the Technical and Miscellaneous Revenue Act of 1988, as will be seen infra at notes 169-74 and accompanying text, these changes failed to achieve the necessary legislative reform.
B. Analysis and Application of Section 6013(e)

A taxpayer seeking protection under the innocent spouse umbrella bears the burden of proving that each provision of section 6013(e)(1) is satisfied before relief will be granted.42

First, the statute requires that the taxpayer file a joint return for the taxable year in question.43 The intention of the parties to file a joint return is a question of fact,44 and in many of the reported decisions this first requirement is frequently stipulated as having been met.45

The second requirement is that the joint return reflect a substantial understatement of tax attributable to grossly erroneous items of one spouse.46 For reasons that will become apparent below, it is important to distinguish between the two types of grossly erroneous items set forth in the statute: (1) omissions from gross income,47 and (2) claims of improper deductions, credits, or basis.48

If the understatement of tax is due to an omission of items from gross income, section 6013(e) relieves the innocent spouse of liability regardless of how great a percentage of gross income the omission represents,49 as long as the resulting understatement of tax50 exceeds five hundred dollars and the other statutory prerequisites are met. This is a more liberal expansion of the original statute,51 and is consistent with its remedial purpose.52 Although there has been some litigation over what is an omission from gross income for purposes of

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46. I.R.C. § 6013(e)(1)(B) (1986). For the basic concepts of this requirement, see supra notes 25-28 and accompanying text.


50. See supra note 26. See also Moskovitz v. Commissioner, 55 T.C.M. (P-H) ¶ 86,357 (1986), in which the court stated that "[i]n order to be relieved of liability, there must be a 'substantial understatement of tax attributable to grossly erroneous items of one spouse.'" Id. at 86 (quoting I.R.C. § 6013(e)(1)(B) (1986)).


52. Allen v. Commissioner, 514 F.2d 908, 915 (5th Cir. 1975).
applying the innocent spouse provision, this is not an issue that is frequently disputed today.

Prior to the 1984 amendments, section 6013(e) provided no relief where the understatement of tax was attributable to claimed deductions. With the 1984 amendments, Congress extended the term "grossly erroneous items" to claims of deductions, credits, or basis for which there is no basis in law or fact which give rise to a substantial understatement of taxable income. Although there has been some litigation over the meaning of "no basis in law or fact," and one leading commentator has criticized the use of this standard, the majority of the controversy surrounding section 6013(e) involves the last two requirements of the statute.

When the assessed deficiency results from a claim of an improper deduction, credit, or basis, the statute provides an additional limitation on relief that is tied to the innocent spouse's adjusted gross income. If the innocent spouse's adjusted gross income for the preadjustment year is $20,000 or less, then relief from joint liability will be available only if the liability described in section 6013(e) also exceeds ten percent of such spouse's adjusted gross income. If the innocent spouse's adjusted gross income for the preadjustment year is greater than $20,000, then the additional limitation for relief is increased from ten percent of such spouse's adjusted gross income to twenty-five percent of such adjusted gross income.

From a policy and fairness viewpoint, these additional limitations are particularly troublesome. If the innocent spouse is married to another spouse at the close of the preadjustment year, the innocent spouse's adjusted gross income includes the income of the new spouse regardless of whether or not they file a joint return. This appears to fly in the face of the purpose for which the statute was originally en-

55. See supra notes 29-32. It does not follow that because deductions lacking in a factual or legal basis will be disallowed, all deductions which are disallowed lack a factual or legal basis. A taxpayer may not rely on the disallowance or inability to substantiate a deduction to prove a lack of basis in fact or law. Neary v. Commissioner, 54 T.C.M. (P-H) ¶ 85,261 (1985).
56. See Borison, supra note 3.
57. I.R.C. § 6013(e)(4) (1986). If the spouse is married to another spouse at the close of the preadjustment year, the spouse's adjusted gross income shall include the income of the new spouse, whether or not they file a joint return.
58. I.R.C. § 6013(e)(4)(C) (1986) defines "preadjustment year" as the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.
60. I.R.C. § 6013(e)(4)(A) and (B) (1986).
acted, and provides no inquiry into the available family income to which the innocent spouse may have access for the payment of any deficiency. Thus, an individual, otherwise eligible for innocent spouse relief, may be denied relief by remarrying an individual who is financially successful.

To illustrate some of the problems created by these arbitrary limitations, assume that a taxpayer is divorced from her husband who, in prior years on their joint return and unknown to her, took erroneous deductions for tax shelter investments that had no basis in fact or law. Further, assume the taxpayer recently remarried, had little or no personal income prior to her remarriage, signed the earlier joint returns in complete reliance on her ex-husband’s representations and was generally eligible to qualify for innocent spouse relief under section 6013(e). If her new husband has adjusted gross income for the preadjustment year in excess of $20,000 and the assessed deficiency does not exceed twenty-five percent of the couple’s adjusted gross income, the innocent spouse will not qualify for relief under section 6013(e). Instead, she will be liable for the assessed deficiency, even though all other requirements of the innocent spouse provision have been satisfied. Additionally, the innocent spouse may have no personal income out of which to pay the assessed deficiency and her new spouse may be financially unable for a number of reasons, as well as understandably reluctant, to assist the innocent spouse in paying a tax deficiency generated solely by the innocent spouse's ex-husband. It seems that this is exactly the type of inequity the statute was adopted to prevent. The 1984 Tax Reform Act changes certainly represent a liberalization of the original statute, but these arbitrary limitations may prevent relief from being granted in deserving situations.

61. See Sanders v. United States, 509 F.2d 162 (5th Cir. 1975), which stated that “Congress intended the [innocent spouse] exception to remedy a perceived injustice, and we should not hinder that praiseworthy intent by giving the exception an unduly narrow or restrictive reading.” Id. at 166-67.

62. This would not be an uncommon situation today as a result of the heavy investment in tax shelters in the early 1980s. The use of such shelters, however, was significantly curtailed by the passive activity loss limitations of the 1986 Tax Reform Act. See I.R.C. § 469 (1986) and the regulations thereunder.


64. For example, the new spouse may have adjusted gross income barely in excess of $20,000 and be obligated under a court order to provide support to minor children of a previous marriage.

The third requirement of the statute, which is the no knowledge or reason to know of the understatement requirement, is the most litigated of the innocent spouse provisions and the most difficult for the courts to consistently apply. To satisfy this requirement, the innocent spouse must establish that in signing the return he or she did not know, and had no reason to know, that there was a substantial understatement of tax. The lack of "actual knowledge" requirement of the statute does not appear to be difficult for the courts to apply and is determined on a facts and circumstances basis. If it is determined that a taxpayer had actual knowledge of the substantial understatement, inquiry into whether the section 6013(e)(1) requirements have been met ends and innocent spouse relief will be denied. Even if the taxpayer seeking relief can establish that he or she has no actual knowledge of the understatement, the taxpayer still "must establish that a reasonably prudent taxpayer, with his or her knowledge of family finances, would have no reason to know of the omission."

Section 6013(e) is designed to protect the innocent, not the intentionally ignorant. As a result, courts have denied innocent spouse relief where a spouse simply chooses not to know of the substantial understatement. For example, in Schmidt v. United States, the wife, who had signed the joint return which omitted income, was denied innocent spouse relief when she admitted she knew of the sale of two pieces of properties at a gain. Her failure to review the tax return that she signed could not satisfy the "no reason to know" requirement of

67. See infra notes 94-162 and accompanying text.
69. Dickey v. Commissioner, 54 T.C.M. (P-H) ¶ 85,478 (1985). Taxpayer's allegation that he did not review the tax return for the taxable years at issue before the return was filed was sufficient to prove lack of actual knowledge of the omissions from income during the taxable years at issue. Id. at 2145. See also Moskovitz v. Commissioner, 55 T.C.M. (P-H) ¶ 86,357 (1986). Section 6013(e) relieves a spouse who signs a joint tax return of the tax liability from the joint return from income earned by the other spouse without knowledge of the first spouse. Ketchum v. Commissioner, 697 F.2d 466, 467 (2d Cir. 1982).
73. 5 Cl. Ct. 24 (1984).
the statute when she knew about the existence of the income that her husband did not report on the return.74

The final condition that must be satisfied for a taxpayer to qualify for innocent spouse relief is that after taking into account all the facts and circumstances, it would be inequitable to hold such taxpayer liable for the deficiency in tax that is attributable to the substantial understatement of the other spouse.75 This represents a change from pre-1984 law as there is no longer any statutory inquiry into whether the innocent spouse benefitted from the understatement. Supposedly, the focus now is solely on whether imposing the tax would be inequitable under all the facts and circumstances.76 Even though there is no longer a specific statutory inquiry into whether a taxpayer “significantly benefitted” from the substantial understatement of income,77 it is the primary factor that courts consider in determining whether it would be inequitable to impose liability on the “innocent spouse” for the payment of the deficiency.78

The determination of whether it would be “inequitable” to impose the tax on the spouse claiming innocent spouse relief has spawned much litigation,79 with the decisions generally turning on whether the court finds that the level of benefits received by the “innocent spouse” were significant.80 In Schmidt v. United States81 the court determined that it would not be inequitable to hold the wife liable for her share of the tax deficiency when it found that she significantly benefitted from the proceeds from the sales of property omitted

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74. Id. at 27. See also Terzian v. Commissioner, 72 T.C. 1164, 1170 (1979). Failure to review a tax return, standing alone, does not relieve a taxpayer of liability for any subsequent deficiency. Altman v. Commissioner, 475 F.2d 876, 880 (2d Cir. 1973).


77. Section 6013(e)(1), prior to its amendment in 1984, explicitly required that a court consider “whether or not the other spouse significantly benefitted directly or indirectly from the items omitted from gross income” to determine if innocent spouse relief was warranted. Walker v. Commissioner, 54 T.C.M. (P-H) ¶ 85,278 at 1247 n.3 (1985).


from gross income. The wife received over $37,000 from the sale of one of the properties acquired by her husband. With these proceeds, she paid her children's college and law school tuitions, which she had no obligation to pay. In addition, she used the proceeds to purchase two pieces of real estate. While recognizing the well-established principle that normal support is not a significant benefit, the court held that the transfer of property traceable to omitted income was evidence of a benefit, and also determined that the benefits received by the taxpayer were significant.

In Clevenger v. Commissioner, the court denied innocent spouse relief when it learned that the omitted income was used to make improvements to property owned jointly by the taxpayer and his wife. Pursuant to their divorce decree, the taxpayer also received his wife's interest in the corporations that they had owned jointly as well as their personal residence. On these facts, the Tax Court found that it would not be inequitable to hold the husband liable for the deficiencies as it found that he significantly benefitted from the omitted income.

Another factor that is considered in determining whether it would be inequitable to impose the tax on the innocent spouse is the degree of control that one spouse has over the family finances. The marital status of the taxpayer seeking innocent spouse relief is another factor to be considered in determining whether it would be inequitable to hold such spouse liable for any deficiency. Although the courts have considered these factors in making this "inequitable" determination, it appears that they are principally applied in the context of whether a "significant benefit" was received by the innocent spouse.

82. Id. at 28.
83. Id. The court, in reaching its decision, relied on the language of Treas. Reg. § 1.6013-5(b) (1974), which provides that "[i]n making such a determination a factor to be considered is whether the person seeking relief significantly benefitted, directly or indirectly, from the items omitted from gross income." Id.
84. 826 F.2d 1379 (4th Cir. 1987).
85. In fact, the court concluded that it would be inequitable not to hold the taxpayer liable since his property was improved and he knew or should have known "that something was rotten in Denmark." Id. at 1382.
87. See S. REP. No. 1537, 91st Cong. (1970), reprinted in 1971-1 C.B. 606, 608. See also Quint v. Commissioner, 54 T.C.M. (P-H) ¶ 85,226 (1985), where the court refused to deny innocent spouse relief simply because the petitioner was still married to her husband. Id. at 1006.
89. In Moskovitz v. Commissioner, 55 T.C.M. (P-H) ¶ 86,357 (1986), the court concluded that innocent spouse relief should be granted to the taxpayer where his spouse had exclusive control over family finances, was able to pay her creditors, and otherwise make use of the ill-
In reviewing cases that have addressed this issue, it is not clear what level of benefits received by an individual will result in a determination that significant benefits have been received by a taxpayer seeking innocent spouse relief. In some cases the benefits received by the innocent spouse appear quite significant, yet courts liberally applying the remedial provisions of the statute have granted innocent spouse relief. This lack of consistency undermines the certainty of the statute's applicability today.

III. WHAT IS THE JUDICIAL GLOSS ON THE REQUIREMENTS TO OBTAIN RELIEF?

A. Have the Courts Articulated Standards for Taxpayers to Avail Themselves of this Provision?

Taxpayers seeking innocent spouse relief must establish that they have satisfied all four of the statutory requirements of section 6013(e)(1). Taxpayers generally have little difficulty determining whether the first two requirements of the statute, the filing of a joint return and the substantial understatement of liability due to grossly erroneous items, have been satisfied. In regard to the no knowledge or reason to know and inequitable requirements as set forth in section 6013(e)(1)(C) and (D), respectively, taxpayers must look to caselaw to determine if these requirements have been met.

First, in determining whether a spouse knew or should have known of the substantial understatement, the standard applied is whether a reasonable person under the circumstances of the taxpayer at the time of the signing of the return could be expected to know of its existence.

There are three factors that courts routinely consider in deter-
mining whether a taxpayer had reason to know of the substantial understatement of tax.⁹⁷ The first factor is the innocent spouse’s degree of participation in the business affairs or bookkeeping of the other spouse.⁹⁸ The second factor is the existence of unusual or lavish expenditures during the year in issue.⁹⁹ The third factor is the guilty spouse’s refusal to be forthright with the innocent spouse concerning the couple’s income.¹⁰⁰ Although these clearly articulated factors have evolved through caselaw, the differing application of these principles has made it difficult for taxpayers to determine whether they qualify for innocent spouse relief.

Second, courts have fashioned a standard for determining whether it would be inequitable to hold the innocent spouse liable for the substantial understatement of tax.”¹⁰¹ However, it too has been inconsistently applied, and it is addressed in more detail below.¹⁰²

B. Is Consistency the Hobgoblin of a Small Mind?

The lack of consistency in applying the “no reason to know”¹⁰³ and the “inequitable”¹⁰⁴ requirements of the statute appears to be a function of how liberally the courts considering these issues have applied the statute. Close scrutiny of the cases illustrates how difficult it may be for taxpayers to determine if their particular situation satisfies these latter two requirements of the statute. By failing to consistently interpret and apply the law, the courts created a “hobgoblin”—a state of uncertainty as to what factual circumstances will satisfy the latter two requirements of the statute. As the cases will demonstrate, the concept of consistency does not appear to be simply attributable to the small-mindedness of a taxpayer seeking innocent spouse relief, but rather is a trait the courts need to develop for this statute to have viability in the future as a remedial provision.

To illustrate this problem of inconsistent application of similar

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¹⁰¹. I.R.C. § 6013(e)(1)(D) (1986); see also infra notes 163-69.
standards, four cases in which the "no reason to know" standard was not met will be compared to four cases in which the standard was determined to be satisfied. The lack of consistency is quite apparent. In *Schmidt v. United States* the court held that the "no reason to know" standard was not satisfied where the taxpayer admitted that although she did not review the tax return when she signed it, she knew about the existence of income that her husband omitted from their joint return. In *Schmidt* the Claims Court determined that mere knowledge of the existence of income was enough to put her on notice that she should have known of the omission of gross income from the return, even though she did not review the return in question.

Another case in which the "no reason to know" requirement was not met is *Trimmer v. Commissioner*. In *Trimmer* the taxpayer learned of his wife’s illegal activities in July 1978 when she informed him of her discharge from her job and the reasons behind the discharge. By October 1978 his wife began serving a prison sentence for stealing. The court found that because the husband had only a seventh grade education, he knew very little about financial matters and relied on his wife to handle their affairs. He signed their joint return for 1978 in 1979, after he became aware of his wife’s illegal activities. Based upon this series of events, the court found that there were sufficient facts within the husband’s knowledge, at the time he signed the return, to provide a reasonably prudent taxpayer with reason to know of the omission of the embezzled income.

106. Id. A taxpayer’s failure to review her tax return cannot satisfy § 6013(e)(1)(B) (this is pre-1984 TRA cite) when the taxpayer knew about the income which was not reported on the return. Id. at 27. See also Altman v. Commissioner, 475 F.2d 876, 880 (2d Cir. 1973); Terzian v. Commissioner, 72 T.C. 1164, 1170-71 (1979).
108. Taxpayer’s wife had embezzled funds from her employer during the years 1976, 1977, and 1978. Id. at 503.
109. Id. at 503-04.
110. Id. at 504. The court further found that prior to the taxpayer’s wife’s incarceration, she had handled the business matters in the taxpayer’s home, including writing checks, paying bills, and accumulating information necessary for the preparation of their joint tax returns, which were customarily prepared by H & R Block. The 1978 joint return was also prepared by H & R Block. Since the taxpayer’s spouse was incarcerated when the 1978 return was prepared, he simply supplied the preparer with information that he had obtained from an envelope maintained by his wife prior to her incarceration. The taxpayer did not mention his wife’s embezzlement to the preparer, and the amount embezzled by the taxpayer’s wife was not reported on the return. Id.
111. Id. The court further stated that neither the taxpayer’s ignorance of the law, nor his lack of actual knowledge of the exact amount embezzled by his wife was sufficient to relieve him of liability for the tax. Id. See also Anderson v. Commissioner, 44 T.C.M. (P-H) ¶ 75,104 (1975).
Although *Trimmer* arguably results in harsh consequences to the taxpayer, particularly in view of his very limited education and complete reliance on his wife to handle their financial affairs, the court strictly construed the "no reason to know" requirement of the statute in denying innocent spouse relief.\(^{112}\)

*Shea v. Commissioner\(^ {113}\) is another instance in which innocent spouse relief was denied because the statutory "no reason to know" requirement was not met. The court found that the taxpayer had the relevant financial records available\(^ {114}\) and was aware that her husband was making unauthorized use of her bank account. The taxpayer knew of her husband's drinking problems and deteriorating condition during the years in question and had reason to suspect his inability to properly handle financial matters. Further, the court found that she was at least marginally involved in her husband's business and was familiar with his expense payment procedure.\(^ {115}\) Under these circumstances, the court concluded that a prudent taxpayer would have at least inquired into her personal financial and tax situation, thereby discovering the omissions.\(^ {116}\) The court found that she made no such effort and held that her failure to know of omissions on the tax return resulted from her own lack of prudence.\(^ {117}\) The court concluded that

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\(^{112}\) As the taxpayer knew of his wife's embezzlement of funds from her employer, this was sufficient to provide a reasonably prudent taxpayer with reason to know of the omitted embezzlement income. 52 T.C.M. (P-H) \& 83,131 at 505. A taxpayer's lack of knowledge of the effect of filing a joint return is of no moment as such knowledge of the law will be imputed to him. *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380 (1947).

\(^{113}\) 780 F.2d 561 (6th Cir. 1986).

\(^{114}\) *Id.* Taxpayer was the secretary-treasurer and a shareholder of her husband's corporation. She was authorized to write checks on, and make deposits to, the corporation's business account and did so at her husband's direction, even though her husband was the only person to examine the corporation's financial statements. *Id.* at 566.

\(^{115}\) *Id.* The taxpayer was authorized to and did draw checks on the corporate bank account. She also made bank deposits, answered the telephone, and performed other routine tasks. Participation in a spouse's business affairs has commonly been held to negate an innocent spouse claim. *Id.* See, e.g., *Quinn v. Commissioner*, 62 T.C. 223 (1974), aff'd 524 F.2d 617 (7th Cir. 1975); *Sonnenborn v. Commissioner*, 57 T.C. 373 (1971).

\(^{116}\) 780 F.2d at 566. The court further stated that only minimal effort would have been required by the taxpayer to open her bank statements and reconcile her checking account, to secure her personal checks in a location not accessible to her husband, to question the purpose for which she was told to issue or receive checks on the account of her husband's business, or to contact her attorney to request information as to the filing of her annual tax returns. *Id.* 117. *Id.* "The petitioner does not make a showing that her husband's financial affairs were unreasonably complex, *see, e.g., Sanders*, 509 F.2d at 166, 169-70, nor does she provide the court with convincing reasons for not reviewing her own bank statements, which is certainly her statutory duty as a bank customer. *Ohio Rev. Code § 1304.29.*" 780 F.2d at 566-67 (footnotes omitted).
the taxpayer had reason to know of the omissions and opportunity to easily discover them.

The taxpayer seeking innocent spouse relief in *Shea* was held to a very high "no reason to know" standard. The court stated that the taxpayer should have: (1) inquired into her personal financial and tax situation; (2) reviewed and reconciled her bank statements; and (3) made more of an effort to determine if her husband had omitted income from their returns. The amount of effort required of the taxpayer in *Shea* has no genesis in the statute and is inconsistent with cases with similar factual situations.

In *Shapiro v. Commissioner* the court observed that the taxpayer seeking innocent spouse relief was an intelligent, mature, educated woman with a college degree. She testified that at her husband's request, she served as an officer and director of his various business enterprises. However, she performed no services for any of these enterprises and knew nothing about the activities in which they were engaged. She signed the joint return for the year in issue without taking account of its contents or making any inquiry about it.

In denying innocent spouse relief, the court held her to a very high "no reason to know" standard, stating that by signing corporate returns, minutes of meetings and other corporate documents as a director or officer, the taxpayer was representing to the world that the matters stated in those documents were true and correct. By signing those documents, the court determined that the taxpayer assumed a responsibility which she could not abdicate. The court further stated that although this taxpayer may in fact have had no actual knowledge of irregularities in the return when she signed it, she could not close her eyes to matters which would put her on notice that there may have been unreported income in the tax return that she signed. Although the taxpayer's standard of living was not lavish or extravagant, the court felt that a person of normal intelligence would know

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119. *See, e.g.*, Estate of Vella, 51 T.C.M. (P-H) ¶ 82,073 (1982). *See also infra* notes 130-34.
120. 55 T.C.M. (P-H) ¶ 86,142 (1986).
121. *Id.* at 822.
122. *Id.* at 823.
123. *Id.*
124. *Id.*
125. *Id. See also* Terzian v. Commissioner, 72 T.C. 1164, 1170 (1979); Adams v. Commissioner, 60 T.C. 300 (1973); G & G Records, Inc. v. Commissioner, 52 T.C.M. (P-H) ¶ 83,343 (1983).
that the extremely modest income reported in the 1977 joint return, and the returns for prior years, would not support the taxpayer, her husband, and two children in the style in which they lived.\textsuperscript{126} The court concluded that the very nominal income reported in the return should have put her on notice that something was wrong. Although she may have preferred not to know what was going on in her husband’s various enterprises, the court felt that she was on notice that something was happening\textsuperscript{127} and that she had a duty to inquire.

Applying the principles of this case, it appears that any taxpayer who is a shareholder or who serves as an officer or director of a business of the other spouse is held to a standard of inquiry knowledge for purposes of satisfying the “no reason to know” requirement of the statute. This conclusion is supported by the result reached in this decision notwithstanding the innocent spouse’s minimal level of involvement in her husband’s businesses.\textsuperscript{128}

A common underpinning present in these four cases is the court’s apparent expectation that the taxpayer seeking innocent spouse relief should have taken some action to determine if there was a substantial understatement of tax. The “no reason to know” standard was significantly heightened in \textit{Shea}\textsuperscript{129} when the court held that the taxpayer not only had a duty to inquire into her husband’s financial affairs, but also to reconcile her checkbook to determine if there was a substantial understatement of tax. In a perfect world with exemplary marriages and excellent spousal communication, such a standard might be a viable and realistic expectation. It certainly should be questioned, however, particularly in view of the statute’s underlying policy, whether a taxpayer should be held to such a high standard in order to satisfy the “no reason to know” requirement of the statute. This heightened standard requires every spouse in effect to audit his or her spouse’s business prior to signing any joint return. Such a standard is unrealistic, impractical, and may undermine confidence in our self-assessing system of taxation.

\textsuperscript{126} 55 T.C.M. (P-H) § 86,142 at 623.
\textsuperscript{127} \textit{Id.} Taxpayer had no money of her own and there was no evidence in the record that her husband had any source of nontaxable funds which would have supported their lifestyle, which included trips to Europe, Las Vegas, and the beach. Additionally, the taxpayer served as an officer or director in two of her husband’s organizations which were the sources of substantial income which was unreported. \textit{Id.}
\textsuperscript{128} \textit{Id.} Aside from signing corporate documents and returns for one or more of her husband’s organizations, the taxpayer performed no services for any of her husband’s businesses and took no part in management. Nor did she investigate or make any inquiry concerning the income or other business affairs of the various companies in which she held positions. \textit{Id.}
\textsuperscript{129} 780 F.2d 561, 566 (6th Cir. 1986).
In contrast to the more strictly interpreted decisions discussed above, set forth below are four cases in which the courts have more liberally interpreted and applied the "no reason to know" requirement of the statute. Although these decisions may be applauded by taxpayers, close scrutiny of these cases in view of the four cases discussed above illustrates the inconsistent application of the judicially articulated standards for relief.

In Estate of Vella v. Commissioner the court applied the standards set forth in Sanders v. United States and granted innocent spouse relief. The court found that the taxpayer's knowledge of her husband's financial affairs was vague and that she did not know he was skimming funds from his business operations. While the record before the court did not establish that the husband was unusually secretive about his finances, the court believed that he did not disclose to his wife the extent of his holdings, many of which he had acquired before their marriage. Further, although there were some expenditures that might be deemed "lavish" for the couple's reported income, the court determined that they were not so lavish as to have necessarily aroused suspicion in the taxpayer's mind. The court then held that the taxpayer's knowledge of her husband's sale of two businesses would not have necessarily triggered suspicion in her mind that income may have been omitted from the return when she was accustomed to leaving all financial matters to her husband and her accountant. The court further found that there was no evidence that the taxpayer knew what amounts were received by her husband from these sales. The court concluded that although the taxpayer

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130. 51 T.C.M. (P-H) ¶ 82,073 (1982).
131. 509 F.2d 162 (5th Cir. 1975). Three frequently considered factors from which a reasonably prudent person would be expected to draw an inference that income was omitted from the return are: (1) unusual or lavish expenditures by the family; (2) participation in business affairs or bookkeeping; and (3) the refusal of the "guilty" spouse to be forthright about the couple's income. Id. at 167.
132. 51 T.C.M. (P-H) ¶ 82,073 at 286-87. But see Schmidt v. United States, 5 Cl. Ct. 24 (1984) and supra notes 105-06 and accompanying text, where mere knowledge of the existence of income was enough to put the innocent spouse on notice of income omission.
133. 51 T.C.M. (P-H) ¶ 82,073 at 288. The court further stated that a reasonably prudent taxpayer, who had but scanty knowledge of her husband's financial dealings, who did not know the amounts received through the transactions, and who left most financial details to her husband, would not be put on notice of omissions from gross income in a year in which reported income increased by over one-third. To the extent that the taxpayer thought of these sales, the court stated that this increase in reported income could have allayed any suspicion. Id. This result seems contrary to well-established caselaw. See Terzian v. Commissioner, 72 T.C. 1164 (1979) where the court declared that "[a] spouse cannot close . . . [his] eyes to . . . facts that might give . . . [him] reason to know of the unreported income." Id. at 1170 (citing Mysse v. Commissioner, 57 T.C. 680, 699 (1972)).
had some knowledge of the family finances and some incomplete in-
formation about her husband's investments, she did not know enough
to give her either actual knowledge or reason to know of the omitted
income.\textsuperscript{134} It is interesting to note that although the taxpayer in \textit{Vella}
had knowledge of the sale of two of her husband's businesses, unlike
the taxpayers in either \textit{Shea}\textsuperscript{135} or \textit{Shapiro},\textsuperscript{136} she was under no duty to
inquire into her husband's business affairs to determine if he had
omitted income from their return. This case is indistinguishable from
\textit{Shea} or \textit{Shapiro} since the innocent spouse in \textit{Vella} had as much or
more of a reason to know of the existence of income. Yet the \textit{Vella}
court found that the "no reason to know" requirement of section
6013(e) was satisfied. This case is particularly difficult to reconcile
with \textit{Schmidt} where the Claims Court held that mere knowledge of
the existence of income was enough to put the innocent spouse on
notice of the omission.\textsuperscript{137}

In \textit{Ballard v. Commissioner}\textsuperscript{138} the Eighth Circuit Court of Ap-
peals liberally applied the factors set forth in \textit{Sanders v. United
States}\textsuperscript{139} to determine that the innocent spouse satisfied the "no rea-
son to know" requirement. The Tax Court rested its decision\textsuperscript{140}
upon the taxpayer's testimony that she knew her husband was in the scrap
iron and auto parts business during 1969 and 1970, even though his
company was not mentioned on their returns or attachments to the
returns for the years in question. The Tax Court focused on the fact
that the taxpayer endorsed some checks in 1969 that were made out
to her husband's business, thus corroborating the taxpayer's aware-
ness of that business.

Although knowledge of the existence of similar items in other
cases has resulted in the "no reason to know" requirement not being
satisfied,\textsuperscript{141} the Eighth Circuit disagreed that the factors relied on by
the Tax Court gave the taxpayer knowledge or reason to know that
her husband had omitted gross income from their 1969 and 1970 re-
turns. The Eighth Circuit relied heavily upon the taxpayer's uncon-
tradicted testimony that she had no involvement in the preparation of
the 1969 and 1970 tax returns, and merely signed them at her hus-

\begin{itemize}
\item \textsuperscript{134} 51 T.C.M. (P-H) \textsuperscript{\textcopyright} 82,073 at 288.
\item \textsuperscript{135} 780 F.2d 561 (6th Cir. 1986).
\item \textsuperscript{136} 55 T.C.M. (P-H) \textsuperscript{\textcopyright} 86,142 (1986).
\item \textsuperscript{137} \textit{See} 5 Cl. Ct. 24 (1984). \textit{See also supra} notes 105-06 and accompanying text.
\item \textsuperscript{138} 740 F.2d 659 (8th Cir. 1984).
\item \textsuperscript{139} 509 F.2d 162 (5th Cir. 1975); \textit{see supra} note 131.
\item \textsuperscript{140} 51 T.C.M. (P-H) \textsuperscript{\textcopyright} 82,466 (1982).
\item \textsuperscript{141} \textit{See, e.g., Schmidt}, 5 Cl. Ct. 24, \textit{discussed supra} at notes 105-06 and accompanying
text.
\end{itemize}
band's request. Although the court viewed such a practice as unwise, the court found that her testimony established that she did not know of any omissions of gross income on the returns, nor did she have any reason to know of the omissions. The record contained no evidence of unusual expenditures by the Ballards, of the wife participating in or keeping the books of her husband's business, or of any evasiveness by the husband in explaining his income to his wife—factors which courts have relied on to put a taxpayer on notice that her or his spouse was concealing income from the government. Because there was much overlap in the husband's various business activities, the court found that the taxpayer reasonably could have concluded that the husband's business was not mentioned in their 1969 and 1970 returns (even though checks made out to the company were received in 1969), because the business was so interrelated with other businesses of the husband, because the husband's scrap iron business operated at a loss during these years, or because the profits of the business were included in husband's wages from another employer which were reported.

The court appears to be creating alternative circumstances under which the taxpayer seeking innocent spouse relief may satisfy the "no reason to know" requirement of the statute. More incredibly, the court found that the innocent spouse met her burden of proving this requirement, notwithstanding the fact that she endorsed checks made out to her husband's business reflecting income that was omitted, and acknowledged that she was aware of the existence of the income that was omitted from the return. This is an extremely broad application of this statute. In view of this decision, taxpayers in the Eighth Circuit should question to what extent, if any, they have a duty to inquire into their spouses' financial affairs.

Another decision liberally applying the "no reason to know" requirement was Ratner v. Commissioner. In Ratner the court had no difficulty determining that the wife had no actual knowledge of the omission. In finding that the taxpayer had no reason to know, the

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142. 740 F.2d at 664.
143. Id.
144. Id. See also Sanders v. United States, 509 F.2d 162, 167-68 nn.15-17 (5th Cir. 1975); Sonnenborn v. Commissioner, 57 T.C. 373, 381-83 (1971).
145. 740 F.2d at 664.
147. 50 T.C.M. (P-H) ¶ 81,333 (1981).
148. Id. at 1178. The taxpayer was embarrassed by her husband's pornographic business
court applied the three factors set forth in *Sanders*. First, the court found no evidence of unusual or lavish expenditures. Second, the court found that the taxpayer had no training in bookkeeping or business. Although the taxpayer wrote checks, she did not keep a running balance in the checkbook or reconcile the monthly bank statements. Except for the normal business transactions of a housewife, the court found that all of her bank transactions were conducted under the direction of her husband. Finally, as to the application of the third factor, the court found that the husband never discussed the details of his business with his wife.

A final case illustrating the inconsistent application of the “no reason to know” requirement is *Johnson v. Commissioner*, which involved a wife’s scheme to defraud her employer. Once again, the court had no difficulty finding that the taxpayer seeking innocent spouse relief had no actual knowledge of the omitted funds. The taxpayer knew that his wife routinely handled checks for her employer. The court found that the innocent spouse’s wife never disclosed her misappropriation of checks to him, and in fact, took various steps to conceal her illegal activities from him. The court concluded that the taxpayer’s limited participation in his wife’s scheme to defraud her employer (endorsing and cashing checks) would not necessarily have given him actual knowledge of the omitted income. The court further determined that the innocent spouse had no reason to know of the omitted income. Although the court recognized that there was a disparity between the family’s total ex-

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and the IRS virtually conceded that the taxpayer did not have actual knowledge of the omission of income from the joint return. *Id.*

149. 509 F.2d 162 (5th Cir. 1975); see supra note 131.

150. 50 T.C.M. (P-H) ¶ 81,333 at 1178. The taxpayer testified quite convincingly of her family’s modest standard of living. *Id.*

151. *Id.* But see *Shea v. Commissioner*, 780 F.2d 561 (6th Cir. 1986) and supra notes 113-19 and accompanying text, where the court required the taxpayer to reconcile monthly bank statements in order to satisfy the “no reason to know” requirement.

152. The third factor in *Sanders* is the guilty spouse’s refusal to be forthright concerning the couple’s income.

153. 50 T.C.M. (P-H) ¶ 81,333 at 1178-79. The husband controlled all of the family financial decisions and completely dominated his wife. The court also found that the husband led her to believe that some of the money being transferred among the accounts came from loans or gifts from members of husband’s family. *Id.* These findings are anomalous.

154. 49 T.C.M. (P-H) ¶ 80,569 (1980).

155. *Id.* at 2408. Although the taxpayer endorsed and cashed 18 misappropriated checks for his wife, the court was convinced that the taxpayer did not know those checks were stolen or that his wife had forged the physicians’ signatures.

156. *Id.* Both the taxpayer and his wife testified that the taxpayer was not aware of the misappropriation when he signed the joint return.
penditures and their reported income for the years in question, it held that this disparity did not necessarily indicate that the taxpayer should have known of the omitted income.\textsuperscript{157} Applying the Sanders factors,\textsuperscript{158} the court concluded that the taxpayer had no reason to know of the omission from gross income,\textsuperscript{159} even though the taxpayer had cashed checks for his wife that she embezzled, there was a discrepancy between their total expenditures and family income, and the taxpayer knew his wife was going to the police station to give statements. Although the husband was aware of certain matters about which a reasonably prudent taxpayer might question,\textsuperscript{160} this court did not impose any duty on the innocent spouse to inquire into his wife's business affairs.\textsuperscript{161}

As the cases discussed above illustrate, it would be unwise for an individual seeking innocent spouse relief to rely too heavily on any one case to establish that such taxpayer had satisfied the "no reason to know" requirement of the statute. The unpredictable and inconsistent application of judicially created standards has cast a shadow over the usefulness of this statute to taxpayers, particularly in view of the expense of litigation. However, this uncertainty is a double-edged

\textsuperscript{157} Id. at 2409. The wife testified that her husband was financially unsophisticated and trusted her to handle these matters. The wife paid the bills, managed the checking account, made most of the purchases, etc. When the court considered the wife's total dominance of the family's financial affairs and the fact that their standard of living remained substantially unchanged, the court believed that the taxpayer had no reason to suspect the existence of any unreported income. The court reached the same conclusion regarding each of the misappropriated checks cashed by the taxpayer which were made payable to the wife's employer. The taxpayer cashed these checks at his wife's request and returned the cash to his wife, who informed him that she would take the cash back to her office. The court further found that although taxpayer was aware of his wife's appearance at the police station in 1975, he did not know the reason for her appearance or the contents of her statement. The court believed that prior to March of 1976, the taxpayer did not know either the specific reasons for his wife's appearances or the contents of her statement. \textit{Id.}

\textsuperscript{158} Sanders v. United States, 509 F.2d 162 (5th Cir. 1975). \textsuperscript{159} Johnson v. Commissioner, 49 T.C.M. (P-H) \S 80,569, 2406, 2410 (1980). First, the record showed that the misappropriated funds were used primarily for groceries, house payments, bills, furniture, and other minor living expenses. These expenditures were in the nature of ordinary support and would not normally give a spouse reason to know of the omitted income. Myss v. Commissioner, 57 T.C. 680, 698 (1972). There was no evidence of any lavish or extraordinary expenditures which would have put the taxpayer on notice of the unreported income. Cf. Estate of Jackson, 72 T.C. 356 (1979). Second, the court noted that the taxpayer did not participate in the family's financial affairs, nor was he involved in keeping books and records. Compare Quinn v. Commissioner, 62 T.C. 223 (1974), \textit{aff'd}, 524 F.2d 617 (7th Cir. 1975), with Terzian v. Commissioner, 72 T.C. 1164 (1979).

160. For example, why was his wife going to the police station to give statements, or what was the reason for the discrepancy in family income?

\textsuperscript{161} Contra Shea v. Commissioner, 780 F.2d 561 (6th Cir. 1986); Schmidt v. United States, 5 Cl. Ct. 24 (1984); Shapiro v. Commissioner, 55 T.C.M. (P-H) \S 86,142 (1986).
sword—it could prove useful to a taxpayer who is willing to settle this issue with the IRS prior to litigation. Those individuals who are more vehement about challenging the liability their spouse, or ex-spouse, has created for them, should proceed cautiously toward trial. An individual’s greatest chance of satisfying the “no reason to know” requirement of the statute may depend on whether the judge is predisposed to apply the remedial purpose of this statute liberally.\textsuperscript{162}

As noted previously, the courts have also lacked consistency in the application of the requirement that it not be inequitable to hold the innocent spouse liable for the deficiency attributable to the other spouse.\textsuperscript{163} A cursory review of a few cases illustrates this point. In \textit{Clevenger v. Commissioner}\textsuperscript{164} the court held it would not be inequitable to hold the taxpayer seeking innocent spouse relief liable where she received her husband’s interest in two corporations and their personal residence, which had been acquired and maintained with the omitted income.\textsuperscript{165}

Other cases, however, wherein the taxpayer received seemingly as much or more benefit as the taxpayer in \textit{Clevenger}, have arrived at different results. For example, in \textit{Estate of Cardulla v. Commissioner},\textsuperscript{166} the court granted innocent spouse relief where the first three requirements of the statute were satisfied. The court then determined it would be inequitable to hold the wife liable for the assessed deficiency even though some of the husband’s bank accounts were in the wife’s name, as well as certain other assets, including a New York city bond, a California ranch, and an apartment building which were held jointly by the taxpayer and her husband.\textsuperscript{167} The court’s rationale for this conclusion was that the benefits received by the taxpayer were more in the nature of ordinary support. Also, in light of the 1984 changes in the statute, the court apparently viewed the benefits received by the taxpayer as so incidental that it felt it would be inequita-

\begin{itemize}
  \item \textsuperscript{162} If the taxpayer’s forum for litigation is federal district court, the predisposition of the judge may not be as important if the taxpayer requests a jury trial.
  \item \textsuperscript{163} For a general discussion of this requirement, see supra notes 74-92 and accompanying text.
  \item \textsuperscript{164} 826 F.2d 1379 (4th Cir. 1987).
  \item \textsuperscript{165} \textit{Id.} at 1382. See also \textit{Durkee v. Commissioner}, 50 T.C.M. (P-H) \$ 81,475 (1981) (the taxpayer significantly and directly benefited from some of the money that her husband omitted from gross income since at least a portion of these funds were used as part of a downpayment on a farm titled in taxpayer’s name); \textit{Estate of Gryder v. Commissioner}, 705 F.2d 336 (1983) (the innocent spouse received title to a considerable amount of property purchased with funds from her husband’s business which were not reported as income; it did not matter to the court that the innocent spouse had received such property by devise and inheritance).
  \item \textsuperscript{166} 55 T.C.M. (P-H) \$ 86,307 (1986).
  \item \textsuperscript{167} \textit{Id.} at 1345.
\end{itemize}
ble to impose liability on the wife. The *Cardulla* decision is a very favorable interpretation for taxpayers, as the omitted income clearly appears to have been used to acquire assets well beyond a normal level of support.\(^{168}\)

Although inconsistency by the courts in applying the "inequitable" requirement of section 6013(e)(1)(D) is not as prevalent as in the "no reason to know" requirement of the statute, it is far from clear when a court will consider it inequitable to impose liability on an innocent spouse. Cases such as *Cardulla*\(^{169}\) may be helpful for taxpayers attempting to settle an innocent spouse controversy with the Service, but the likelihood of courts giving much weight to that decision is uncertain, particularly in view of the significant amount of assets the innocent spouse received.

**IV. Changes Enacted Under the Technical and Miscellaneous Revenue Act of 1988—A Step in the Wrong Direction**

In 1988 Congress enacted a transitional rule to provide additional relief under the innocent spouse provision in very limited situations.\(^{170}\) Generally, this amendment applies if: (1) on a joint return filed before January 1, 1985, there was an understatement attributable to disallowed deductions of the other spouse the amount of which exceeded the taxable income shown on the return; (2) the innocent spouse establishes that in signing the return he or she did not know (or have reason to know) that there was such an understatement; (3) the marriage terminated; and (4) the net worth of the innocent spouse immediately following the termination of the marriage was less than $10,000. If these conditions exist, then the innocent spouse is relieved of liability for tax (including interest, penalties, and other amounts) for the year to the extent the liability is attributable to the understatement.\(^{171}\) The 1988 changes further provide that a refund will be allowed notwithstanding any other law, or rule of law, if a

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168. *See, e.g.*, *Johnson v. Commissioner*, 49 T.C.M. (P-H) ¶ 80,569 (1980), where the court found that the husband had used the funds misappropriated by his wife which she had omitted from gross income for groceries, bills, and other items of ordinary support for the family. To this extent, he did not significantly benefit from the omitted income. *See also* *Moskovitz v. Commissioner*, 55 T.C.M. (P-H) ¶ 86,357 (1986); *Quint v. Commissioner*, 54 T.C.M. (P-H) ¶ 85,226 (1985).


171. *Id.*
refund claim is filed within one year of the date of enactment.172

Although these amendments broaden the innocent spouse relief available under the statute, albeit in very limited circumstances, such changes are a step in the wrong direction for several reasons. First, the relief is available only for taxable years before 1985. It does not provide similar relief for taxpayers in identical situations after 1984.173

Second, the transition rule only applies if the understatement attributable to disallowed deductions of the other spouse exceeds the taxable income on the return. This condition is so narrowly drafted that it is difficult to imagine much applicability other than in an instance where the taxpayer's ex-spouse is financially well off and has disallowed deductions that exceed the taxable income on their joint return. Lower income taxpayers will be less likely to utilize this provision as they generally will not be in a position to take deductions that, when subsequently disallowed, exceed the taxable income shown on their return. A remedial provision that appears to favor an innocent spouse whose ex-spouse had above average earnings should be questioned.

Third, the $10,000 net worth figure selected as the benchmark for providing relief under this transition rule is another example of the arbitrariness of this statute. It is difficult to imagine any situation in which an otherwise qualifying innocent spouse with a net worth of $10,001 is any less deserving of relief than an innocent spouse with a net worth of $9999. This is yet another example of this statute setting an arbitrary limitation on the availability of relief for spouses who are otherwise just as deserving of relief as those who happen to fall within its artificial parameters.174

Finally, the marital status of a spouse seeking innocent spouse relief should not be a determining factor in granting relief under this transitional rule if the other requirements of the statute are satisfied. Merely because an innocent spouse remains married should not result

172. Id. No interest is payable, however, for any period prior to the date of enactment, which is November 10, 1988.

173. Although the Tax Reform Act of 1984 extends innocent spouse relief to disallowed deductions for post-1984 years, an individual in 1985 and thereafter who meets the requirements of the special transition rule enacted in Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6004, 102 Stat. 3685 (1988), but fails the applicable gross income limitation test of I.R.C. § 6013(e)(4) will be ineligible for innocent spouse relief. This is particularly harsh if the individual seeking innocent spouse relief only fails the gross income test because of her new spouse's income being included in her income under I.R.C. § 6013(e)(4)(D).

174. See supra notes 55-58 and accompanying text.
in a denial of relief if the circumstances otherwise justify such treatment. There is no basis for treating innocent spouses who are divorced more favorably than those who remain married. The existence of a marriage should not eliminate the availability of relief, particularly in view of the numerous reasons why couples may or may not choose to remain married.

V. PROPOSALS FOR MODIFICATION AND REFORM OF EXISTING LAW

Congress should eliminate the requirements of sections 6013(e)(4)(A) and (B), respectively, which condition the granting of innocent spouse relief upon the understatement of tax exceeding a specified percentage of the innocent spouse's income. Congress has already eliminated this arbitrary requirement where the understatement of tax is attributable to an omission of gross income from the return.\textsuperscript{175} It is difficult to understand why a spouse, who otherwise meets all the requirements for relief, except that the understatement of tax attributable to deductions that have no basis in fact or law does not exceed an arbitrary percentage of such spouse's adjusted gross income, should be denied relief, while another taxpayer in an identical economic situation, but whose deficiency is based upon an omission of gross income, would be entitled to relief. This seems to be a narrowing of the remedial purpose for which the statute was enacted.\textsuperscript{176}

From both a fairness and an administrative tax policy standpoint, Congress should provide similar standards for relief, regardless of whether the substantial understatement of tax is attributable to an omission from gross income or to a claimed deduction for which there is no basis in fact or law.

If the proposed change suggested above is not made and a taxpayer who may be eligible for innocent spouse relief subsequently remarries, Congress should modify the statute to exclude the new spouse's income from the computation of the innocent spouse's adjusted gross income.\textsuperscript{177} This change would recognize the practicalities of a multiple marriage society, would compute the adjusted gross income limitations of the statute solely on the innocent spouse's income,

\textsuperscript{175} See I.R.C. § 6013(e)(4)(E) which excepts omissions from gross income from the application of the limitations of § 6013(e)(4).

\textsuperscript{176} See supra note 59.

\textsuperscript{177} I.R.C. § 6013(e)(4)(D) basically provides that if the taxpayer seeking innocent spouse relief is married to another spouse at the close of the preadjustment year, the innocent spouse's adjusted gross income shall include the income of the new spouse, whether or not they file a joint return.
and would minimize the involvement of a new spouse who undoubt-
edly would prefer not to become embroiled in a tax controversy cre-
ated by his or her spouse's former mate. From a policy standpoint,
the statute may be viewed as discouraging subsequent marriages, at
least until the applicable statute of limitations for assessing deficien-
cies of the previous marriage expires, since the statute includes the
new spouse's income regardless of whether the taxpayer and new
spouse file a joint return.\textsuperscript{178} From a tax planning perspective, a
couple may be well advised to live together until the statute of limita-
tions expires for assessing tax deficiencies of the prior marriage. The
effect of avoiding the applicability of this rule in second marriage situ-
ations is likely to be considered contrary to the values of a vast major-
ity of the taxpayers in this country and may not be the type of social
behavior our government wants to indirectly encourage through its
tax policy.

The final legislative change that should be made is the modifica-
tion of the provision recently enacted by Congress in 1988.\textsuperscript{179} This
limited transitional relief is too narrow in its scope. The underlying
policy for the statute is contrary to the conditioning of relief on the
ability of a taxpayer to satisfy such an arbitrary standard.\textsuperscript{180}
Although this recent legislation might provide relief to a deserving
innocent spouse who might not otherwise qualify for relief,\textsuperscript{181} the pro-
vision should be modified to address the concerns raised above.\textsuperscript{182}

The remaining area for reform would be a call for courts decid-
ing innocent spouse cases to apply the standards for relief more con-
sistently and liberally. Where innocent spouse relief depends on a
strict versus liberal application of the statute, the vagaries of each
court may cause taxpayers to lose confidence in our system of ad-
ministering the tax laws, and result in an unwillingness to voluntarily
comply with them. The underlying policy suggesting a liberal appli-
cation of the statute to remedy a perceived injustice is quite clear,\textsuperscript{183}
and courts should be mindful of this policy when deciding these cases.

\textsuperscript{178} I.R.C. § 6013(e)(2)(D) (1986).
\textsuperscript{179} See text accompanying note 170.
\textsuperscript{180} See supra note 12.
\textsuperscript{181} See supra notes 18-22. Prior to 1984, a taxpayer could not qualify for innocent spouse
relief if the understatement was not attributable to an omission of an item from gross income.
\textsuperscript{182} See supra notes 170-73.
\textsuperscript{183} See supra notes 13 and 50.
VI. PLANNING FOR A CLIENT IN VIEW OF SECTION 6013(e) TODAY

Generally, by the time a taxpayer is in a position to determine if he or she qualifies for innocent spouse relief, there is not much that a tax adviser can do for the years in issue. Initially, the tax adviser should review any deficiency notices, the returns in question, and learn as much about the circumstances of the preparation, signing, and filing of the returns to see if there are any other grounds on which the client may be relieved of liability for the assessed deficiency. If other grounds for relief exist, there will be no need to approach the case from an innocent spouse posture.

If a client has moved since the filing of the returns for any open years, or is divorced and living at an address other than that provided on the return, the tax practitioner should advise the client to immediately send notice by registered or certified mail of the change of his or her address to the IRS, and any appropriate state taxing authority, so that any subsequently mailed deficiency notice to an old address will not be sufficient notice by the Service.

If the tax liability assessed against the innocent spouse cannot be dismissed on procedural grounds and the case proceeds towards trial, it is imperative that the innocent spouse be willing to testify. A review of the decided cases indicates that innocent spouse relief is generally not granted where the taxpayer is present, but fails to testify on his or her own behalf.

Where a practitioner has the opportunity to consult with a taxpayer before the taxpayer's upcoming marriage, particularly in the second marriage context, it would be prudent to raise the consequences of filing joint income tax returns with the new spouse. Although the filing of separate returns by a client and his or her spouse avoids the problems associated with establishing entitlement to innocent spouse relief in the future, filing separately may exact a price. Prior to advising a married client to file a separate return, a

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187. In addition to obvious differences based on filing status, such as the basic standard deduction under I.R.C. § 63 and tax rates under I.R.C. § 1, there are less obvious considerations. For example, under the 1986 Tax Reform Act, there is a limitation on the ability of taxpayers to deduct losses from passive activities. Under I.R.C. § 469, there is a limited excep-
thorough review of the taxpayer’s tax situation should be performed and full disclosure of all consequences should be made.

In view of decisions such as Shapiro, practitioners should be very careful when advising both spouses in a family business context, particularly where one spouse signs documents and returns in a ministerial or subservient capacity, to disclose the complete consequences of signing such documents. This appears to be an area ripe for a conflict of interest claim against the practitioner, the likelihood of which is increased where the culpable ex-spouse and business remain a client of the adviser, and the innocent ex-spouse receives a deficiency assessment.

Finally, when representing an individual in a divorce who has little or no knowledge of the other spouse’s financial affairs, the practitioner should seek an indemnity for all subsequently assessed taxes arising from the other spouse’s financial activities during the marriage in the property settlement agreement. Although not binding on the Service, this will provide the innocent spouse with a contractual remedy against the responsible ex-spouse in the event there is a subsequent assessment of joint liability which is attributable to the other spouse’s activities.

VII. Conclusion

In the final analysis, the innocent spouse provision is not refuse to be discarded. The statute still fills a gap resulting from the imposition of joint liability where couples file joint returns. However, the statute needs legislative fine tuning and judicial liberalization and consistency to fully realize the purposes for which it was enacted.