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Outside Counsel

'Innocent Spouse' Tax Relief in Same-Sex Married Couples

Janis Cowhey and David H. Glusman, New York Law Journal

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When the Internal Revenue Service (IRS) conducts audits of joint tax returns, whether for same-sex couples or traditional heterosexual couples, the starting assumption of the government is that both taxpayers are jointly and severally liable for any tax or penalty assessed. That means that both of the taxpayers will be held accountable without regard to whose income was understated or whose expenses were overstated. This is true without regard to the original reason for the audit (audits are usually computer-generated based on closely guarded IRS algorithms, but can also come from confidential "whistleblowers").

Sometimes, however, the issues underlying the audit findings relate solely to one spouse, while the other spouse knows nothing of either the audit or the issues. In such cases, the IRS provides that taxpayers who filed a joint return with a spouse or ex-spouse who erroneously or fraudulently misstated income or expenses may be eligible to apply for relief of tax, interest, and penalties if he or she meets specific requirements. The IRS recognizes this as "innocent spouse" relief from collection efforts against such taxpayers' separate assets. Knowing when or if this protection is available, and how to react early in the process, can make a significant difference in the ultimate outcome.

The issues that are likely to arise when contemplating use of innocent spouse relief available under the Internal Revenue Code (IRC) are just as likely to occur in same-sex couples as in heterosexual couples. In many cases, there are additional areas of concern for same-sex couples that may need to be addressed if the IRS has attempted collection efforts on the innocent spouse due to alleged or actual underpayment of tax by the other spouse.

Applying Relief

In general, innocent spouse relief, as set forth in Internal Revenue Code §6015, may be available in circumstances where one spouse has materially understated income, overstated expenses and/or underpaid taxes on a married-filing-joint tax return. In addition to the routine circumstances that give rise to these collection efforts, changes in the law due to the U.S. Supreme Court decision in *United States v. Windsor* (i.e., the ability to amend

previously filed returns to file as married) have complicated the circumstances for filing and collection by the IRS.

The U.S. Supreme Court, in the *Windsor* decision ([U.S. v. Windsor](#), 133 S.Ct. 2675 (2013)) issued June 26, 2013, determined that Section 3 of the federal Defense of Marriage Act (DOMA), which defined marriage as between one man and one woman, was unconstitutional. This decision then led the way for joint filing by any same-sex married couple provided the marriage is recognized under the laws of the state in which the marriage occurred, thus opening the door to more joint returns. It follows that it also opened the door to more situations wherein one spouse is unaware of unreported or misstated items on the tax return, due to false statements by the other spouse. Because the joint filing ability is new to same-sex couples, there is generally a lack of awareness of the obligations that go along with a joint tax return.

As an example, some couples filed amended tax returns post-*Windsor* to change their filing status to married, based on having previously been legally married in a state recognizing same-sex marriage. If such an amended return gave rise to a refund which, upon examination, the IRS determined was bogus (let's leave for another time the question of whether or not it was truly a false return), the IRS might attempt to levy joint bank accounts as well as bank accounts in either of the two individuals' names. If John Smith filed a false informational tax return and he deposited into his personal account an IRS refund check based on the amended return, but Richard Smith, the innocent spouse, was completely unaware of the fraudulent issues with the return, did not participate in any benefit from the refund and properly followed the IRS procedures, Richard would likely be eligible for innocent spouse relief if the IRS attempted to levy his personal bank account in a collection effort.

The types of issues that can give rise to innocent spouse arguments include failure to report income from bank or brokerage accounts or from business sources. This could be due to the provision of a false Social Security number to a banker or broker, or to taking deductions or losses that are not deemed legitimate by the IRS, such as losses on partnership investments not in accordance with IRS positions. In these instances, if Richard was legitimately unaware of the failures to adhere to IRS policy and proclamations, and he did not directly benefit from the unreported income, he would likely be able to benefit from innocent spouse provisions allowing him NOT to be personally liable for the additional tax and penalty assessed on the joint return.

Court Cases

Most of the court cases regarding an innocent spouse are fact-specific. Nevertheless, there are several issues that are routinely taken into account, either by practice or by regulation, to guide the IRS (or the courts upon appeal) to a determination of whether an individual can avail him- or herself of the innocent spouse protection. Interestingly, one of the factors taken into account is whether, after the point in time when the tax matters arose, a separation or divorce has taken place. This can be complicated in today's climate, with many states not yet having caught up with *Windsor* with regard to the implementation of divorce statutes.

The determination takes into account whether the innocent spouse benefits from the understatement of income (or overstatement of the deduction), and whether the innocent

spouse has or should have had knowledge of the tax underpayment, including whether the innocent spouse had a reasonable basis to assume there were sufficient marital assets to pay the tax liability. In addition, whether the innocent spouse would suffer significant economic hardship is taken into account.

In [*Wilson v. Commissioner*](#) (705 F.3d 980 (9th Cir. 2013)) Karen Wilson was deemed to be eligible for innocent spouse relief after the §6015(f) factors were reviewed. She was divorced, she derived no significant benefit from the understatement, she had no knowledge of the understatement, she would suffer economic hardship if the IRS made an assessment against her, and the court deemed her credible in stating she had no knowledge of her husband's business activity.

In *Harris v. Commissioner*, Docket No. 14290-12 (T.C. Memo. 1961-324.) the Tax Court granted innocent spouse relief with an unusual twist. While spousal abuse is often counted in the factors under §6015(f) (effectively, the spouse signed a return knowing the return wasn't accurate, but she signed reasonably expecting physical or psychological abuse would follow the historical pattern), in this case it was the pattern of abuse of the children that led Ms. Harris to sign returns that contained false information, and the court extended the fear of her children's abuse as a prime factor, along with the significant economic hardship test.

The Tax Court held that there was evidence of physical abuse of the children even though there was no allegation of direct abuse against the requesting spouse. The court recognized the threat of abuse to the children was sufficient to be deemed a material factor in forcing the innocent spouse to sign a return without having a chance to properly review it.

For the other side of the coin, *Reilly-Casey v. Commissioner*, (T.C. memo 2013-292[1]) yielded no spousal relief. The holding was that the spouse had "...sufficient knowledge to detect the understatements and that she benefited from the understatements." One of the strong factors in *Reilly-Casey* was the lack of compliance in subsequent years, which weighed relatively heavily in the decision.

Types of Relief

IRC §6015 offers three types of relief.

- Innocent Spouse Relief under §6015(b).
- Allocation of Liability under §6015(c).
- Equitable Relief under §6015(f).

Under Innocent Spouse Relief (§6015(b)), the taxpayer must establish that he had no knowledge of the underpayment, and the IRS must determine that it would be inequitable to hold the taxpayer liable under all facts and circumstances. Divorce or separation would be a factor as well.

Under Allocation of Liability (§6015 (c)), the IRS must establish some level of knowledge on the part of the non-innocent spouse, the taxpayer must be divorced or living separately and legally separated (this is only available in states where legal separation exists) and the taxpayer must not have been part of a fraudulent scheme.

Under Equitable Relief (§6015 (f)), Rev. Proc. 2013-34 provides a methodology for evaluating claims for "equitable relief." In a circumstance where it can be shown that the tax return was signed under duress, equitable relief is available to the innocent spouse because the return is ultimately deemed not to have been jointly filed. In these circumstances, the liability will generally go totally to the spouse who created the duress. Interestingly, the threat against children of the marriage has been deemed to be the equivalent of forcing a signature under duress.

Among the additional items considered by the IRS are the nature of the erroneous items and their amounts relative to other items of the tax return; the financial knowledge of the taxpayers, including educational and business background of the requesting spouse; the extent of the requesting spouse's participation in the activity that resulted in the erroneous item; whether the requesting spouse failed to question the erroneous items in a fashion such that a reasonable person would have been expected to raise such questions; and whether the erroneous item represented a material departure from the recurring pattern of prior tax returns. This item may be less applicable for some same-sex married couples post-*Windsor*, if no prior joint tax returns have been filed and the requesting spouse did not have access to the prior tax returns of the other spouse.

The rules for requesting relief under the innocent spouse provisions are particularly complex and subject to the facts on hand. One alternative available to an individual concerned about his or her spouse's failure to properly file tax returns accurately is to file 'married filing separately,' even post *Windsor* and even having been married in a state that legally recognizes same-sex marriage.

The history of many of these cases makes it clear that marriage in the post-*Windsor* age, allowing for filing of joint federal (and many state) tax returns, opens up new questions that must be addressed based on knowledge, trust and keeping your eyes open. For those entering the relatively new realm of same-sex marriage, this is one more area where the "good news" of *Windsor* is tempered when one spouse may have tax issues.

Janis Cowhey, an attorney and CPA, is a partner, tax and business services, at Marcum, a public accounting and advisory services firm, and co-leader of its LGBT and non-traditional family practice group. David H. Glusman is a partner, advisory services, at the firm.

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