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The Innocent Spouse Relief: A Reconciliation of Conflicting Judicial Interpretations

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by

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INTRODUCTION

When a married couple elects to file a joint federal income tax return, their combined income is generally taxed at a rate which is lower than if each spouse had filed a separate tax return.[1] A price for this advantage, however, is that the tax due on the aggregate income is a joint and several liability.[2] Accordingly, the entire tax liability (including interest, penalties, and other amounts) may be assessed against either spouse.[3] This can lead to harsh consequences where, for example, one spouse omits reportable income or claims false deductions and conceals these violations from the other spouse against whom the resulting tax liability is assessed.[4]

In response to pleas for statutory relief from such an inequitable result, an "innocent spouse" provision was added to the Internal Revenue Code in 1971.[5] As originally enacted, these provisions were applicable only to omissions from gross income. In 1984, amendments were enacted to include relief from understatements of tax liability resulting from disallowed deductions, credits, or basis in property which had no basis in fact or law for inclusion in the joint return filed.[6]

This paper reviews the statutory requirements for obtaining the innocent spouse relief, briefly identifies the degree of consensus among the courts in interpreting key provisions of the statute, and then focuses on the major area of conflict in qualifying for relief: the "lack of knowledge" requirement on the part of the alleged innocent spouse. Particular attention is given to the rigid standard utilized by the Tax Court in its interpretation of this critical requirement versus the broader, more flexible standard employed by the U.S. Courts of Appeal for the Eighth and Ninth Circuits. Finally, an analysis of a workable reconciliation of these conflicting standards is set forth, together with some expectations as to the future resolution by the courts.

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1 *See* I.R.C. § 1 (1988), *see also* Sonnenborn v. Commissioner, 57 T.C. 373, 380-81 (1971).

2 I.R.C. § 6013(d)(3) (1988).

3 *Id.*

4 *See, e.g.*, Scudder v. Commissioner, 48 T.C. 36 (1967).

5 Act of Jan. 12, 1971, Pub. L. No. 91-679, §1, §4 Stat. 2063, 2063 (codified as amended at I.R.C. § 6013(e) (1988 & Supp. III 1992)).

6 Act of July 18, 1984, Pub. L. No. 98-369, § 424(a), 98 Stat. 801, 801 (codified as amended at I.R.C. § 6013(e) (1988 & Supp. III 1992)).

STATUTORY REQUIREMENTS FOR THE INNOCENT SPOUSE RELIEF

While innocent spouse relief is available to a nonculpable spouse, I.R.C. § 6013(e) contains specific requirements which must be met in order for such spouse to be relieved of all or a portion of the joint liability. These requirements are:

(1) a joint return has been made under § 6013 for the taxable year,[7]

(2) on such joint return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,[8]

(3) the other spouse establishes that at the time of signing the return he or she did not know, and had no reason to know, that there was such substantial understatement,[9] and

(4) taking into account all the facts and circumstances, it would be inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to the substantial understatement.[10]

Section 6013(e) then proceeds to define two key phrases used in requirement (2) above. The first is "substantial understatement of tax"[11] and the second is "grossly erroneous items."[12]

Generally, a "substantial understatement" is an understatement exceeding $500.[13] If, however, the understatement is due to an unallowable deduction, credit, or basis (as opposed to omissions from gross income), there is an added requirement. This requirement is that if the Adjusted Gross Income ("AGI") of the innocent spouse in the "preadjustment year" is $20,000 or less, then the understatement must be greater than 10% of the AGI.[14] If the AGI in the preadjustment year is more than $20,000, the understatement must exceed 25% of his or her AGI in the preadjustment year before relief can be obtained.[15] The preadjustment year is the most recent taxable year of the spouse ending before the date the tax deficiency notice is mailed.[16]

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[7] I.R.C. § 6013(e)(1)(A) (1988).
[8] I.R.C. § 6013(e)(1)(B) (1988).
[9] I.R.C. § 6013(e)(1)(C) (1988).
[10] I.R.C. § 6013(e)(1)(D) (1988).
[11] I.R.C. § 6013(e)(3) (Supp. III 1992).
[12] I.R.C. § 6013(e)(2) (1988).
[13] I.R.C. § 6013(e)(3) (Supp. III 1992).
[14] I.R.C. § 6013(e)(4)(A) (1988).
[15] I.R.C. § 6013(e)(4)(B) (1988).
[16] I.R.C. § 6013(e)(4)(C) (1988).

"Grossly erroneous items" are those items which, with respect to the reportable income of a spouse, are omitted from gross income.[17] If, on the other hand, such items were claims of deductions, credits, or basis by such spouse, they are "grossly erroneous items" only to the extent there is no basis in fact or law for making such claims.[18]

If the nonculpable spouse meets the burden of establishing that all of these statutory requirements and definitions are met, then he or she is relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year.[19]

JUDICIAL INTERPRETATIONS OF SECTION 6013(e): AREAS OF GENERAL AGREEMENT

As previously indicated, failure to satisfy any one of the statutory requirements disqualifies relief under § 6013(e), the "innocent spouse" provisions.[20] Accordingly, the Internal Revenue Service and the courts meticulously scrutinize the facts in each case to ensure strict statutory compliance before relief is granted. Although there continues to be ongoing litigation as to the interpretation of each of the key provisions and definitions noted above, there has been a clear narrowing of differences between taxpayers, the IRS and the courts in most areas, namely:

The Existence of a "Joint Return"

The key element in determining whether a joint return has been filed is the intent of the two spouses.[21] Although the signatures of each on the return is *prima facie* evidence of a joint return, evidence of a contrary intent is accepted by the courts.[22] Hence, if one spouse can show that his or her signature was forged[23] or was the result of duress,[24] fraud,[25] or misrepresentation[26] by the other spouse, then there is no joint or several liability of such spouse.[27] On the other hand, courts will find that a joint return has been made where one spouse did not actually sign the return if it can be proved that it was his or her intent that it be a joint return of the spouses.[28]

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[17] I.R.C. § 6013(e)(2)(A) (1988).

[18] I.R.C. § 6013(e)(2)(B) (1988).

[19] I.R.C. § 6013(e)(1) (1988).

[20] *See* I.R.C. § 6013(e) (1988 & Supp. III 1992).

[21] *E.g.*, Federbush v. Commissioner, 325 F.2d 1, 2 (2d Cir. 1963).

[22] Federbush v. Commissioner, 34 T.C. 740, 757 (1960), *aff'd per curium*, 325 F.2d 1 (2d Cir. 1963); Kann v. Commissioner, 18 T.C. 1032, 1045 (1952), *aff'd*, 210 F.2d 247, 251 (3d Cir. 1953), *cert. denied*, 347 U.S. 967 (1954); Howell v. Commissioner, 10 T.C. 859, 866 (1948), *aff'd per curium*, 175 F.2d 240 (6th Cir. 1949).

[23] *E.g.*, Bauer v. Foley, 404 F.2d 1215, 1220 (2d Cir. 1968).

[24] *E.g.*, Huelsman v. Commissioner, 416 F.2d 477, 479 (6th Cir. 1969).

[25] *See id.*

[26] *E.g.*, Berenbeim v. Commissioner, 61 T.C.M. (P-H) 1991-272.

[27] *See, e.g.*, Cassity v. Commissioner, 56 T.C.M. (P-H) 1987-181.

[28] *See, e.g.*, McRae v. Commissioner, 57 T.C.M. (P-H) 1988-374.

The Criteria For a "Substantial Understatement"

The specificity of § 6013(e)(3) and (4) greatly narrows the potential for disagreement. Where disputes do reach the courts, they are resolved on the basis of the specific facts of each case, most of which turn on accounting and/or mathematical determinations of compliance with the statute.[29]

The Definition of "Grossly Erroneous Items"

As stated in § 6013(e)(2)(A), an omission from gross income in any amount is a grossly erroneous item.[30] The relatively few disputes as to this definition involve interpretations of whether the item omitted was properly includable in gross income. The more frequent disputes in this area concern disallowed deductions, credits, or basis in an amount for which there is no basis in fact or law.[31] The courts have been consistent in denying innocent spouse relief whenever the spouse fails to meet the burden of proving that the disallowed item is utterly without factual or legal support.[32] Accordingly, relief has consistently been denied unless the claimed deduction, credit, or basis is determined by the courts to be "fraudulent,"[33] "frivolous,"[34] "phony,"[35] or "groundless."[36] Hence, if a court finds any support in law or fact, regardless of how unpersuasive, it will disallow relief as not being a grossly erroneous item.[37]

The Meaning of "Inequitable To Hold The Other Spouse Liable"

This provision calls for a determination based on all the facts and circumstances of each specific case.[38] In assessing the equity of holding a spouse liable, the courts generally consider factors such as (1) whether the spouse claiming relief significantly benefited from the grossly erroneous item attributable to the culpable spouse;[39] (2) whether the spouse claiming relief has been deserted by, or divorced or separated from,

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[29] For this reason, there is a dearth of helpful cases involving definitional issues of whether an understatement exists. *See, e.g., id.*

[30] I.R.C. § 6013(e)(2)(A) (1988).

[31] I.R.C. § 6013(e)(2)(B) (1988).

[32] *See, e.g.*, Douglas v. Commissioner, 86 T.C. 758 (1986); Sivils v. Commissioner, 86 T.C. 79 (1986). *See also* Purcell v. Commissioner, 826 F.2d 470 (6th Cir. 1987), *cert. denied*, 485 U.S. 987 (1988).

[33] *E.g., Douglas*, 86 T.C. at 762-63.

[34] *See id.*

[35] *See Purcell*, 826 F.2d at 475; *Douglas*, 86 T.C. at 762-63.

[36] *E.g., Sivils*, 86 T.C. at 83.

[37] *E.g., Purcell*, 826 F.2d at 476; *Douglas*, 86 T.C. at 763; *Sivils*, 86 T.C. at 84-85.

[38] *See* I.R.C. § 6013(3)(1)(D) (1988). *See also* Treas. Reg. § 1.6013-5(b) (1974).

[39] *See* Estate of Krock v. Commissioner, 93 T.C. 672, 677 (1989). *See also* S. REP. NO. 91-1537, 91st Cong., 2d Sess. 3 (1970).

the culpable spouse;[40] (3) and the probable future hardships that would be faced by the nonculpable spouse if he or she is not relieved from liability.[41] Generally, the courts do not decide this question unless and until all other requirements have been resolved in favor of the innocent spouse, particularly the "knowledge of the understatement" requirement which is next discussed in detail.

KNOWLEDGE OF THE UNDERSTATEMENT: THE MOST LITIGATED AND CONTROVERSIAL REQUIREMENT

The most controversial of the requirements for innocent spouse relief is the question of when should a spouse be denied relief for reason of knowing, or having reason to know, that there was a substantial understatement of tax resulting from a grossly erroneous item attributable to the other spouse.

The courts are in general agreement that relief is denied where a reasonably prudent person in possession of all the information actually or constructively known by the nonculpable spouse would know or have reason to know, of the substantial understatement of tax on the joint return.[42] Likewise, there is general agreement as to the factors to be considered in reaching this determination, which would include: (1) the innocent spouse's level of education and business background,[43] (2) his or her degree of involvement in the business or transaction giving rise to the understatement,[44] (3) the existence or nonexistence of lavish or unusual expenditures,[45] (4) a sudden and/or marked increase in the past standard of living of the family,[46] (5) the degree of joint participation in family financial matters,[47] and (6) the degree of evasiveness and deceitfulness of the culpable spouse.[48]

Where the courts sharply disagree, however, is in defining the standards to be utilized in evaluating these factors. In general, the Tax Court has adopted a more stringent standard in its "lack of knowledge" decisions,[49] whereas the U.S. Courts of

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[40] *See* Treas. Reg. §1.6013-5(b) (1974). *See also* Flynn v. Commissioner, 93 T.C. 355, 367 (1989).

[41] *See* Sanders v. Commissioner, 509 F.2d 162, 166-67 (5th Cir. 1975).

[42] Stevens v. Commissioner, 872 F.2d 1499, 1505 (11th Cir. 1989); Sanders v. States, 509 F.2d 162, 167 (5th Cir. 1975).

[43] *E.g.*, Mysse v. Commissioner, 57 T.C. 680, 689-92 (1972).

[44] *See id.*

[45] *E.g.*, *Sanders*, 509 F.2d at 167.

[46] *See, e.g., i.d*

[47] *See, e.g., id.*

[48] *See, e.g., id.* "The Courts, particularly the Tax Court, have utilized all or most of the factors in construing the "lack of knowledge" requirement from the initial enactment of Code Sec. 1013(e), finding both for and against the granting of innocent spouse relief." *See, e.g., Mysse*, 57 T.C. at 689-92; McCoy v. Commissioner, 57 T.C. 732, 733, 735 (1972).

[49] *See* Bokum v. Commissioner, 94 T.C. 126 (1990); *aff'd*, 992 F.2d 1132 (11th Cir. 1993); Sonnenborn v. Commissioner, 57 T.C. 373 (1971).

Appeal for the Eighth and Ninth Circuits have rejected the use of a rigid standard and extend their inquiry to a consideration of the facts and circumstances impacting the level of constructive knowledge of the understatement to which the nonculpable spouse will be held.[50] The specific factor at the center of this controversy is the consequence of the nonculpable spouse having actual knowledge of the transaction or events causing the understatement, without having actual knowledge of the resulting understatement itself. These conflicting views are described and evaluated separately.

THE TAX COURT STANDARD: AUTOMATIC DENIAL OF RELIEF IF THERE IS ACTUAL KNOWLEDGE OF THE TRANSACTION CAUSING THE UNDERSTATEMENT

From its first decisions involving newly-enacted § 6013(e), the IRS and the Tax Court have employed an exacting standard in determining whether a spouse knew, or had reason to know, of the understatement of tax. This took the form of a rigorous application of the factors discussed above in determining what he or she had reason to know about the circumstances resulting in the understatement. This view is clearly illustrated in *Sonnenbrom v. Commissioner*, a case decided in the same year (1971) that the innocent spouse provisions were enacted. In this case, the Tax Court was clear in stating its perspective that an innocent spouse must fully comply with "the carefully detailed conditions set forth in Section 6013(e)."[51] Thereafter, the Tax Court has consistently employed a rigid objective standard of what it considers a prudent person would have reason to know about the understatement rather than considering what the spouse had reason to know based upon the facts and circumstances of each case.[52]

The "knowledge of the understatement" cases in which the Tax Court is in clear conflict with the Eighth and Ninth Circuit Courts of Appeal are those in which the nonculpable spouse has actual knowledge of the transaction underlying the claim of a grossly erroneous deduction, credit or basis but alleges lack of knowledge of the resulting understatement of tax. The Tax Court takes the position that such knowledge of the transaction, *standing alone*, precludes allowance of innocent spouse relief.[53] It reaffirmed the use of this rigid standard in its 1990 decision of *Bokum v. Commissioner*.[54]

The facts in *Bokum* are highly instructive as to the standard used by the Tax Court. Margaret Bokum filed a joint return with her husband, Richard, for 1977.[55] Previously, in 1971, Richard formed a Subchapter S corporation which purchased a large ranch for

[50] *See* Erdahl v. Commissioner, 930 F.2d 585 (8th Cir. 1991); Guth v. Commissioner, 897 F.2d 441 (9th Cir. 1990); Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989).

[51] *Sonnenborn*, 57 T.C. at 380-81.

[52] *See id.* at 381-82.

[53] *See id.* at 382.

[54] Bokum v. Commissioner, 94 T.C. 126 (1990), *aff'd*, 992 F.2d 1132 (11th Cir. 1993).

[55] *Id.* at 131.

the purpose of conducting a cattle and ranch business.[56] In 1977, the corporation sold a substantial portion of the ranch and made a distribution of this sale and other amounts to Richard, the sole stockholder.[57] The reporting of this transaction was challenged by the Internal Revenue Service and the parties stipulated to a substantial deficiency on the joint 1977 return which resulted primarily from the erroneous reduction of reportable dividend income by the amount of Richard's basis in the corporate stock.[58] Margaret claimed innocent spouse relief under § 6013(e).[59] After finding that the requirements of § 6013(e)(2)(B) were met (namely, that the error in basis resulted from a "grossly erroneous item"), the Tax Court then denied relief on the basis that Margaret had reason to know of the understatement of tax because she knew of the underlying transaction which was the sale of the ranch.[60] Despite the fact that she had a limited educational and business background, had never worked outside the home, did not participate in corporate or Richard's business affairs, was not involved in the preparation of the return, and the reporting of the transaction was admittedly complex, the Tax Court nevertheless concluded that because Margaret knew of the transaction that gave rise to the substantial understatement she was disqualified, under § 6013(e)(1)(C), from innocent spouse status.[61] As discussed below, although the decision was supported by an 11 to 5 majority vote, the court was sharply divided as to the appropriate standard to be used in resolving the "knowledge of the understatement" issue.[62]

THE COURTS OF APPEAL FOR THE EIGHTH, NINTH AND ELEVENTH CIRCUITS: A MORE COMPREHESIVE "KNOWLEDGE OF THE UNDERSTATEMENT" STANDARD FOR DEDUCTION, CREDIT AND BASIS CONTROVERSIES

Ninth Circuit Court of Appeals

Several months prior to the Tax Court's decision in *Bokum*, the Court of Appeals for the Ninth Circuit reversed the Tax Court's decision in *Price v. Commissioner*.[63] In this

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[56] *Id.* at 129.

[57] *Id.* at 127.

[58] *Id.* at 132-34.

[59] *Id.* at 128, 135-37.

[60] *Id.* at 139-40. According to the majority opinion:

> We have found that Mragaret knew of the sale of the range. Petitioner's erroneous claim of basis stems from a misapprehension of the tax consequences and not the facts of the sale. Accordingly, if the relevant underlying transaction is that sale, then Margaret knew of the circumstances that gave rise to the substantial understatement and thus is disqualified from the innocent spouse status under . . . [I.R.C. §] 6013(e)(1)(c).

Id. at 146.

[61] *Id.* at 148-49.

[62] *Id.*

[63] Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989). This decision was decided on October 18, 1989, just five months prior to *Bokum*.

case, Patricia Price knew that her husband, Charles, had taken a large deduction on their jointly filed return which was related to a gold mining venture in which she knew he had invested.[64] Patricia had limited involvement in the couple's financial affairs, had no involvement in the mining investment, there were no lavish expenditure during this period of time, and she was deceived by her husband when she questioned him about the reporting of the transaction.[65] Evidence admitted during the trial established that Patricia signed the return only after receiving assurance of its correctness and that it had been prepared by a certified public accountant.[66] Although the Tax Court found that Patricia did not know of the incorrectness of the deduction, it denied her innocent spouse relief by holding that her knowledge of the underlying transaction disqualified her from innocent spouse status since it put her on notice of the resulting understatement.[67]

In a methodical approach to construing § 6013(e)(1)(C) (i.e., whether Patricia knew or had reason to know of the understatement), the Ninth Circuit Court of Appeals first found that, based on the record, Patricia had met her burden of showing lack of actual knowledge of the understatement.[68] It next turned to the question of whether she had reason to know of the understatement at the time of signing the return.[69] Applying the factors discussed above (level of education, involvement in the family's business and financial affairs, presence or absence of lavish expenditures or changes in lifestyles, the evasiveness and deceitfulness of the culpable spouse and her efforts to ascertain the correctness of the reporting of the transaction), the court found that "a reasonably prudent person in Patricia's position at the time she signed the return could not be expected to know that the return contained a substantial understatement."[70]

The court distinguished cases involving omissions from income from those cases involving grossly erroneous deductions, credits, or basis (frequently referred to merely as "deduction cases").[71] It basically agreed with the Tax Court that in omission cases a knowledge of the underlying transaction does put the spouse on notice that an understatement results when it is left off the return.[72] However, it rejected the use of this standard in deduction cases, in part because it would for the most part wipe out innocent spouse protection in those cases.[73] The Court emphasized that knowledge of the underlying transaction in deduction cases is a significant factor to be considered in determining

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[64] *Id.* at 960-61.

[65] *Id.* at 961, 965.

[66] *Id.* at 961.

[67] *Id.* at 965.

[68] *Id.*

[69] *Id.* at 965-66.

[70] *Id.* at 965.

[71] *Id.* at 963-64.

[72] *Id.*

[73] *Id.* at 963 n. 9.

whether the innocent spouse had such full knowledge of the transaction as to be put on notice of the resulting understatement.[74] In essence, the Court found that such knowledge of the underlying transaction imposed a duty of further inquiry on the innocent spouse to determine if the deduction is valid, but that, standing alone, such knowledge does not preclude relief.[75] It then noted that if this "duty to inquire" standard was not utilized, Patricia's only remaining defense would then be ignorance of the law, which is unacceptable in attempting to show lack of reason to know of the understatement.[76] As a final consideration, the Court then found that it would be inequitable not to grant Patricia relief in view of the facts of the case, a conclusion the Tax Court also indicated it would have reached if it had ruled favorably on all the other requirements of § 6013(e).[77]

Eleventh Circuit Court of Appeals

Earlier in 1989, the Court of Appeals for the Eleventh Circuit in *Stevens v. Commissioner* upheld the Tax Court in its denial of innocent spouse relief by concluding that the petitioner, Madeline Stevens, failed to prove that she had no reason to know of the substantial understatements of tax liability.[78] In 1974, Madeline's husband, Robert, formed a securities firm in which he was sole shareholder, president, and treasurer.[79] Madeline served as corporate secretary and her duties included record-keeping related to the sale of tax shelters, preparing reports to be sent to the Securities and Exchange Commission, and typing business correspondence.[80] Syndicators frequently discussed the pros and cons of tax shelters in her presence.[81] Following audits of the Stevens' joint tax return for 1976 through 1979, the Internal Revenue Service issued a notice of substantial tax deficiencies for those years due to the disallowance of deductions claimed for tax shelter losses and the disallowance of related loss carryforwards.[82] After stipulations by the parties, the only remaining issue at trial was whether Madeline was entitled to relief from the joint tax liability as an "innocent spouse."[83]

The two issues raised on appeals were (1) whether the Tax Court failed as a matter of law to apply the correct legal standard in evaluating the knowledge element of § 6013(e)(1)(C), and (2) whether the Tax Court erred in concluding that Madeline failed

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[74] *Id.* at 964-65.

[75] *Id.* at 965-66.

[76] *Id.* at 964.

[77] *Id.* at 966.

[78] Stevens v. Commissioner, 871 F.2d 1499, 1506-08 (11th Cir. 1989). This decision is particularly significant since the *Bokum* decision is on appeal to this Court.

[79] *Id.* at 1500-01.

[80] *Id.* at 1501.

[81] *Id.*

[82] *Id.* at 1502.

[83] *Id.*

to satisfy these elements necessary for relief even if the correct standard had been applied.[84] The Court of Appeals first found that the Tax Court utilized the correct standard in inquiring whether Madeline, in signing the returns, knew or had reason to know that the returns contained unallowable deductions.[85] Because the Tax Court in its decision did not discuss whether Madeline had actual knowledge of the understatements, the appeals court limited its inquiry to whether she had reason to know of them.[86] Citing *Sanders v. United States*,[87] the Court held that a spouse has "reason to know" if a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted.[88] The Court found that further investigation by Madeline was warranted, based upon her level of education (two years of college), involvement in the business, knowledge of the investment resulting in the erroneous deductions, lavish expenditures made on her behalf, and Robert's admitted evasiveness to her questioning of the returns.[89] Noting that Madeline confessed that she ultimately "blindly" signed the returns, the Court found that she failed to meet her duty of further inquiry as to the accuracy of the return and therefore failed to prove she did not have reason to know of the substantial understatements of tax.[90]

Eighth Circuit Court of Appeals

Subsequent to *Bokum*, *Price* and the *Stevens* decisions, the Court of Appeals for the Eighth Circuit reversed the Tax Court in its 1991 decision in *Erdahl v. Commissioner*.[91] In this case, Bruce Erdahl invested in a limited partnership organized to acquire a luxury condominium complex.[92] The funds used for this investment were borrowed from the pension fund of a professional corporation he established for his medical practice.[93] His wife, Gwen, was aware of this loan since she was a trustee of the pension plan and her signature was required for a plan amendment required to make the loan.[94] On their 1982 joint return, the taxpayers claimed a significant loss from the partnership which was subsequently disallowed by the Internal Revenue Service after the Erdahls were divorced.[95] The taxpayers conceded the resulting tax deficiency and additions to tax, but Mrs. Erdahl petitioned the Tax Court for relief from liability under the innocent spouse

[84] *Id.* at 1503.

[85] *Id.* at 1504-05.

[86] *Id.* at 1505.

[87] Sanders v. United States, 509 F.2d 162, 167 (5th Cir. 1975).

[88] *Stevens*, 871 F.2d at 1505.

[89] *Id.* at 1506-07.

[90] *Id.*

[91] Erdahl v. Commissioner, 930 F.2d 585 (8th Cir. 1991).

[92] *Id.* at 587.

[93] *Id.*

[94] *Id.* at 588.

[95] *Id.*

provision of § 6013(e).[96] After stipulations by the parties, the only remaining issues were whether she knew or had reason to know of the understatement at that time she signed the return and whether it would be inequitable to hold her liable for the tax deficiency.[97] The Tax Court decided that Mrs. Erdahl was not entitled to innocent spouse relief because she knew or had reason to know of the underlying circumstances which gave rise to the disallowed loss, thereby not reaching the issue of whether it would be inequitable to hold her liable for the deficiency.[98] The Eighth Circuit reversed the Tax Court's decision, expressly agreeing with the Ninth Circuit's conclusion in *Price* that mere knowledge of the transaction which underlies the erroneous deduction, without more, does not preclude relief.[99] This Court adopted the same basic standard as that utilized by the Ninth Circuit in *Price* and *Guth* and asks whether a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted.[100] It also expressly agreed with the Ninth Circuit that although mere knowledge of the underlying transaction that produced omitted income is sufficient to deny innocent spouse relief, application of this test to deduction cases would for the most part wipe out innocent spouse protection.[101] Accordingly, the Court concluded its decision with the finding that the Tax Court had imposed a far more stringent standard on Mrs. Erdahl than required by § 6013(e)(1)(C) because it failed to consider the totality of the circumstances relative to her at the time she signed the return.[102]

IDENTIFICATION AND RECONCILIATION OF APPARENT JUDICIAL CONFLICTS

As discussed above, although there is continuing litigation over the right to innocent spouse relief under § 6013(e) in different factual situations, there has been a significant narrowing of disagreements among the courts as to the standards, or factors, to be utilized in reaching their decisions. Thus, there is a continuing development of consensus as to standards to be used in determining the existence of a "joint return," the criteria for a "substantial understatement of tax," the definition of "grossly erroneous items" in both omissions of income and deductions cases, and the criteria for "inequitability" in denying relief.

The major area of continuing controversy and conflict among the courts is that relating to § 6013(e)(1)(C), the requirement that the claimant for relief meet the burden

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[96] *Id.*

[97] *Id.*

[98] *Id.* at 590.

[99] *Id.* at 590-91.

[100] *Id.* (quoting Stevens v. United States, 872 F.2d 1499, 1505 (11th Cir. 1989)).

[101] *Id.* at 589 (citing Price v. Commissioner, 887 F.2d 959, 963 (9th Cir. 1989).

[102] *Id.* at 591.

of proof that in signing the joint return he or she did not know, and had no reason to know, that there was a substantial understatement in such return. With respect to substantial understatements resulting from omissions of income, there is little difference among the courts as to the standard to be used: actual knowledge of the underlying transaction, per se, is generally accepted as actual or constructive knowledge of the resulting understatement.

The sharp conflict in interpretation of the "lack of knowledge" provision applies to those cases involving substantial understatements resulting from inclusion in the return of grossly erroneous items of deductions, credits, or basis. The Tax Court continues to follow the philosophy it first enunciated in *Sonnenborn v. Commissioner*,[103] a case it decided in 1971 - the same year § 6013(e) was enacted. This perspective is that the benefits of filing a joint return are available in exchange for the burdens of joint and several liability of the spouses for the resulting tax due on the joint return. In its 1990 decision in *Bokum*, the Tax Court continued to cite its *Sonnenborn* philosophy of strict compliance with the "carefully detailed conditions set forth in Section 6013(e)."[104] The significance of this is that the Tax Court has refused to change its standard for resolving controversies over the issue of whether a spouse knew or had reason to know of the understatement solely from knowledge of the underlying transactions both in omission from income cases and in deduction cases, despite the Ninth Circuit having previously rejected the use of this standard in deduction cases in its detailed 1989 opinion in *Price* followed by a similar conclusion in its decision in *Guth v. Commissioner*.[105] In its lengthy *Bokum* opinion the Tax Court expressly rejected the Ninth Circuit's broader standard of recognizing "knowledge of the underlying transaction" as significant, but not controlling, in cases involving substantial understatements resulting from the disallowance of grossly erroneous items of deductions, credits, or basis.[106] Accordingly, the Tax Court states its refusal to follow the opinion in *Price* except in those instances where appeal lies to the Court of Appeals for the Ninth Circuit.[107]

In deciding the 1991 case of *Erdahl v. Commissioner*, the Court of Appeals for the Eighth Circuit reversed the Tax Court's denial of relief and solidly adopted the Ninth Circuit's standard. The Eighth Circuit outright rejected the standard used by the Tax

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[103] Sonnenborn v. Commissioner, 57 T.C. 373 (1971).

[104] Bokum v. Commissioner, 94 T.C. 126, 151-52 (1990), *aff'd*, 992 F.2d 1132 (11th Cir. 1993) (quoting *Sonnenborn*, 57 T.C. at 381).

[105] Guth v. Commissioner, 897 F.2d 441 (9th Cir. 1990).

[106] *Bokum*, 94 T.C. at 152-56.

[107] *Id.* at 151. This applies to taxpayers who reside, at the time they file their Tax Court petitions, in Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, or South Dakota.

Court in *Bokum* in "knowledge of the transaction" cases involving substantial understatements attributable to grossly erroneous items of deductions, credits, or basis.[108]

Although the Tax Court in *Bokum* did aggressively defend its exacting standard that a spouse is held to actual or constructive knowledge of a resulting understatement whenever he or she has knowledge of the underlying transaction in both omission and deduction cases, it used a standard in *Stevens* that was identical to that used by the Eighth, Ninth and Eleventh Circuit Courts of Appeal as discussed above.[109] Additionally, its more recent applications of this standard to its decisions are increasingly reconcilable with the criteria utilized by the Eighth and Ninth Circuits. For example, careful analyses of the *Bokum* decision discloses that despite its stated refusal to follow *Price*, the Tax Court set forth evidence supporting that "a reasonable person with Margaret's background" would have noticed the erroneous subtraction of Richard's basis from the sizable reportable divided, and she should have noticed that the tax preparer's block had not been filled in.[110] The Tax Court then concluded that Margaret either knew or had reason to know of the circumstances that gave rise to the substantial understatement and thus was disqualified from relief under § 6013(e)(1)(C).[111] This is an apparent attempt to establish that since she failed to make further inquiry as to the corrections of the return under these circumstances, Margaret was disqualified from innocent spouse status even if this broader standard embraced by the Eighth, Ninth, and Eleventh Circuit Courts of Appeal had been used. Additionally, the Tax Court was sharply divided in its opinion, with ten judges formally agreeing with the decision, one judge concurring with the majority in result only while expressing concern over "unnecessarily creating a decisional conflict with the Ninth Circuit,"[112] and five judges dissenting. Further, three judges formally a part of the majority wrote a concurring opinion expressing their belief that Circuit's analysis in *Price* was consistent with their belief that in deduction, credit

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[108] Erdahl v. Commissioner, 930 F.2d 585, 586-87, 589, 589 n. 5 (8th Cir. 1991). Accordingly, the Tax Court now must extend the application of the *Price* and *Erdahl* standards to those taxpayers who reside, at the time they file their petitions, in Arizona, California, Idaho, Montana, Nevade, Oregon, and Washington.

[109] *See Bokum*, 94 T.C. at 151-57. *See also Erdahl*, 930 F.2d at 589-90; Guth v. Commissioner, 897 F.2d 441, 443-44 (9th Cir. 1990); Price v. Commissioner, 887 F.2d 959, 964-65 (9th Cir. 1989); Stevens v. Commissioner, 872 F.2d 1499, 1504-05, 1505 n. 8 (11th Cir. 1989).

[110] *Bokum*, 94 T.C. at 147-48.

[111] *Id.* at 148-50. The Tax Court stated:

> The standard to be applied in determining whether a putative innocent spouse has "reason to know," under [I.R.C. §] 6013(e)(1)(C) is whether "a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted."

Id. at 148 (quoting *Stevens*, 872 F.2d at 1505). This is an apparent attempt to establish that Margaret was disqualified from relief even if this broader standard embraced by the Eighth, Ninth, and Eleventh Circuit Courts of Appeal were used.

[112] *Id.* at 159-60 (Parr, J., concurring).

and basis disallowance cases the Court's inquiry of the "reason to know" of the understatement should go beyond the mere knowledge of the underlying transactions and include other circumstances indicating a lack or presence of a reason to know.[113] In effect, then only seven of the judges voting in *Bokum* were left fully endorsing the view that the restrictive "knowledge of the transaction" rule, standing alone, equates to knowledge of the understatement. The remaining nine judges either fully or substantially agreed with the Eighth and Ninth Circuits' standard.

A further indication of movement toward reconciliation of this conflict is that the citations in *Bokum* of prior Circuit Courts' opinions as support for the Tax Court's standard are less than fully convincing upon careful analysis.[114] Finally, while several Tax Court decisions in addition to *Bokum* are now on appeal to various Circuit Courts of Appeal, all are omission of income cases rather than disputes involving erroneous deduction items.

CONCLUSION

This author believes that the broader standard used by the Eighth Circuit in *Erdahl*, the Ninth Circuit in *Price* and *Guth* and the Eleventh Circuit in *Stevens* will be supported by other Circuits when "knowledge of the understatement" cases involving erroneous deduction items are decided by them. Further, as noted above, a probable majority of the Tax Court has philosophically already adopted this broader standard and can be expected to soon broaden the narrow standard enunciated in the majority opinion in *Bokum*, particularly if the Eleventh Circuit Court of Appeals utilizes it in deciding the appeal of this case. Until this de facto reconciliation becomes a formality, counsel to taxpayers seeking innocent spouse relief in grossly erroneous deduction, credit, and basis disallowance cases should utilize the above-discussed Eighth, Ninth, and Eleventh Circuits' standard in gathering evidence to support the position of their clients.

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[113] *Id.* at 158-59 (Swift, J., concurring).

[114] For example, the majority opinion cites as support Purcell v. Commissioner, 826 F.2d 470, 474 (6th Cir. 1987). *Bokum*, 94 T.C. at 146 However, the "knowledge of the transaction" issue in *Purcell* involved an ommission from income and not an erroneous deduction. *See Purcell*, 826 F.2d at 471-72. It also cites Stevens v. Commissioner, 872 F.2d 1499, 1505 (11th Cir. 1989) and Shea v. Commissioner, 780 F.2d 561, 566 (6th Cir. 1986). *Bokum*, 94 T.C. at 148. In citing *Stevens* and *Shea* the Tax Court endorses the standard to be applied as "whether a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted." *Id.* at 148 (quoting *Stevens*, 872 F.2d at 1505). This is the same standard which was utilized by the Eighth Circuit in *Erdahl* and the Ninth Circuit in *Price* and *Guth*. *See* Erdahl v. Commissioner, 930 F.2d 585, 589-90; Guth v. Commissioner, 897 F.2d 441, 443-44 (9th Cir. 1990); Price v. Commissioner, 887 F.2d 959, 964-65 (9th Cir. 1989).