CAL

TAX NETWORK

Newsletter of the Tax Procedure and Litigation Committee
Taxation Section of the State Bar of California

July 2010

IN THIS EDITION

ARTICLE EXTRACT REPRINTED FROM ORIGINAL
CITE AS:
Donald Lowrey, 'Innocent Spouse Relief: Knowledge Threshold For Erroneous Deductions v. Omitted Income' [July 2010 p.5] *Tax Network* , newsletter of the Tax Procedure and Litigation Committee, Taxation Section of the State Bar of California.

Innocent Spouse Relief: Knowledge Threshold For Erroneous Deductions v. Omitted Income

By Donald Lowrey, J.D., LL.M.

SUMMARY

Helen Korchak and Winnie Greer asserted in unrelated cases, innocent spouse relief where the common issue was "when does a spouse know enough to preclude relief?" Both cases arise from investments in the same tax shelter scheme. Both petitioners are well educated but claimed lack of knowledge even though they had both signed MFJ tax returns in which the tax shelter deduction was significant. However, the outcomes were decided differently under IRC Section 6015(b)(1)(C), the "knew-should-have-known" requirement.

The two cases are interesting on different levels. First, *Greer v. Commissioner* No. 09-1420 decided in the Sixth Circuit in February 2010, explains the erroneous deduction standard, first expressed in the Ninth Circuit in *Price v. Commissioner (887 F.2d 959)*, which is now the majority view. Second, both the *Greer* and *Korchak* cases arise from their husbands' unfortunate investment in the same tax shelter partnership, Madison Recycling. For some perspective, it is worth noting that Madison Recycling has been in tax litigation for 14 years which cascaded into tax controversies for its partners. The cases discuss a different approach for Erroneous Deductions versus Omitted Income. However, you may conclude that for the practitioner, a practical application of the rules falls somewhat short of a bright-line test. Even with good facts, a petitioner may have an uphill fight.

Overview – Relief from Joint Liability Under IRC § 6015(b)

Married individuals may file a single joint return of income taxes.[1] When a joint return is made, the liability with respect to any tax due is joint and several.[2] However, an individual taxpayer may be relieved of a liability for tax that is attributable to an understatement on a joint return.

[1] IRC § 6013.
[2] IRC § 6013 (d)(3).

The "traditional" basis for relief from joint and several liability has four essential requirements for relief:[3]

- A joint return has been made.
- On the return, there is an understatement of tax attributable to erroneous items of one of the individuals filing a joint return.
- The other individual establishes that in signing the return, he or she did not know and had no reason to know that there was an understatement.
- By application of the facts and circumstances test, it would be inequitable to hold the other individual liable for the deficiency in the tax attributable to the understatement.

If these conditions are satisfied and the requesting spouse makes a timely election, [4] the requesting spouse shall be relieved of liability to the extent that the liability is attributable to the understatement.

Formula Approach to a Facts and Circumstances Test

Not surprisingly, the difficult issue is proving that the requesting spouse had an absence of actual or constructive knowledge of the understatement. The issue most often turns on whether the requesting spouse had reason to know of the item causing the deficiency. Because this is a "facts and circumstances" test, you might imagine that there is considerable room for argument. However, by regulation there is a list of the factors to be considered. These are[5:]

- The nature of the erroneous item, and the amount in relation to other items.
- The financial situation of the joint filers.
- The requesting spouse's educational background and business experience.
- The extent of the requesting spouse's participation.
- Whether the spouse failed to inquire about the item before signing the return.
- Whether the item represented a significant change in reporting from prior years.

As a result, a petitioner will attempt to present facts to mirror these factors. A common fact pattern is that the spouse knew something about the facts giving rise to the understatement but was not experienced in financial affairs, did not participate in the activity, did not have business or tax education and trusted the other spouse to manage their financial affairs. The Service and the some Tax Court decisions are mechanical in weighing these factors.

Understatement

In order to obtain innocent spouse relief, there must have been an understatement of tax attributable to erroneous items on a return.[6] An understatement is defined as the excess of the amount required to be shown on the return over the tax imposed.[7] The IRS believes that for IRC §6015 purposes, a deficiency and an understatement are treated the same.[8]

Erroneous Item

An "item" is defined as that which is required to be separately listed on an individual income tax return. "Items include, but are not limited to, gross income, deductions, credits, and basis."[9] Erroneous items include unreported (omitted) income or incorrect deduction, credit or basis. "An erroneous item is any item resulting in an understatement or deficiency in tax to the extent such item is amended from, or improperly

[3] IRC §6015(b). This section replaces the former § 6013(e) as part of the Internal Revenue Service Restructuring and Reform Act of 1998.
[4] IRC §6015((b)(1)(E). Requiring election to seek relief within two years of the time that collection activity has begun.
[5] Treas. Reg. 1.6015-2(c)
[6] IRC §6015((b)(1)(B).
[7] IRC §6662(d)(2).
[8] IRM 25.15.3.4.1
[9] Treas. Reg. 1.6015-1(h)(3).

reported (or improperly characterized) on an individual income tax return."[10]

When does the Petitioner Know Enough to Preclude Relief?

Price vs. Commissioner 887 F.2d 959 [64 AFTR 2nd 89-5822] (9th Cir. 1989) is the leading case in erroneous deduction cases and is believed to be followed by a majority of jurisdictions. Patricia and Charles Price owned shares in a Columbian gold mining venture. The IRS disallowed a $90,000 deduction for development expenses incurred in the mining operation from the Price's 1992 joint return, resulting in a $40,120 deficiency. In that year Charles had self-employment income of $80,000 and Patricia has W-2 wages of $23,000.

Patricia had studied sociology at a junior college for two years and later worked at carpooling company where she eventually became a branch manager. Charles was working as an investment broker and became involved in a Columbian gold mining operation, owning several shares. With regard to the mining venture, Patricia had not reviewed an offering circular nor did she know of any of the particulars of the investment. She knew that her husband had purchased an interest in the venture and testified that she trusted Charles in financial matters. Patricia had reviewed the return "cursorily" and noticed the $90,000 deduction for the mining expenses, which she testified "…was a bit much." The Tax Court denied her innocent spouse protection because she had failed to carry her burden to establish that in signing return she did not know and had no reason to know that there was a substantial understatement. Patricia appealed.

Reason to Know of Substantial Understatement

On appeal, the Court agreed that the Patricia did not know the legal consequences of the deduction. Also, the Court found that there was no evidence to suggest that Patricia "knew" that the return contained a substantial understatement. The issue on appeal was whether Patricia had "reason to know" of the substantial understatement.

A spouse has "reason to know" of a substantial understatement if a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained a substantial understatement. There were not unusually lavish expenditures made by the couple, Patricia had limited involvement in the financial affairs of her marriage and in no involvement with the mining venture. The Court found that a reasonably prudent person in Patricia's position "could not be expected to know that the return contained a substantial understatement".[11]

Duty to Inquire

However, she knew enough to have put her on notice. "Such notice is provided if the spouse knows sufficient facts that a reasonably prudent taxpayer in her position would be led to question the legitimacy of the deduction."[12] The court noted that the size of the deduction as compared to the total income reported ($90,000 deduction, $103,000 income); together with the unusual nature of the item (a Columbian gold mine) was sufficient to put Patricia on notice.

"In such a situation, a duty of inquiry arises, which, if not satisfied by the spouse, may result in constructive knowledge of the understatement."[13] The Court found that Patricia did not ignore the deduction because she questioned Charles about it, and had refused to sign the return until after Charles had assured her that a reputable CPA had prepared the return. The court distinguishes the facts of *Price* from one in which the Tax Court denied relief where a spouse ignored a large deduction and had refused to make inquiries. The court concluded that giving Patricia's relative lack of experience and understanding of financial affairs, she had satisfied her duty of inquiry.[14]

Lack of Knowledge of Tax Consequences is Not a Defense

In *Mitchell Et. Al. v. Commissioner*, 292 F.3d 800 [AFTR 2d 2002-2691] (2002) Herbert Mitchell re-

[10] IRM 25.15.3.4.1.

[11] *Price v. Comm'r* at 965.
[12] *Price v. Comm'r* at 965.
[13] *Price v. Comm'r* at 965.
[14] *Price v. Comm'r* at 966.

ceived a retirement distribution of $666,564.51 in 1991. However, he did not roll over the retirement distributions but instead used the proceeds to buy Treasury securities. Unfortunately, Mr. Mitchell died in March 1992. Mrs. Ella Mitchell filed a joint return for 1991 and accurately reported that the entire distribution but inaccurately reported $628,000 as an excluded rollover (the difference of $39,633.27 was employee contributions). The IRS determined a deficiency and Mrs. Mitchell was denied relief in the Tax Court on her innocent spouse petition.

On appeal, that the Court agreed with the Tax Court's determination that: 1). Mrs. Mitchell did not know the tax consequences of the distribution, but 2). She did know every fact necessary to determine that the distribution was fully taxable. Although Mrs. Mitchell did not know in fact that that there was an understatement, she did know enough to give her "reason to know" of the understatement on the 1991 joint return.

Mrs. Mitchell argued that the "knowledge of the transaction" used by the Tax Court in her case, was inappropriate because it applied to erroneous deduction cases. Instead she urged that the standard in *Price v. Comm'r*, should be followed. She interpreted *Price* to mean that her lack of knowledge of the tax consequences of receiving income, or its proper treatment on the return, establishes that she did not have reason to know of the underpayment.

The *Mitchell* Court found fault with this logic. The Court stated that no court, including *Price*, had gone that far. Instead the Court decided that Mrs. Mitchell knew every fact necessary to determine the legal consequences of the income and that her defense is simply that she did not know the consequences. The court stated "[n]othing in Price undermines our determination. Ignorance of the law, standing alone, as it does here, is not a defense under any test."[15]

Knowledge of the Transaction Test

In *Cheshire v. Commissioner*, 282 F.3d 326 [89 AFTR 2d 2002-900] (2002), the IRS determined that on their 1992 income tax return, David and Katherine Cheshire had understated a taxable retirement distribution by $131,591 and had underreported interest income earnings of $717. In the year of the distribution, he rolled over a portion but also made large deposits into their joint checking account to buy a car, start a business and pay off their mortgage. Katherine knew of all of these transactions.

Mr. Cheshire self-prepared their 1992 joint income tax return, reporting the distribution. However, Mr. Cheshire mistakenly believed that retirement distributions used to pay off a mortgage were not taxable. Before signing the return Katherine questioned David about the deduction, and David falsely told his wife that he had consulted with a CPA. Mr. Cheshire had persistent problems with alcohol which resulted in the Cheshire's separating in 1993. They subsequently divorced. In the decree, Katherine was awarded unencumbered title to the marital residence.

After an audit of their self-prepared joint income tax return, the IRS determined that David and Katherine Cheshire had underreported their income. Mrs. Cheshire brought an action in Tax Court for innocent spouse relief and was denied relief under §6015(b), (c), and (f). Thereafter Mrs. Cheshire sought appellate review.

Omitted Income or Erroneous Deduction?

Courts have agreed that in omitted income cases, a spouse's actual knowledge of the underlying transaction that produced the income is sufficient to preclude innocent spouse relief.[16] The Tax Court has applied the "knowledge of the transaction" test to both types of cases.[17] However, with this case, the Fifth Circuit adopted the *Price* approach. In *Price*, the Ninth Circuit had said that actual knowledge of the underlying transaction, standing alone, is not enough to preclude innocent spouse relief in erroneous deduction cases.

[15] *Mitchell v. Comm'r* at 804.

[16] *Reser v. Commissioner*, 112 F.3d 1258, 1265.

[17] *Bokum v. Comm'r*, 94 T.C. 126,151 (1990).

In *Cheshire*, the Commissioner argued that the case was one of "omitted income" and that "knowledge of the transaction" test is applicable. The Appellant on the other hand, argues that the facts show an "erroneous deduction" and that the "knowledge of the incorrect deduction standard" is therefore applicable.

Nevertheless, the Court found the result was the same under either test. Under the "knowledge of the transaction" test applied in omitted income cases, Mrs. Cheshire had actual knowledge of the retirement distributions at the time that she signed the return. Under the "knew or had reason to know" test applied to erroneous deduction cases, Mrs. Cheshire knew all the facts surrounding the transaction giving rise to the understatement. Therefore Appellant had "reason to know" of the improper deduction as a matter of law.

The Court concluded that Mrs. Cheshire's had failed both tests and therefore her defense was a mistaken belief as to the treatment of the retirement distributions. When a spouse knows enough about the underlying transaction that are innocent spouse defense rests entirely upon the mistake of law, she has "reason to know" of the understatement as a matter of law. Ignorance of the law cannot establish an innocent spouse defense to tax liability[18].

Greer 2010. Erroneous Deduction - Relief Denied

In *Greer v. Commissioner* No. 09-1420 F.3d [105 AFTR 2d 2010-977] (2010), Winnie Greer appealed an adverse judgment of the US Tax Court finding her ineligible for relief from joint and several liability arising from disallowed investment credits claimed on her 1982 income tax return and carry back refunds claimed for the prior three years.

In 1967 she married Daniel Greer, a chemical engineer. After the marriage, she worked for a few years as a high school music teacher. Thereafter she raised her children and pursued a master's degree in music education. In 1979 she began a photography business specializing in wedding and portrait photography. She relied on her husband Daniel and all financial matters and he did not mislead or conceal any financial activities from Winnie.

The transactional facts in *Greer* are complex and span many years. By way of summary, after the sale of assets of a closely held business, the Greer's received a distribution in 1982 of $146,918.02 each. In that same year, Mr. Greer invested in a recycling business partnership, Madison Recycling. The Greer's CPA described the investment as "fairly aggressive" because it was expected to return $1.75 of tax benefits for each $1 invested. The IRS subsequently disallowed the partnership's claimed tax benefits in 1987, which has been the subject of separate litigation that has continued for 14 years. Madison's tax problems have had a domino effect generating other tax controversy cases (See *Korchak* below).

On their 1982 joint income tax return, the Greer's took a credit of $51,131. Because of AMT, losses were carried back two years while investment credits were carried back three years. In addition, the Greer's made application for Tentative Refund on Form 1045 for each year affected by the carry back. Mrs. Greer knew about the investments and there was no issue that her husband concealed any of the facts. Mrs. Greer relied upon her husband for financial management, signed their joint income tax returns, signed a declaration relating to the Form 1045 and she was aware of three refund checks received as a result.

Constructive Knowledge, Duty to Inquire

With regard to Mrs. Greer's § 6015(b) claim, the Court addressed the "did not know and had no reason to know" element of Paragraph (C). "Courts have interpreted the reason to know element to encompass two separate types of constructive knowledge. First, a spouse may have reason to know of an understatement reflected on the tax filings. Second, even if they spouse does not having reason to know of an understatement, he or she nonethe-

[18] *Cheshire v. Comm'r*, 89 AFTR 2d at 2002-905

less may have reason to know of a possible understatement, giving rise to a duty to inquire into the possibility."[19]

Review of Erroneous Deduction Cases Distinguished From Omitted Income Cases

The test applied by the Tax Court has been that in both omitted income and erroneous deduction cases, that it would apply a "knowledge of the transaction" test.[20] With *Greer*, the 6th Circuit adopted the *Price* view. The "knowledge of the transaction" test is appropriate in omitted income cases, but not in erroneous deduction cases.

"The knowledge of the transaction test leaves room for taxpayer to claim innocent spouse relief in omitted income claims, because the understatement arises in such cases from information being left off of a return, and a spouse otherwise may not have known nor had reason to know that information. In erroneous deduction cases, the understatement arises from information being *included* on return, so a spouse who signed the tax return necessarily learns of the transaction."[21]

The Court also noted that the *Price* standard can be applied to determine whether a spouse had a duty of inquiry. Where the tax return set forth deductions or credits that are large relative to the size of the underlying investment or the reported income, a duty to inquire further is imposed on a spouse.

Mrs. Greer argues that she left financial decisions to her husband and had no reason to suspect his errors. The Court stated that "being a homemaker cannot alone relieve the spouse of joint and several tax liability on a joint return and that one spouse cannot bury his or her head in the sand or turn a blind eye to the other's accounting."[22]

Erroneous Deduction – Relief Granted

Ernest and Helen Korchak were also partners in Madison Recycling. Mr. Korchak made the family financial decisions and he invested in Madison in 1982 without consulting Mr. Korchak. Ernest had earned a B.S. degree in chemical engineering. Helen had earned a B.S. degree in biochemistry. She worked as homemaker for 12 years and then worked as a research scientist and continued to do so through the events surrounding this case. Neither Ernest nor Helen had taken any tax, financial or accounting courses. They signed a joint return for 1982 in which Schedule E statements reported a $58,089 loss for Madison Recycling and a qualified investment credit Recovery of $77,500. Their combined wages & salaries were $481,648. However, Helen only became aware of the Madison investment in 1986 when she signed Form 872, Consent to Extend the Time to Assess Tax.

In due course, the IRS disallowed Madison's partnership tax benefits and the trouble rolled downhill to the Korchak's. Their first Tax Court case was adversely decided in 2005.[23] In Mrs. Korchak's case the Tax Court sympathetically described Mrs. Korchak's lack of knowledge and experience through many paragraphs of the decision, leading up to this query:

"Helen Korchak is eligible for retirement. She has a retirement fund that she has long contributed to. Unfortunately, she is now faced with the prospect of horrific federal tax liability in excess of $2 million, with interest and penalties. Should she be punished for being a loving, trusting wife, a homemaker and mother who also had career aspirations and a keen interest in science?"[24]

The Court granted relief, finding that a reasonably prudent taxpayer under the petitioner's circums-

[19] *Greer v. Comm'r*, (Citing Kistner v. Comm'r, 18 F.3d 1521, 1525 (1994) and Price v. Comm'r, 887 F.2d 959, 965 (1989).
[20] *Bokum v. Comm'r* , 94 T.C. 126, 146 (1990). A spouse has reason to know of an understatement if the spouse had knowledge of the transaction giving rise to the claimed tax benefits.
[21] Greer v. Comm'r, at pg. 99-3014 (emphasis in original).
[22] Greer v. Comm'r AFTR 2010-987. See *Price v. Comm'r* at 965.
[23] *Ernest Korchak v. Comm'r,* T.C. Memo 2005-244
[24] *Korchak v. Comm'r,* T.C. Memo 2006-185 at 1272

tances at the time of signing the 1982 joint return could not have been expected to know that the tax liability stated in their return was erroneous. As an aside, it's not surprising that the Court also granted relief under § 6015(f).

What of Mrs. Korchak's duty to inquire? The Court found that a reasonably prudent taxpayer under petitioner's circumstances at the time of signing the 1982 joint tax return would not have had a duty to investigate further whether the tax liability stated in that return was erroneous.

Reconciling Korchak with Greer

The two cases are remarkable in the similarity of the facts. Both of the spouses seeking relief were well educated; both had relied upon their husbands to make financial decisions; both were homemakers who also pursued careers. Neither of them had any particular investment knowledge, business education or tax training. Their tax trouble stems from the same underlying partnership investment in Madison Recycling. The investment decision in each case was made solely by their husbands.

Mrs. Korchak's situation is sympathetic. She was facing retirement with a huge tax liability impairing her future. However, Mrs. Greer situation is not much different. She is in her sixties and could not satisfy her tax liability without wiping out her personal retirement account and family inheritance.

Why was Mrs. Korchak granted relief when Mrs. Green was not? The *Greer* Court distinguished the two cases. First, Mrs. Korchak did not even know that her husband had made the Madison investment while Mrs. Greer did know of the investment. Second, the Madison benefits did not stand out on the Korchak's tax return because they sat among other losses and credits. However, on the Greer's return, Madison was the lone entry on schedule E and was the only investment that could have resulted in the energy investment credit that was claimed. The court stated that these facts (referring her duty of inquiry) "should have helped Mrs. Greer connect the dots in ways that Mrs. Korchak did not."

Is there a Conclusion?

The problem with dots, is that they can be connected in different ways. The Korchak's return only had a handful of losses and credits and Madison Recycling was a significant item. Under the articulated tests, even though Mrs. Korchak did not know of the original investment, she was a biochemist and research scientist; and probably should have been charged with a duty to inquire into any significant loss on her joint return.

If there is a lesson to be learned, it is that the practitioner must completely think through all of the possible arguments at the outset of representation. In particular, erroneous deductions cases must consider not only a lack of actual or implied knowledge, but also whether a duty of inquiry applies and whether the taxpayer's position can be fatally reduced to an ignorance of the law defense.