Forgotten But Not Gone: The Rights of the Nonelecting Spouse and Other Developments in Relief from Joint and Several Liability

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Karen Hawkins and Edward Perry analyze the recent Tax Court decisions interpreting relief from joint and several liability.

In the Restructuring and Reform Act of 1998 (RRA '98), Congress directed the IRS to issue regulations implementing the changes to innocent spouse relief contained in new Code Sec. 6015.[1] Practitioners are eagerly awaiting this guidance. Meanwhile, in a series of decisions this spring and summer, the U.S. Tax Court has moved ahead decisively to clarify provisions of the new statute in two key areas: (1) the rights of the nonelecting spouse to contest an electing spouse's request for relief; and (2) the availability of judicial review of the Secretary's decision to deny "equitable" relief under Code Sec. 6015(f).[2] In addition, the Tax Court reopened the controversy, which had existed for years, regarding what constitutes "knowledge" sufficient to deny an electing spouse relief from a joint and several liability.

Rights of the Nonelecting Spouse

Code Sec. 6015(g) provides that the Secretary shall prescribe:

> (2) regulations providing the opportunity for an individual to have notice of, and an opportunity to participate in, any administrative proceeding with respect to an election made under subsection (b) or (c) by the other individual filing the joint return.

Code Sec. 6015(e)(4) provides that the Tax Court shall establish:

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> rules which provide the individual filing a joint return but not making the election under subsection (b) or (c) with adequate notice and an opportunity to become a party to a proceeding under either such subsection.

The court's rules are contained in new Tax Court Interim Rules 320 to 325. Effectively, the onus is placed upon the Commissioner to serve notice on the nonelecting spouse of a proceeding under subsections (b) or (c) of Code Sec. 6015. The nonelecting spouse then has 60 days to file a notice of intervention with the court.

Prior to RRA '98, the accepted view was that the nonelecting spouse was not entitled to intervene in a proceeding to determine the electing spouse's right to innocent spouse relief.[3] In *T. Corson*,[4] applying the criteria of Code Sec. 6015(e), the Tax Court denied the Commissioner's motion for entry of decision against a nonelecting spouse. *Corson* involved a tax shelter deficiency from the early 1980's which was asserted against both spouses. The Corsons petitioned the Tax Court jointly in 1985, but due to the length of time necessary to litigate a test case, their action remained unheard 10 years later. In 1996, following appellate confirmation of the test cases, the Tax Court granted the electing spouse's motion to amend the joint Petition to include a request for innocent spouse relief.

In that same year, the electing spouse stipulated with the Commissioner that, but for any application of Code Sec. 6013(e), she was liable for an income tax deficiency for 1981 in the amount of $21,711. The nonelecting spouse did not object to the motion to amend and, two years later, stipulated to a settlement with respect to his income tax liability for 1981 in the amount of $21,711. In 1998, when the IRS proceeded administratively to address the "innocent spouse" issue, it provided the nonelecting spouse with notice and an opportunity to furnish "information relevant to a determination as to whether such relief would be appropriate."[5] In 1999, on the verge of trial, District Counsel and the electing spouse stipulated that the latter was entitled to Code Sec. 6015 relief under subsection (c). District Counsel then sought unsuccessfully to obtain a stipulation from Mr. Corson regarding his prior settlement and Mrs. Corson's Code Sec. 6015 relief. When he refused, Counsel filed the motion for Entry of Decision, which is the subject of Judge Nims' Opinion.

In a ruling limited by the nature of the proceedings (*i.e.*, an effort by the Commissioner to force the entry of a decision against Mr. Corson through a motion) the court held that Code Sec. 6015(e)(4) conferred "some [new] participatory entitlement" in the nonelecting spouse to contest the award of relief to the electing spouse. In analyzing the statutory basis for the court's review of a claim for Code Sec. 6015 relief, Judge Nims observes that the court has jurisdiction to address a claim for Code Sec. 6015 relief when it is raised as an affirmative defense in a petition filed in response to a Statutory Notice of Deficiency.[6] The court also has jurisdiction to determine relief from joint and several liability pursuant to a petition filed by the electing spouse following an unsuccessful (or nonresponsive) administrative proceeding.[7] Reading subsections (g) and (e) together, Judge Nims finds that they:

> reveal a concern ... with fairness to the nonelecting spouse and with providing him or her an opportunity to be heard on innocent spouse issues. Presumably, the purpose of affording to the nonelecting spouse an opportunity to be heard first in administrative proceedings and then in judicial proceedings is to insure that innocent spouse relief is granted on the merits after taking into account all relevant evidence. After all, easing the standards for obtaining relief is not equivalent to giving relief where unwarranted.[8]

In denying the Commissioner's motion to compel entry of the decision against Mr. Corson, Judge Nims stopped short of defining the "precise contours" of the rights intended to be granted to nonelecting spouses under Code Sec. 6015. He noted, but did not specifically adopt, the nonelecting spouse's view that Congress intended that the "nonelecting spouse become a 'full player' in the process of determining innocent spouse relief, such that each of three parties now has rights to fully litigate the issue."[9]

Interestingly, the court does not address whether the nonelecting spouse had been diligent in asserting his rights under Code Sec. 6015(g) or (e) (he did not object to the electing spouse's motion to amend their joint Petition in 1996), or whether he already had participated meaningfully in the administrative proceedings (by responding to Appeals' inquiries in 1998). Apparently, the court implicitly determined that the nonelecting spouse's conduct

was insufficient to override the statutory directive to provide the nonelecting spouse with the opportunity to be "a party" to the determination of Code Sec. 6015 relief.

If pre-RRA '98 "sitting on one's hands" will not prevent one from having a later opportunity to intervene, will the same conduct post-RRA '98 eliminate or reduce that right? For example, would a nonelecting spouse's knowing failure to participate in an administrative proceeding to determine innocent spouse relief preclude her or him from intervening in the Tax Court's review of an unfavorable administrative decision? Nothing in the statute conditions the right to participate in the Tax Court proceeding on participation in an earlier administrative proceeding. However, permitting this result raises troubling questions about the "lack of symmetry" with the restrictions imposed upon the electing spouse under Code Secs. 6320 and 6330.[10]

> These [intervention] decisions raise legitimate concerns about protecting the safety, privacy and freedom from intimidation of the electing spouse.

In *K.A. King*,[11] the court decisively affirmed the reasoning in *Corson* and promulgated procedural rules applicable to all cases, including small tax cases, with respect to intervention by a nonelecting spouse in the proceedings to determine Code Sec. 6015 relief for the electing spouse. In that case, the IRS issued separate notices of deficiency to the nonelecting spouse and to the electing spouse. The nonelecting spouse did not file a petition with the court and the Commissioner assessed the full tax liability against him. The electing spouse timely petitioned the court, not denying the underlying tax liability, but alleging that she was entitled to relief from joint and several liability pursuant to Code Sec. 6013(e).

Following the trial, but before the court issued its opinion, Code Sec. 6015 was enacted. In its brief on the applicability of new Code Sec. 6015, the Commissioner advised the court that Ms. King appeared to qualify for relief pursuant to Code Sec. 6015(b) and that her former spouse objected to the grant of that relief. Referring to Code Sec. 6015(e)(1)(A) as a "stand-alone" proceeding, the court directed the Commissioner to notify the nonelecting spouse of his right to intervene in the electing spouse's proceeding. The *pro se* electing spouse did not file an objection to the nonelecting spouse's timely motion to intervene.

Addressing for the first time the rights of nonelecting spouses who are not petitioners before the court, Judge Ruwe held, expansively, that "whenever, in the course of *any* proceeding before the Court, a taxpayer raises a claim for relief from joint liability under Code Sec. 6015, and the other spouse (or former spouse) is not a party to the case, the Commissioner *must* serve notice of the claim on the other individual of his or her opportunity to file a notice of intervention ..." (*emphasis supplied*).[12] The required procedures include providing a copy of Interim Tax Court Rule 325 with the notice, and certification by the Commissioner to the court that such notice has been given.

While holding that the nonelecting spouse must be given his or her right to intervene, however, the *King* case leaves several essential issues open. It does not address, for example, whether the filing of the notice of intervention is subject to deliberative action by the court or whether the nonelecting spouse is automatically accorded status as an intervenor. The Tax Court Rules of Practice and Procedure are silent on the topic of intervention, generally. With respect specifically to Code Sec. 6015 relief, Interim Tax Court Rule 325(b) states that "if the other [spouse] desires to intervene, then such individual shall file a notice of intervention with the court." This rule apparently contemplates something less than a full-blown motion proceeding with respect to the intervention.

Tax Court Rule 1(a) states that where the Tax Court has prescribed no applicable rule of procedure, the "Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand." Federal Rules of Civil Procedure 24(a) and (b) provide for intervention as a matter of right, and for permissive intervention, respectively. In either case, though, the party seeking to intervene must bring a motion upon which the district court must rule.

In addition to foregoing a full elucidation of the procedure for accomplishing intervention, the *King* decision leaves for future cases the delineation of the precise rights of the intervenor. For example, *King* does not clarify

whether the intervenor has all the rights of a party to the proceeding, such as the right to introduce and exclude witnesses or whether the intervenor will be limited to cross-examination of the electing spouse's witnesses. Finally, the court has not dealt with the possibility of limiting the subject matter scope of the intervention. For example, it might be appropriate, on the facts, to permit intervention as to the electing spouse's actual knowledge of the nonelecting spouse's Swiss bank account, but not as to whether the electing spouse spent too much money on frivolous purchases.

Aside from accommodating the express wording of the statute, the results in *Corson* and *King* appear appropriate on policy grounds. Our system of jurisprudence is centered on the notion that the truth is most likely to be served where parties with adverse interests are permitted wide latitude to present evidence on an issue. Where one spouse has already conceded liability for the underlying tax, or at least is unable by that point to contest it, the IRS is not in a truly adversarial role with respect to the remaining spouse's claim for Code Sec. 6015 relief. This is particularly so where the nonelecting spouse has assets that are greater than, or more accessible to the IRS than, those of the electing spouse. More often than not, these cases will present the classic "whipsaw" situation for the Commissioner to exploit to his advantage by placing the IRS in the position of "stakeholder." Nonetheless, the court's current position, constrained by the statute, promises to encourage the revisitation of many marital dissolution issues even if previously raised in other forums.

These decisions raise legitimate concerns about protecting the safety, privacy and freedom from intimidation of the electing spouse. In most cases, Code Sec. 6015 relief issues will arise after a marriage has soured. Disclosure, in some cases, of the electing spouse's current address or job, or other identifying information, could endanger her or him. The Commissioner currently redacts this information from the information provided the nonelecting spouse "when warranted," according to a recent news item, but even the IRS is not clear whether this information would have to be provided if the nonelecting spouse pressed for disclosure of the entire administrative file under the Freedom of Information Act.[13]

Availability of Judicial Review of Administrative Decisions Under Code Sec. 6015(f)

A second major development in judicial interpretation of Code Sec. 6015 has been the Tax Court's determination that it has jurisdiction to review denials by the Commissioner of relief under the provisions of Code Sec. 6015(f), applying an abuse of discretion standard. Initially, the Commissioner, and many practitioners, assumed that the language contained in Code Sec. 6015(e) limited Tax Court review to appeals from administrative denials of elections made pursuant to Code Sec. 6015(b) or Code Sec. 6015(c). This was the Commissioner's consistent litigating position until Spring 2000.

In *M.B. Butler*,[14] the electing spouse sought relief from joint and several liability pursuant to Code Sec. 6015(b). The Commissioner had issued a joint notice of deficiency to Ms. Butler and her husband based on their failure to report pass-through income from an S Corporation in which he was a shareholder. In their joint petition to the Tax Court, Ms. Butler claimed innocent spouse relief pursuant to former Code Sec. 6013(e). Subsequent to the trial, Code Sec. 6015 was enacted, and Ms. Butler was unsuccessful in convincing the Commissioner to reconsider her claim administratively under Code Sec. 6015(f).

The court performed a detailed analysis of why Ms. Butler did not qualify for relief under Code Sec. 6015(b), pointing to her business acumen and her involvement in her husband's finances. Irrespective of its conclusion, the court took the opportunity specifically to reject the Commissioner's argument that the flush language of Code Sec. 6015(e)(1) referencing only elections under Code Sec. 6015(b) or (c) precluded the court's review of the Commissioner's denial of relief under Code Sec. 6015(f). Noting the strong presumption reflected in case law that an administrative decision always is subject to judicial review, the court held that the exception to that presumption (*i.e.*, actions that, unequivocally, have been committed to agency discretion by law) did not apply in this case. Finally, relying heavily on the language in Code Sec. 6015(e)(1)(A) that an electing spouse may petition the court to "determine the appropriate relief available to the individual *under this section*," the court found no limitation in the phrase "this section," which precluded its review of the Commissioner's determination under Code Sec. 6015(f).

The court, in *Butler*, determined that the appropriate scope of its review would be to apply a "facts and circumstances" analysis, but only to determine if an "abuse of discretion" had occurred. The court clearly does not intend to review *de novo* the Commissioner's determinations under Code Sec. 6015(f). Applying an abuse of discretion standard of review to the facts before it, the court concluded that the Commissioner had not abused his discretion in denying relief to Ms. Butler because she was "fully engaged" in the family's finances; she was still married to and living with the nonelecting spouse; there was no demonstration of prospective economic hardship if relief was not granted; and there was no evidence that the nonelecting spouse had ever abused Ms. Butler in any way. Therefore, since there was no "compelling reason" for the Commissioner to grant relief, the denial of relief was not an abuse of discretion.

In a case decided shortly after *Butler*, the court found in *D. Fernandez*[15] an opportunity to articulate further the extent of its jurisdiction under Code Sec. 6015(f) in a context in which it also found that the Commissioner had abused his discretion in denying relief to the electing spouse. Since the court had upheld the Commissioner's determination in *Butler*, the Commissioner was not able to appeal the court's holding regarding its jurisdiction under Code Sec. 6015(f). *Fernandez* presented the first opportunity for the Commissioner to challenge the court's position on its jurisdiction. The rapidity with which the Commissioner acquiesced to the *Fernandez* decision,[16] stunned many in the practitioner community. The following month, Chief Counsel issued an even more stunning Notice announcing a change in the IRS's litigating position with respect to the Tax Court's Code Sec. 6015(f) jurisdiction.[17] The Commissioner's acquiescence in *Fernandez* and Chief Counsel's subsequent Notice appear to have settled the IRS's litigation posture regarding the scope of the Tax Court's jurisdiction to hear appeals from administrative denials of relief. It remains to be seen whether the court intends its jurisdiction under Code Sec. 6015(f) to encompass *all* proceedings before it where Code Sec. 6015(f) has been raised, whether as an affirmative defense to a deficiency notice, or in the context of a collection due process hearing or pursuant to proceedings under Code Sec. 6015(e). The trap for the unwary currently is hidden in the court's holding in *Fernandez:* reasoning that the language in Code Sec. 6015(e)(1) is a procedural requirement applicable to all electing taxpayers, and not a substantive limitation on its jurisdiction, the court deems its Code Sec. 6015(f) review available only to those who also make an (unsuccessful) election for relief under Code Sec. 6015(b) or (c).[18]

Fernandez, read literally, precludes Tax Court review of relief sought by spouses in nondeficiency situations, *e.g.*, those situations where the tax shown as due on the filed return has not been paid.

As a matter of statutory construction, the court's analysis in *Fernandez* is unsatisfying. Its decision in *Butler* did not depend on parsing language. The court may have been seeking a more explicit statutory justification for its review of Code Sec. 6015(f) determinations than provided in *Butler*. In the process, however, it raised several troubling issues. *Fernandez*, read literally, precludes Tax Court review of relief sought by spouses in nondeficiency situations, *e.g.*, those situations where the tax shown as due on the filed return has not been paid.

In addition, the reasoning in *Fernandez* appears to preclude Tax Court review of unfavorable Code Sec. 6015(f) determinations for spouses in community property states filing separately. Code Sec. 66(c) applies to situations where one spouse files a separate return, not knowing or having reason to know that an item of community income was omitted from the return, and equity calls for relief.[19] RRA '98 added a Code Sec. 6015(f) equitable relief "equivalent" to Code Sec. 66(c).[20] An individual filing a separate return from a community property state has no access to Code Sec. 6015(b) or (c) elections, and must rely solely on Code Sec. 66(c). Given the position taken by the Commissioner in the recent *K. Cheshire*[21] case (discussed *infra*), a spouse seeking relief in a community property state has an uphill battle.

In the last of the Code Sec. 6015(f) decisions, *F.L. Charlton*,[22] the court had before it for the first time, both spouses making elections for relief under multiple provisions of Code Sec. 6015. Mr. Charlton concedes that there is an income omission on his ex-wife's (Sarah Hawthorne) Schedule C but

argues for relief, under Code Sec. 6015(b) or (c), from the additional self-employment tax because the Schedule C is Ms. Hawthorne's "item." Ms. Hawthorne concedes that she does not qualify for relief under Code Sec. 6015(b) or (c) with respect to certain rental expense deductions from her ex-husband's rental activities, but argues for relief under Code Sec. 6015(f). Judge Colvin reaffirms the court's jurisdiction under Code Sec. 6015(f), citing only to *Butler*, although the *Fernandez* case had been released before *Charlton*. Because the Commissioner had not fully considered Hawthorne's claim, the court returns the case to administrative status noting that Ms. Hawthorne may file a motion to seek the court's review of any denial of Code Sec. 6015(f) relief.

The "sleeper" in *Charlton* is Judge Colvin's analysis of Mr. Charlton's entitlement to relief under Code Sec. 6015(b) and (c). Finding that Charlton prepared the couple's return, that he was generally familiar with his ex-wife's schedule C activities, and that he had unfettered access to the schedule C financial data, Judge Colvin concludes that Charlton "had reason to know" that income on the schedule C had been understated. However, treating Code Sec. 6015(c) as a "no fault" provision,[23] the court concludes that at the time he signed the return, Mr. Charlton did not have actual knowledge that income had been omitted from the schedule C, *even though* Charlton had access to, but did not compare, the schedule C bank records with the list of income given to him by Ms. Hawthorne. Charlton's credible testimony, coupled with evidentiary flaws in respondent's case,[24] resulted in respondent failing to carry the burden to show Mr. Charlton's *actual* knowledge of the omitted income. For Code Sec. 6015(c) relief, Charlton's "reason to know" was irrelevant.

The Elusive Grinning Specter: *K. Cheshire*

In its most recent decision in the Code Sec. 6015 relief arena, the Tax Court has reopened the long standing controversy under former Code Sec. 6013(e) regarding what constitutes "knowledge" for purposes of denying relief from joint and several tax liability.[25] With respect to income omissions, these authors understood the standard under former Code Sec. 6013(e) to be "could a reasonable person under the taxpayer's circumstances at the time s/he signed the return be expected to know income had been omitted from the return?" In other words, the spouse seeking relief had to establish that in signing the return, s/he did not know or have reason to know that an income-producing transaction attributable to his/her spouse was not reported on their joint return.[26]

Back in the "bad old days" of Code Sec. 6013(e)(post-1984), there was a split among the Circuits and the Tax Court regarding the extent of the knowledge required under the "knew or should have known" criteria of that subsection to deny relief to the "innocent spouse" with respect to liability resulting from a grossly erroneous deduction attributable to the other spouse. The Tax Court, following a 1987 Sixth Circuit case *(J. Purcell)*, applied the same "knowledge-of-the-transaction" test used in omission of income cases to erroneous deduction cases; *i.e.*, would a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return be expected to know that the tax liability was understated or that further investigation was warranted. Mere knowledge of the underlying transaction that was the source of the grossly erroneous deduction, credit or basis precluded relief under Code Sec. 6013(e).[27] In *Bokum*, the Tax Court inquired into whether the spouse had reason to know that the basis claimed for S corporation stock was overstated by her husband in an apparent effort to reduce the amount of gain reported on the distribution of the proceeds from the sale of corporate assets. The court concluded that since the spouse knew of the sale of the underlying corporate assets, she was precluded from innocent spouse relief. The court based this determination on its perception that a reasonably prudent taxpayer in spouse's position would be expected to know that further inquiry or investigation was warranted. Therefore, spouse had a duty to inquire about the correctness of the amount of the basis subtracted from the proceeds distributed.[28] Mrs. Bokum could not obtain the benefits of Code Sec. 6013(e) by "turning a blind eye"—by preferring not to know of facts fully disclosed on a tax return of such a numerical magnitude as would reasonably put her on notice that further inquiry would need to be made. Thus, because a spouse undertakes certain responsibilities when she signs a joint tax return, she cannot escape those responsibilities by ignoring the tax return's contents.[29]

The contrary position, articulated in cases from the Ninth, Eighth, Seventh, Fifth and Second Circuits granted relief to a spouse who established that s/he did not

know, and did not have reason to know, that a deduction taken on the return would give rise to a substantial understatement.[30] In the seminal case of *P.A. Price*, the Ninth Circuit Court of Appeals initially determined that a reasonably prudent person in Mrs. Price's position did not have reason to know that the deduction gave rise to a substantial understatement.[31] However, the court then addressed whether Mrs. Price knew enough facts to put her on inquiry notice, *i.e.*, would a reasonably prudent taxpayer in her position have questioned the legitimacy of the deduction? The court explained that, in such a situation, a duty of inquiry arises "which may result in constructive knowledge of the understatement being imputed to her." The Ninth Circuit stated that the size of the deduction *vis-a-vis* the total income reported, when considered in light of the fact that spouse knew of the investment, was enough to put Mrs. Price on inquiry notice.[32] Nevertheless, the court held that Mrs. Price had satisfied her duty of inquiry because she had questioned her husband about the deduction and had refused to sign the return until her husband assured her that a reputable CPA had prepared it.[33] Thus, constructive knowledge of the substantial understatement was not imputed to Mrs. Price. These authors have understood *Price* and its progeny to articulate the standard for relief from joint and several liability in connection with a grossly erroneous deduction as: "[W]hether 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."[34] The factors to be weighed in applying this standard to a particular set of facts are the same as those in income omission cases (*i.e.*, the spouse's level of education; the spouse's involvement in the family's business and financial affairs; the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and the culpable spouse's evasiveness and deceit concerning the couple's finances) except, mere knowledge of a transaction was insufficient to deny relief unless the spouse was put on notice that a particular deduction might result in a substantial understatement and then failed to inquire further.[35]

As Judge Swift's concurring opinion in *Bokum* aptly points out, the distinctions in "knowledge" of omissions or "knowledge" of deductions triggered by the statutory language of former Code Sec. 6013(e) were ones of semantics. In the final analysis, most courts adhered to the Supreme Court's approach in pornography cases—the judges knew an innocent spouse when they saw one and the facts of each case were given greater or lesser weight to support the conclusion the court wanted to reach.[36] The stated difference between omission and deduction cases was as follows:

> [I]n omission cases the understatement is caused by includable income being left off a return. Therefore, it is considerably easier for a spouse to show that she was unaware of the transaction giving rise to the omission, and thus to qualify for relief. ... But because deductions are necessarily recorded, any spouse who at least reads the joint return will be put on notice that *some* transaction allegedly has occurred to give rise to the deduction ... In addition, when we look beyond the *language* courts have used in omission cases to the *function* such a standard has served, we see that it represents merely a different way of approaching what is the same inquiry as the one we announce today ... That is, in income omission cases, knowledge of the transaction is virtually equivalent to knowledge of the understatement because if a spouse knows of a transaction which generated income that the return does not report, then it is extremely likely that she will know that the return does not report all income (unless she merely lacks knowledge of tax consequences). Thus, the omission cases that have examined whether a spouse had knowledge of the transaction in a sense really have been looking to discern whether she knew or had reason to know of the substantial understatement[37] (*citations omitted*).

In light of the historical context of judicial decisions surrounding former Code Sec. 6013(e), the Tax Court's recent Opinion in *Cheshire*[38] is worthy of attention for several reasons. First, the majority Opinion, written by Judge Jacobs reaffirms the Tax Court's rigid position on what constitutes "knowledge" for items of omitted income under Code Sec. 6015(b). From what must have been a heavily debated court conference, the majority opinion gleaned 10 additional votes.[39] The case also spawned one concurring opinion

and two dissenting opinions, with three judges joining in the dissent written by Judge Colvin.[40] Second, the court appears to have created, intentionally or unintentionally, a new standard by which future cases involving "knowledge" of income omissions under Code Sec. 6015(c) will be reviewed. And, third, the majority analyzes this pension exclusion case as an "omitted income" case under former case law.[41]

Kathryn and David Cheshire were married for 23 years. Ms. Cheshire is a college graduate who, after staying home for 10 years to raise a family, taught elementary school. In 1985, the Cheshires purchased their personal residence that, in 1992, had a mortgage balance of approximately $99,000. In 1992, Mr. Cheshire, an alcoholic by anyone's standards,[42] took early retirement and received a total of $229,924 in lump-sum pension distributions.[43] The majority opinion traces the uses of the funds in some detail. Slightly more than $42,000 was rolled into an IRA account. An amount of $99,425 was used to pay off the personal residence mortgage.[44] $20,000 went to purchase a new Ford Explorer.[45] Unspecified amounts went to pay the family's expenses, provide start-up capital for Mr. Cheshire's new business, acquire a family truck, buy a car for one of their children and open a college bank account for their daughter. In addition, Mr. Cheshire took approximately $45,000 of the funds and opened a brokerage account for himself. When David Cheshire prepared the couple's 1992 income tax return, he reported a pension distribution of $199,771 *on the return*, and excluded $143,621 of that amount as not taxable.

Here's the "rub": *Noting the difference in reporting between gross distributions and the reported taxable amount on the face of the return, and before she signed the return, Ms. Cheshire questioned her husband about the correctness of excluding a portion of the distribution from taxable income.* Lying, David told his wife that he had consulted with a local CPA and had been advised that the pension funds that were rolled into the IRA, as well as those used to pay off the residence mortgage, were not taxable. Apparently, this was David's second big lie. The first being his initial deceit in not disclosing to his wife (and by not reporting on their tax return) that an additional $30,153 had been distributed to him by his employer from various retirement-related accounts.[46]

> The extensive factual recitation in [*Cheshire*] suggests ... that the majority believes it knows an innocent spouse when it sees one, and Ms. Cheshire was not it.

Accepting her husband's answer regarding the tax consequences of the pension distribution (at least to the extent of her knowledge of having received $199,771 into the community), Ms. Cheshire signed the return, which showed *de minimus* tax due, and presumed her husband would write a check and mail the return. The Cheshires separated in July 1993, and their dissolution became final in December 1994. In August 1994, after receiving an inquiry from the IRS, Ms. Cheshire discovered David's third and fourth lies—the return had not been mailed, nor had the tax or the credits reflected on the return for estimated tax payments, been paid. Ms. Cheshire borrowed money to pay the $8,526 in total tax due on the return, which she filed in response to the IRS inquiry. The Commissioner issued a statutory notice of deficiency, *inter alia*, for the unreported $30,153 in distributions and the understated taxable amount of the pension distribution ($229,924 less $42,183 less $56, 150), $187,741.[47] Respondent reduced Ms. Cheshire's exposure by conceding her entitlement to relief from joint and several liability with respect to the $30,153 in additional pension distributions that David failed to disclose to her or report on their joint tax return.[48]

The majority analyzes Ms. Cheshire's eligibility for Code Sec. 6015 relief under subsections (b), (c) and (f). Judge Jacobs finds subsection (b) inapplicable because of Ms. Cheshire's "actual knowledge of the underlying transactions ... giving rise to the ... understatement of tax."[49] Despite the complete repeal of former Code Sec. 6013(e), the majority finds the language of new Code Sec. 6015(b)(1)(C) similar enough to warrant application of prior case law. Citing to *Bokum*, the court concludes that its existing standard for "knowledge" in omitted cases remains viable as the standard to apply to elections for relief under Code Sec. 6015(b)(1)(C), *i.e.*, "actual knowledge of the underlying transaction that produced the omitted income. ..." is fatal.[50]

In denying Ms. Cheshire relief under Code Sec. 6015(c), the court

points to the statutory language that denies relief if the Commissioner "demonstrates that the [electing spouse] had actual knowledge, at the time such individual signed the return *of any item giving rise to a deficiency*. ..." [51] The court formulates a new "knowledge" standard for elections under Code Sec. 6015(c): an actual and clear awareness ... of the existence of an item which gives rise to the deficiency. ...[And, it says,] [i]n the case of omitted income, the electing spouse must have an actual and clear awareness of the omitted income." [52] In a footnote, the court says it is leaving "to another day" the manner in which this new standard will be applied in disallowed deduction cases.[53]

The *Cheshire* facts would seem to make this case one more analogous to a deduction case than an income case. Page one of a Form 1040 provides lines for reporting the gross amount of a pension distribution and for reporting the amount of the distribution that is taxable in the current year. Mr. Cheshire was correct to exclude from the gross distribution amount the sum which he rolled over into an IRA. He was incorrect in excluding the amount used to pay off the residence mortgage. It is not a stretch to compare the exclusions associated with the pension reporting by the Cheshires to the mischaracterization between ordinary income and capital gain done by the Bokums.[54] In *Bokum*, the court concluded that the mischaracterization amounted to a deduction item because all gross income amounts had been reported as *something* on the tax return.

Notwithstanding footnote 6 in *Cheshire*, it is difficult to imagine how the court will distinguish deduction cases under Code Sec. 6015(c)(3)(C). As the facts reflect, Ms. Cheshire saw the large amount of the pension distribution reported on the face of the income tax return. Even the Ninth Circuit would find an inquiry obligation had arisen because of the magnitude of the amount.[55] Once inquiry is made (presumably before the return is signed) and a response received, the spouse has become aware (actually and clearly) of the existence of the item on the tax return which subsequently gives rise to the deficiency. If there is no inquiry (as in *Charlton*) or the inquiry does not produce a response (or a satisfactory response), and the electing spouse signs the return in "blissful" ignorance, will the court grant relief?[56]

In formulating its analysis of Code Sec. 6015(c) relief in omitted income cases, the court focuses on the single word "item" as referring to the item of income that should have been reported on the return.[57] But the statutory phrase is "any item giving rise to a deficiency (or portion thereof) which is not allocable to such individual. ..."[58] The Cheshires did report the pension distribution on the face of the return. The disparity resulted from the amount, which Mr. Cheshire chose to exclude as not subject to tax. In his concurring opinion, Judge Thornton states that the majority in defining "item" in the manner it does, has "inherently reject[ed] respondent's argument that actual knowledge of an 'item' means actual knowledge merely of the event or transaction giving rise to the deficiency." [59] He finds it "most likely" that the phrase "actual knowledge that an item on a return is incorrect" in the legislative history refers to gross income from a particular source that is *incorrectly reported on the return*. And the electing spouse's understanding or belief regarding the proper tax treatment for the omitted item (in this case) is immaterial.[60]

One of the more puzzling aspects of *Cheshire* is the manner in which the majority finds the Commissioner abused his discretion in not applying Code Sec. 6015(f) to grant relief from the accuracy-related penalty assessed to Ms. Cheshire with respect to the taxable portion of the pension distribution. Finding that Ms. Cheshire had reasonable cause and acted in good faith in her acceptance of Mr. Cheshire's explanation for the reduction in the taxable portion of the distribution, the majority relieves Ms. Cheshire of the penalty.

The machinations that the majority has gone through to deny relief to Ms. Cheshire will cause practitioners to struggle with new standards, and old law applied to new statutes, for some time to come. The extensive factual recitation in the case suggests to these authors that the majority believes it knows an innocent spouse when it sees one, and Ms. Cheshire was not it. In reading the facts which the court chooses to emphasize, it is difficult not to think that the majority simply did not believe Ms. Cheshire should be relieved of liability because she had benefited from the pension funds to the extent used to acquire unencumbered assets distributed to her in the marital dissolution. While the majority makes a point of acknowledging that there is no "equitable" element in Code Sec. 6015(c), it appears to have fashioned its own substitute in the *Cheshire* case with its new "actual and clear awareness" standard. It would have been preferable for the court to find that, because of the facts and circumstances specific to the Cheshires in this case, the pension distribution was a shared item of both spouses

for which Ms. Cheshire could not elect relief under Code Sec. 6015(b) or (c).[61]

The dissents by Judges Parr and Colvin[62] emphasize the remedial nature of new Code Sec. 6015, the clear congressional intent to provide broader relief than was available under former Code Sec. 6013(e) and the need to construe the language of the statute liberally to implement congressional intent. Both view the language of the subsection as ambiguous, requiring examination of the legislative history, and find the majority's construction of Code Sec. 6015(c)(3)(C) in conflict with that legislative history. And, both caution against the application of interpretations of former Code Sec. 6013(e) to the broad structural and substantive changes resulting in new Code Sec. 6015.

Judge Colvin is particularly critical of his colleagues for relying on an unpublished (and he believes, inapplicable) Ninth Circuit case[63] to support the majority's analysis of Code Sec. 6015(c) and in failing to address his opinion in *Charlton* (discussed *supra*). Judge Colvin believes that the majority's failure to distinguish, or otherwise address, the *Charlton* decision, will result in confusion and inconsistent treatment for electing spouses. If Judge Thornton's concurring opinion accurately reflects the majority position on Code Sec. 6015(c)(3)(C), it may be that Judge Colvin has misconstrued his colleagues' holding. It was possible for Mr. Charlton to be actually and clearly aware that his wife has her own business without being actually and clearly aware that she had failed to report all the income from it on their joint tax return. The majority did not hold that knowledge of the income-producing activity bars relief under Code Sec. 6015(c) as respondent had urged. The majority opinion is much more insidious because it holds that if you learn about income because it is reported somewhere on the tax return, but are misled about its character for tax purposes, you can never obtain relief under Code Sec. 6015(c) because you have "actual and clear knowledge" of the "item" giving rise to the deficiency.

Conclusion

Since January, the Tax Court has done much to grapple with the ambiguities and omissions that make up the patchwork quilt which is Code Sec. 6015 in an effort to provide guidance and direction for taxpayers and their representatives, as well as for the Commissioner. We now know that nonelecting spouses have significant rights of participation in proceedings involving relief from liability for the electing spouse. We also know that under many circumstances, the Tax Court will review cases in which the Commissioner has denied relief under Code Sec. 6015(f). And, we know that case law under former Code Sec. 6013(e) continues to permeate the court's thinking in the difficult analysis of the concept of "knowledge." There are certainly many unanswered questions remaining. However, the court's willingness to step up, as quickly as circumstances permit, and state it's position on these issues is a clear statement of its recognition of the need for guidance in this area.

ENDNOTES

[1] Restructuring and Reform Act of 1998 (P.L. 105-206) (RRA '98). RRA '98 expanded the relief offered an electing spouse significantly beyond what was provided by Code Sec. 6013(e). Code Sec. 6015 provides for election out of joint and several liability (Code Sec. 6015(b)); elective limitation of liability (Code Sec. 6015(c)); and, equitable relief where neither election is available (§6015(f)). While the requirements for an election under Code Sec. 6015(b) derive from former Code Sec. 6013(e) (in significantly modified form), in no case does relief from joint and several liability hinge on whether the electing spouse would have qualified for relief under former Code Sec. 6013(e). For ease of reference, throughout this article the expanded relief from joint and several liability provided by Code Sec. 6015 will be referred to collectively as "Code Sec. 6015 relief."

[2] For purposes of this article, the term "electing spouse" means that spouse who is requesting the Code Sec. 6015 relief in question. The term "nonelecting spouse" means that spouse who is not seeking the Code Sec. 6015 relief sought by the first spouse. These terms necessarily are imprecise. Nothing prevents a "nonelecting spouse" from making his or her own separate request for Code Sec. 6015 relief.

[3] *See*, for example, *S. Ravetti Est.*, CA-9, 94-2 USTC ¶50,524, 37 F3d; *S.P. Garvey*, 66 TCM 355, Dec. 49,206(M), TC Memo. 1993-354; *V.F. Himmelwright*, 55 TCM 403, Dec. 44,644(M), TC Memo. 1988-114.

[4] *T. Corson*, 114 TC—, No. 24, Dec. 53,882 (2000).

[5] *Id.*, slip op. at 5. The IRS took two years to address the Code Sec. 6013(e) issue. Appeals began its investigation in early 1998. On July 8, 1998, it advised Mrs. Corson that it had served notice of the claim on Mr. Corson, had solicited his input and intended to deny her claim. The authors are unaware why Appeals would have solicited Mr. Corson's input prior to the effective date of RRA '98, since the law in effect at that time contained no provision for spousal notification.

[6] The court cites to its recent decisions in *M.B. Butler*, 114 TC 276, Dec. 53,869 (2000) and *F.L. Charlton*, 114 TC 333 Dec. 53,879 (2000). *See supra* note 4, (slip op. at 16-17).

[7] Citing to *D. Fernandez*, 114 TC 324 (2000). *See supra* note 4, (slip op. at 17).

[8] *See supra* note 4, (slip op. at 19-20).

[9] *See supra* note 4, (slip op. at 13).

[10] An issue may not be raised at a due process collection hearing if "the issue was raised and considered at a previous hearing under Code Sec. 6320 or in any other previous administrative or judicial hearing" and "if the person seeking to raise the issue participated meaningfully in such."

[11] *K.A. King*, 115 TC—, No.8, Dec. 53,994 (2000).

[12] *Supra* note 11 (slip op. at 13). The court apparently does not envision circumstances under which a nonelecting spouse should, or could, be deemed to have sat on his/her rights, or to have participated meaningfully in some other judicial proceeding such as would preclude the "necessary procedural

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requirements" it has seen fit to impose through the *King* case.

[13] *Innocent Spouse Issues Plague Practitioners, IRS, and Courts*, TAX NOTES TODAY, 2000 TNT 115-4 (June 14, 2000).

[14] *See Butler, supra* note 6.

[15] *See Fernandez, supra* note 7.

[16] AOD CC-2000-06.

[17] CC Notice N(35)000-338: "[t]he Service now agrees that the Tax Court, the United States District Courts..., and the Court of Federal Claims have jurisdiction to consider whether the Service abused its discretion in denying equitable relief under [§]6015(f)." This presumptuous "anointing" of jurisdiction will inevitably be revisited in the future.

[18] "... before an individual may petition this Court for review of innocent spouse relief, including relief under subsection (f), such individual must make an election under subsections (b) and/or (c)." *But see* the broader language in *Butler* that an administrative decision always is subject to judicial review, and under Code Sec. 6015(e)(1)(A), the court has jurisdiction to Adetermine appropriate relief ... under this section.

[19] The statute says nothing about overstated deductions resulting in an incorrect reporting of adjusted gross income, and therefore, a deficiency.

[20] "[I]f taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency... attributable to an item for which relief is not available under the preceding sentence, the Secretary may relieve such individual of such liability."

[21] *K. Cheshire*, 115 TC—, No. 15, Dec. 54,028 (2000).

[22] *F.L. Charlton*, 114 TC 333, Dec. 53,879 (2000).

[23] The court's analysis does not consider even whether a duty to inquire exists under Code Sec. 6015(c), presumably because Judge Colvin did not read the subsection to impose such a standard.

[24] At trial, respondent apparently introduced the bank records but not the list.

[25] Congress first implemented an exception to joint and several liability for certain spouses who filed joint returns in the form of an innocent spouse provision in 1971. *See* Act of Jan. 12, 1971, Section 1, P. L. 91-679, 84 Stat. 2063. The original provision provided relief only to those innocent spouses who were otherwise subject to liability because of an understatement due to an omission of taxable income. In 1984, Congress expanded the scope of the provision, bringing within its ambit deficiencies arising from invalid deductions, credits or basis. *See* Tax Reform Act of 1984, P.L. 98-369, Section 424, 98 Stat. 494, 801-803 (1984).

[26] Under former Code Sec. 6013(e), all income omissions were deemed to be grossly erroneous. *See*, for example, *J. Bliss*, CA-2, 95-2 USTC ¶50,370, 59 F3d 374, 378 n.1; *A.M. Resser*, CA-7, 96-1 USTC ¶50,045, 74 F3d 1528, 1535-36; *D.L. Wiksell*, CA-9, 96-2 USTC ¶50,398, 90 F3d 1459.

[27] *R.D. Bokum II*, 94 TC 126, Dec. 46,408 (1990), aff'd on other grounds, CA-11, 93-2 USTC ¶50,374, 992 F2d 1132,; *J. Purcell*, CA-6, 87-2 USTC ¶9479, 826 F2d 470, 474; *N.N. Bellour*, 69 TCM 3010, Dec. 50,717(M), TC Memo. 1995-284; *see also S. Berman*, 66 TCM 1798, Dec. 49,509(M), TC Memo. 1993-629 (taxpayer denied innocent spouse status despite her lack of knowledge of culpable husband's fraud).

[28] *See Bokum, supra note 27*, at 147-148. Before reaching its holding in *Bokum*, the court first had to determine whether the understatements on the return were attributable to income omissions or grossly erroneous deductions. The court concluded that *both* the basis issue and the capital gain/ordinary income characterization issue should be analyzed as erroneous deductions.

[29] *Bokum, supra* note 27, at 148.

[30] *P.A. Price*, CA-9, 89-2 USTC ¶9598, 887 F2d 959; *G. Erdahl*, CA-8, 91-1 USTC ¶50,184, 930 F2d 585, 589; *R.J. Reser*, CA-5, 97-1 USTC ¶50,416, 112 F3d 1258, 1267; *J. Hayman*, CA-2, 93-1 USTC ¶50,272.

[31] *See Price, supra* note, at 965.

[32] *See Price, supra* note, at 965-966.

[33] *See Price, supra* note 30, at 965.

[34] *See Reser supra* note 30 (the proper test of a spouse's knowledge in an erroneous deduction case is whether the spouse seeking relief knew or had reason to know that the *deduction* in question would give rise to a substantial understatement of tax on the joint return); *See also, Stevens*, CA-11 USTC ¶9330, 872 F2d 1499; *see* Erdahl, *supra* note 30.

[35] *See Price, Hayman, Erdahl* and *Reser, supra* note 30. *See P.H. Friedman*, CA-2, 95-1 USTC ¶50,235, 53 F3d 523.

[36] *See Price supra* note 30, ftnote 10: "The fact that [the factors used to analyze knowledge for deduction issues] comport with factors courts have used in omission cases further bolsters our assertion that the legal standard we announce today is in essence no different functionally than the one used in omission cases."

[37] *See Price, supra* note 30, ftnote 9.

[38] *Supra* note 21.

[39] One judge voted with the majority in result only. These writers do not believe that the nonvoting status of the two other judges awaiting confirmation of second terms would have changed the outcome in this case.

[40] Interestingly, *Bokum*, upon which the majority relies heavily to support its analysis of Code Sec. 6015(b), evoked the same disparate reactions from the court in 1990. The majority in *Bokum* garnered ten votes, with Judge Parr, who dissents in *Cheshire*, concurring in the result only. There was one concurring Opinion, and the two dissenting opinions were joined by a total four other judges.

[41] The case is appealable to the Fifth Circuit, which the majority believes will sustain its analysis. *Reser, supra* note 30, relied upon by the majority for that purpose was a deduction case in which the appeals court rejected the Tax Court's ruling that Mrs. Reser knew or had reason to know of the substantial understatement. *See also*, discussion of *Price, supra*.

[42] In March, 1993, his last "gracious" act before beginning a jail sentence for a drunk-driving conviction, was to prepare the Cheshires' 1992 joint income tax return. In June, 1993, clearly a slow learner, Mr. Cheshire was involved in an alcohol-related auto accident.

[43] The couple resided in Texas, a community property state. Ms. Cheshire presumably was entitled to one-half the proceeds of the distribution.

[44] This asset was eventually transferred to Ms. Cheshire as part of the community property division in the couple's marital dissolution.

[45] Ms. Cheshire received this in the property settlement also.

[46] While the opinion does not reflect this, it may be inferred from the concessions made by Respondent before trial to grant Ms. Cheshire "innocent spouse" relief with respect to that amount. *Cheshire*, slip op. at 8.

[47] Except for the penalty discussed, *infra*, the balance of the adjustments are not critical to the Section 6015 relief analysis in this case.

[48] Based upon the positions taken by Respondent in the case, the authors assume that Ms. Cheshire was granted relief under Code Sec. 6015(c) with respect to the unreported $30,153.

[49] *Cheshire*, slip op. at 16. There is a small amount of unreported interest at issue in this case as well but its import to the overall decision is negligible.

[50] *Cheshire*, slip op. at 16.

[51] Code Sec. 6015(c)(3)(C). (*Emphasis added.*) The court finds "merely example" the Conference Report that "if the I.R.S. proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply. ..." H. CONF. REPT. 105-599, at 253 (1998).

[52] *Cheshire*, slip op. at 19.

[53] Of which, the electing spouse presumably will always have actual and clear awareness because an excess deduction will always appear on the tax return somewhere.

[54] "On their 1977 tax return, petitioners reported the entire dividend portion of the distribution

from Quinta. Thus, even though the parties' *settlement* shows that Quinta's misallocation caused petitioners to report too much as long-term capital gain and too little as a dividend ... the effect of the mischaracterization adjustment to petitioners' tax return is to disallow petitioners' section 1202 deduction against this item. Thus, the mischaracterization adjustment relates to a 'claim of a deduction. ...'" *Bokum, supra* note 27, at 141-142.

[55] In fact, Ms. Cheshire did inquire further regarding the taxable versus nontaxable portions of the pension distribution as her husband had reported them on their joint return.

[56] "For purposes of Code Sec. 6015(c), unlike for purposes of Code Sec. 6015(b) and (f), equitable considerations in holding the putative innocent spouse liable for unpaid tax or any deficiency are of no import." *Cheshire*, slip op. at 18. But then, "[s]ection 6015(c)(3)(C) does not explicitly state or reasonably imply that relief is denied only where the electing spouse has actual knowledge that the item ... is *incorrectly* reported on the return." *Cheshire*, slip op. at 20. (Emphasis in original.)

[57] The majority states that it is of no import that Ms. Cheshire did not know that the amount of the retirement distribution was misstated on the return. *Cheshire*, slip op. at 23. This cannot be the case since the facts clearly state that the entire amount, of which Ms. Cheshire was aware, was reported on the tax return and that prior to trial the Commissioner granted relief (presumably under Code Sec. 6015(c)) to Ms. Cheshire for the additional $30,153, which her husband did not tell her about and which was not reported on their return. *See* also, *Charlton* discussion, *supra*.

[58] Code Sec. 6015(c)(3)(C).

[59] *Cheshire*, slip op. at 29.

[60] *Cheshire*, slip op. at 30. Is not this the situation for Katherine Cheshire?

[61] Living in a community property state entitled Ms. Cheshire to one-half the proceeds of the pension distribution which she appears to have received in the form of the personal residence and the jeep.

[62] Judge Colvin also dissented in *Bokum*.

[63] *D.L. Wiksell*, CA-9, 2000-1 USTC ¶50,330, 215 F3d 1335 (unpublished), affg. 77 TCM 1336, Dec. 53,236(M), TC Memo 1999-32. This is the sequel case to *Wiksell*, CA-9, 96-2 USTC ¶50,398, 90 F3d 1459, in which the Ninth Circuit crafted a "partial innocence" concept under former Code Sec. 6013(e) which found its way into the new statute as Code Sec. 6015(b)(2). On remand, the Tax Court granted partial relief to the taxpayer under former Code Sec. 6013(e). Not satisfied, Ms. Carpender (Wiksell) sought total relief under new Code Sec. 6015(c).