The innocent spouse: a close look at a classic case

On appeal, the court sees a very different story.

By David Ellis, CPA
Guest Contributor

At first it looked like Karen Wilson had finally caught a break. Her husband, Lloyd, had gone from a small-time self-employed insurance salesman earning about $30,000 a year, to a maven of international finance netting $20,000 a month. This new-found cash flow eventually was enough to provide the Wilsons with two houses in Modesto, California, (before the housing crash) and $250,000 in an offshore bank account. Then the letter came.[1]

The Wilsons were married in 1983. At that time Karen was working as a clerk at a gas station and did not have much education beyond high school. Eventually, she was able to work her way into a position as a loan officer at a local credit union. Lloyd earned about $2,700 a month from his insurance business. Thus it remained for 14 years.

Then sometime in 1997, Lloyd began netting $20,000 a month from a Ponzi scheme called the Venture Fund Group. With cash pouring in, Karen was able to quit her job at the credit union to help Lloyd with bookkeeping and paperwork. Soon they were able to buy two new homes. They used one for a residence and another for an office. Each home had a mortgage.

For tax years 1997 and 1998, the Wilson's filed joint tax returns which were prepared by one Roosevelt Drummer. Mr. Drummer's professional credentials are not stated in the record. On the tax returns, the Wilsons failed to report substantial income that Lloyd was sending to offshore accounts in the name of a grantor trust, which he controlled. As was inevitable, in May of 1999, a letter from the Security Exchange Commission (SEC) arrived ordering Lloyd to "cease and desist" his fraudulent business. Thus, ended the Wilson's $20,000 a month income.

Shortly thereafter, Lloyd hired a licensed CPA to review their situation. The CPA advised the Wilsons to amend their 1997 and 1998 tax returns so as to properly report the offshore trust income. They followed this advice and also had him file their 1999 tax return. When combined, the three years of tax returns showed a total tax liability of $540,000.

Not surprisingly, the bills piled up, and the Wilson's marriage broke down. According to the trial record, Lloyd spent most of 2000 and 2001 "staying home and doing nothing," while Karen took a job with a commercial real estate company. In March of 2002, Karen submitted IRS Form 8857, seeking innocent spouse relief for tax years 1997, 1998, and 1999.

The IRS denied Karen's request for relief in March of 2003 based on its finding that she "did not have a reasonable belief" that the tax would be paid because there was an outstanding balance from 1998 when the 1999 return was filed. Karen and the IRS appeals office went back and forth for a time but got nowhere. Eventually, she petitioned the Tax Court and the case went to trial in 2005, with Karen representing herself. This trial did not go well for Karen, but for a variety of reasons, she was granted a second trial, this time with the assistance of a *pro bono* counsel. A second trial was held in 2008. Meanwhile the Wilson's divorce had been finalized in 2007.

The court's opinion

When married couples file a joint tax return, both spouses are generally liable for the return's accuracy, as well as the entire amount of tax due. However, in certain cases it is possible for the spouse to be granted relief under the "innocent spouse" provisions of IRC §6015. Specifically, §6015(f) grants relief if "taking into account all the facts and circumstances it is inequitable to hold the individual liable."

The court used a seven-factor balancing test to decide if Karen should be granted innocent spouse relief:

1. Marital status: Since Karen was legally divorced from Lloyd, this factor weighed in her favor.
2. Abuse: No evidence was presented that Karen was abused by Lloyd. This factor was deemed to be neutral.
3. Significant benefit: This factor weighs against relief if the requesting spouse "significantly benefited (beyond normal support) from the unpaid tax liability or items giving rise to the deficiency." IRS regulations define a significant benefit as "any benefit in excess of normal support." In other words, a spouse cannot enjoy "the lifestyles of the rich and famous" with ill-gotten gains and then expect the government to grant him/her a tax waiver via innocent spouse relief.
   In Karen's case, both the IRS and the Tax Court found in Karen's favor on this issue.
4. Later compliance with federal tax laws: Because Karen had several minor tax debts (outside of the tax debts she jointly incurred with Lloyd), and she presented no evidence that their debts had been resolved, this factor "slightly weigh[ed] against relief."
5. No knowledge or reason to know the taxes would not be paid: If a spouse signs a joint return knowing or having reason to know that the taxes will not be paid, this is considered a factor which can weigh against the granting of innocent spouse relief. Taking several factors into consideration, including Karen's evident lack of business sophistication and limited education, the court ruled that it was reasonable to believe that at the time she signed the tax returns, the taxes would eventually be paid. Thus, the "knowledge factor" was not deemed to weigh against granting Karen relief.
6. Economic hardship: This factor will weigh in favor of the taxpayer if satisfaction of the tax liability will leave the taxpayer unable to pay basic living expenses. The court found that Karen credibly testified that paying a $540,000 tax debt would render her "unable to meet reasonable basic living expenses." At best after taking into account only necessities, Karen only had $114 a month to spare, and the court found that such a small sum would be "grossly insufficient" to pay down the tax debt in any meaningful way.
   The court also took note of the fact that Karen's lifestyle was "anything but luxurious," as she was living in a modest home in Modesto, California, while supporting a minor son in penury. Taking all of the above into consideration, the court ruled that the economic hardship factor weighed in Karen's favor.
7. Attribution: The last contested fact was whether the tax liability was attributable to Lloyd. Here the court found that Karen merely assisted with clerical duties and had no real understanding of Lloyd's business. The court therefore ruled that the tax liability was entirely attributable to Lloyd.

Thus, Karen had five of the seven factors weigh in favor of relief (no knowledge, economic hardship, attribution, divorced, and no significant benefit). The court therefore concluded that granting Karen relief from her joint tax liability for the years in question was appropriate. This means that the IRS can no longer pursue her for any of the debt she incurred while she was married to Lloyd. Her $540,000 tax liability was wiped away with the stroke of a pen.

And what of Lloyd? The IRS must now turn to him as the sole source for collecting the $540,000 in back taxes (plus penalties and interest). We know not what has become of this matter, for outside of Tax Court proceedings a taxpayer's dealings with the IRS are generally confidential. Perhaps Lloyd has filed bankruptcy or made use of one of the payment options offered by the IRS such as an offer in compromise or an installment payment plan. Presumably the IRS collected the $250,000 in the foreign bank account and any other liquid assets to be found. However, when all is said and done, what we are left with is one innocent spouse (Karen) and one large unpaid tax debt.

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[1] ***Karen Marie Wilson v. Commissioner of Internal Revenue*** (January 15, 2013) United States Court of Appeals, Ninth Circuit, Case No. 10–72754