



## IN CASE YOU MISSED IT – January 2023

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Almost every day, federal and state courts issue opinions that affect taxpayers. The IRS and state taxing authorities also publish guidance on myriad topics.

Each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

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[Jason Todd Reynolds et al v. Commissioner](#) – Wife denied relief from joint tax liability

[Code Sec. 6013](#) provides that when a married couple files a joint income tax return, each spouse is jointly and severally liable for the entire tax due during the taxable year. Joint and several liability may create a situation where one spouse is responsible for actions of the other spouse that they feel they had no part of and received no benefit from. In certain cases, it would be unfair to hold the innocent spouse liable for the actions of the guilty spouse. In recognition of this inequity, Congress has provided relief to the innocent spouse from joint and several liability through [Code Sec. 6015](#). This case demonstrates the judicial analysis that a Court engages in when considering whether or not relief under Code. Sec. 6015 is appropriate.

The years at issue in this case were from 2004 to 2007. The taxpayers were married in 2002 and had five children. The taxpayers lived in a five-bedroom house, had four cars, sent their children to private school, and went on a family vacation at least annually. The facts revealed that during those years the taxpayer-husband sometimes bought luxury gifts including designer bags for his wife.

Taxpayer-wife was a licensed attorney who maintained a solo law practice from her basement during the years before the court. Taxpayer-husband was the director of finance for National City Christian Church from 2001 to 2008, with an annual salary of \$95,000.

The couple had two jointly held bank accounts which were used to cover household expenses. Taxpayer-husband was responsible for the family's finances, including preparing yearly tax returns.

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Taxpayer-wife was responsible for maintaining the household, including paying private school tuition and shopping for household items.

Throughout the years at issue, in addition to his annual salary that was paid bi-monthly, taxpayer-husband was embezzling funds from the church where he worked. He would write himself checks out of the church's checking account and depositing the money into the joint bank accounts that he maintained with his wife. The checks were similar in amount to those he received for his salary, but were deposited at sporadic intervals. He was eventually indicted and sentenced to 97 months in prison for the embezzlement.

The couple remained married throughout his prison sentence from 2013 to 2018. In fact, during that time, taxpayer-wife gave birth to the couple's fifth child.

The crime put the family into financial distress. In 2013, taxpayer-wife filed for chapter 7 bankruptcy, the house was foreclosed on in 2014, and she and the children were forced to move in with her parents.

In 2014 taxpayer-wife got a job with the U.S. Department of Agriculture with an annual salary of \$143,000 per year. She was able to buy a new house in July 2016, and when taxpayer-husband was released from prison in May 2018, he moved into the family's new home.

Not surprisingly, taxpayer-husband failed to include his embezzled funds on the couple's income tax returns for the years 2004 to 2007, resulting in an understatement of income, and leaving the couple jointly and severally liable to the IRS for hundreds of thousands of dollars of tax deficiency, interest, and penalties. In 2014, taxpayer-wife timely filed a petition for innocent spouse relief from these joint and several liabilities under Code. Sec. 6015.

Code Sec. 6015 provides three possible avenues for spouses seeking relief from joint and several liability. Code Sec. 6015(b) and (c) are statutory relief measures that apply if certain enumerated conditions are met. Code Sec. 6015(f) is an equitable relief measure that may apply when the taxpayer cannot satisfy the conditions of 6015(b) or (c), but it would be inequitable to hold the individual liable. The taxpayer bears the burden of proving they are entitled to relief under all three of these possibilities.

Relief under Code Sec. 6015(c) requires that the taxpayer seeking relief and the individual with whom they filed the joint return are no longer married, are legally separated, or were not members of the same household for the 12-month period before the innocent spouse election was filed. As the taxpayers remained legally married, taxpayer-wife was left to argue that they were not members of the same household while taxpayer-husband was in prison. The Court rejected this argument on the theory that the incarceration was a "temporary absence." The taxpayers had their fifth child while he was in prison, and they never made a formal attempt to end their marriage or legally separate. The court found that it was "reasonable to assume that the absent spouse [would] return to the household." Therefore, under [Treas. Reg. 1.6015-3\(b\)\(3\)\(i\)](#), they remained members of the same household throughout the prison sentence, precluding relief under Code. Sec. 6015(c).

Relief under Code Sec. 6015(b) applies when all five of the following conditions are met: (A) a joint return has been made; (B) on such return, there is an understatement attributable to one of the individuals filing the joint return; (C) the other (requesting, or innocent) spouse *did not know and had*

*no reason to know* of the understatement at the time the return was signed; (D) taking into account all of the facts and circumstances, it would be inequitable to hold the requesting spouse liable for the deficiency; and (E) the requesting spouse timely elects relief.

The taxpayers' joint tax returns for the years at issue included some understatements that the IRS conceded were solely attributable to Mr. Reynolds' actions, so the Court considered whether taxpayer-wife could obtain relief under Code Sec. 6015(b) for those resulting liabilities. Innocent spouse relief was not sought with respect to the deficiencies arising from omissions of taxpayer-wife's income; thus, conditions (A) and (B) were satisfied.

The Court then looked at condition (C) — whether she knew or had reason to know of the understatement at the time she signed the return. The Court considered taxpayer-wife's level of education, her involvement in the family's business and financial affairs, the presence of lavish or unusual expenditures (compared with past income levels and spending patterns), and taxpayer-husband's evasiveness and deceit about the unreported income. Her legal education weighed against her; the Court noted that even though she practiced in nontax fields, her legal training should have led her to suspect an understatement of income. Furthermore, because they used the same joint bank accounts, the Court concluded that she should have noticed that her husband's deposits were almost twice what they should have been. Finally, contrary to her arguments, the court found that taxpayer-husband "did not go to great lengths" to try and hide his embezzlement since he simply deposited them into their joint bank account.

The Court did not have the evidence of the couple's spending in earlier years to determine whether or not their expenditures during the years at issue were lavish or unusual. However, taken all together, the fact that taxpayer-wife was highly educated, was involved in the family's finances, and not actively deceived by taxpayer-husband, was enough for the Court to find that she had reason to know of the understatement and therefore was not eligible for relief under Code Sec. 6015(b).

The Court then considered whether she could be eligible for equitable relief under Code Sec. 6015(f). Equity is one of the five requirements under Code Sec. 6015(b) and an independent ground for relief under Code Sec. 6015(f). In considering whether it would be inequitable to hold taxpayer-wife liable for the deficiency, the Court focused its consideration as to whether she had continued to comply with tax laws, whether the liability would subject her to economic hardship, and whether she derived a significant benefit from the understatement.

The issue of compliance with tax laws weighed against taxpayer-wife as in later tax years she continued to have problems with compliance, having filed late one year and understating her income on another return.

The Court also did not find that the liability would subject her to economic hardship. She had a job with the government that gave her a take-home income of \$6,400 per month. Although she estimated to the Court that her monthly expenses exceeded this and were \$10,000 per month, she did not provide substantiation of the reasonableness of these expenses; thus, the Court did not consider them.

Finally, the Court found that she had derived significant benefits from the unreported income as she received expensive gifts from her husband, and the family had four cars, sent the children to private school, and took annual vacations. This factor also weighed against relief.

Ultimately, the Court found that it would not be inequitable to hold taxpayer-wife liable for the understatement. She had reason to know of the understatement, continued to fail to comply with the tax laws, and benefitted from her husband's criminal actions. She failed to present sufficient evidence that would have weighed in her favor, including documentation that the liability would subject her to economic hardship despite her steady income. She therefore did not qualify for relief under any of the provisions in Code Sec. 6015, and remained jointly and severally liable to the IRS for hundreds of thousands of dollars.

*Takeaway:* Married taxpayers who are filing joint returns should keep in mind that they will be jointly and severally liable for the amounts due on the return whether or not they are the parties who earned the income. Although there are protections for relief from liability under the Code, they are limited, and the “innocent” spouse will bear the burden of proof to show that he or she is eligible to receive such relief.

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