

Actual Knowledge Required to Deny Innocent Spouse Relief

Cross References

- *Smith/Hodge*, T.C. Summary 2025-6

Married taxpayers filing joint returns are jointly liable for the tax liability reported on the return, as well as any liability for a deficiency subsequently determined by the IRS, even if all of the items giving rise to the deficiency are allocable only to one spouse.

IRC section 6015 allows a taxpayer to obtain relief from joint and several liability in certain circumstances. One circumstance applicable to this case allows a separated or divorced spouse to elect to limit liability for any deficiency assessed with respect to a joint return to the portion of the deficiency that is properly allocable to the electing spouse. Under this election, the items giving rise to the deficiency are taxed as if the spouses had filed separate returns.

The electing spouse must establish that:

- 1) A joint return was filed,
- 2) When the election for relief is filed, the electing spouse is no longer married to, is legally separated from, or has not been a member of the same household at any time during the previous 12 months as the individual with whom the electing spouse filed the joint return to which the election relates,
- 3) The election for relief was made after a deficiency was determined but no later than two years after the IRS began collection activities, and
- 4) The deficiency remains unpaid.

There is no dispute between any of the parties in this case that these threshold requirements are satisfied.

IRC section 6015 provides that relief is not available if it is demonstrated that the individual making an election had actual knowledge (at the time such individual signed the return) of any item giving rise to a deficiency (or portion thereof) which is not allocable to such individual.

The IRS agreed with the electing spouse that she was eligible for relief.

However, the non-electing spouse has the right to challenge this determination in court, which is the focus of this court case. If the non-electing spouse can prove that the electing spouse did in fact know about the items giving rise to a deficiency, then innocent spouse relief is not granted and both spouses remain jointly liable for the entire tax debt.

The electing spouse was an employee and received a W-2 for her income. The non-electing spouse was self-employed and received a 1099-MISC for his income. He also received a 1099-C for the discharge of cancelled debt.

The spouses filed a joint federal income tax return for the year at issue. Throughout their marriage, both spouses maintained separate checking and savings bank accounts and never had a joint bank account.

At the time they filed the joint return for the year at issue, the spouses were legally separated. The electing spouse was responsible for maintaining, organizing, and providing various records used to prepare their joint returns to a paid income tax return preparer. The tax return did not include any amount of cancellation of indebtedness income, nor did it include some of the self-employment income received by the non-electing spouse. The IRS issued a notice to both spouses about the unreported income.

After requesting innocent spouse relief, the IRS granted relief to the electing spouse, but the non-requesting spouse objected, claiming she should have known about the unreported income since she was the one collecting and providing all of the tax information to their tax return preparer.

The tax court was tasked with determining whether the electing spouse had actual knowledge on a preponderance of the evidence as presented by the electing spouse, the non-electing spouse, and the IRS.

Actual knowledge is an actual and clear awareness, as opposed to reason to know, of the existence of an item which gives rise to the deficiency (or portion thereof). In the case of omitted income, the electing spouse must have an actual and clear awareness of the omitted income. The applicable standard is the electing spouse's actual subjective knowledge.

Actual knowledge is not to be inferred from evidence that the electing spouse merely had reason to know of the omitted income. Actual knowledge must be established by the evidence and shall not be inferred based on indications that the electing spouse had a reason to know.

The non-electing spouse argued that the electing spouse must have been aware of the unreported income because she was responsible for preparing their joint federal income tax return and had access to his bank account. He said: "she could not have been completely oblivious to it."

The court stated the electing spouse did not have any knowledge of the unreported compensation the non-electing spouse received or the discharge of indebtedness. During the relevant period, the spouses maintained separate residences, and the non-electing spouse visited only infrequently. The information returns were addressed to the non-electing spouse and the unreported income was directly deposited into his separate personal bank account. The non-electing spouse provided no evidence to the court of the electing spouse's knowledge of the unreported income or the discharge of indebtedness except for his unverified and self-serving testimony.

Considering all the circumstances, the court stated that the electing spouse did not have actual knowledge of the items of unreported income attributable to the non-electing spouse when the return for the year at issue was prepared and filed. The court ruled the electing spouse was entitled to innocent spouse relief on the unreported income attributable to the non-electing spouse.