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## **Innocent Spouse Update: A change in the law, and what constitutes actual knowledge**

**By Yvonne R. Cort**



Practitioners interested in seeking innocent spouse treatment for their clients should be aware of the current law with respect to the scope of review. For appeals to the U. S. Tax Court, the information under review in an innocent spouse case is limited to the administrative file and newly discovered information. In addition, a recent U. S. Tax Court case addressed some of the issues commonly encountered in innocent spouse matters. While not precedential, the case is a useful real-life demonstration of the application of the innocent spouse rules.

If a taxpayer filed jointly and believes only the other spouse should be liable for the tax, the innocent spouse program offered by the IRS may provide a solution. The program includes primarily three kinds of relief: innocent spouse; separation of liability; and equitable relief. The first two are available for an understatement of tax. Equitable relief is available for either an underpayment or understatement of tax. All three forms of relief are colloquially called “innocent spouse”, and the same application form (Form 8857) is used.

An *underpayment* of tax is when the return was filed with the correct amount of tax due, and the tax has not been paid. An *understatement* of tax is when more tax should have been shown on the tax return. An understatement could arise, for example, when a taxpayer received income and did not include it on the return, or when the IRS audits a return resulting in additional tax due.

Relief is available only for jointly filed returns, and the initial hurdle is whether the requesting spouse knew of the issue at the time the return was filed. The IRS will focus on whether the spouse had actual knowledge, and whether a reasonable person in the same situation would have known of the understatement or underpayment. Both spouses are expected to review the tax return before filing and question items that do not appear accurate.

In *Todisco v. Comm’r of Internal Revenue*, No. 3532-14S, (U.S.T.C. Oct. 6, 2021) the requesting spouse, April Gonzales, asked for innocent spouse relief for an understatement of tax for two years, 2010 and 2015. For each year, the IRS issued a Notice of Deficiency, disallowing certain deductions, resulting in additional tax due. The Court considered whether Ms. Gonzales knew or had reason to know of the understatement at the time she signed the returns. Ms. Gonzales was a high school graduate with no education or experience in business, finance or accounting, and was the primary caregiver for three children during the years at issues.

The Court focused on the erroneous deduction related to the non-requesting spouse’s unreimbursed business expenses, including mileage, meals and entertainment. The ex-husband asserted that Ms. Gonzales had knowledge because she had access to financial information, and paid credit card bills with their joint checking account. The Court disagreed: since the ex-husband had calculated the deduction based on the standard per diem and mileage rate, Ms. Gonzales’ access to or knowledge of their financial information was not determinative. The Court held that she did not have actual knowledge of the understatement.

Ms. Gonzales knew about the 2010 deficiency at the time she signed the 2015 tax return, and didn’t ask about the 2015 expenses. However, Ms. Gonzales had asked her ex-husband about the Notice of Deficiency for 2010, and her ex-husband dismissed her question, saying she was “too stupid” to understand. With that in mind, the Court found that Ms. Gonzales had satisfied her obligation to inquire about the items on the 2015 return. The Court’s determination and reasoning on these two critical issues highlight the fact-sensitive nature of innocent spouse applications, and the importance of considering all the facts and circumstances.

As the *Todisco* case showed, it’s essential to establish the factual record. The Taxpayer First Act affected the scope of review for innocent spouse applications filed after July 1, 2019. Under the revised Section 6015(e)(7), the Tax Court can only consider the administrative file, and new items not previously discovered or available. A practitioner should consider including currently helpful as well as potentially relevant information. The application, Form 8857, has been updated and encourages applicants to submit documentation.

Innocent spouse can be a powerful tool for taxpayers with a balance due. However, not every spouse is eligible, and it’s important to develop a strategy and provide the IRS with supporting documentation. Practitioners and their clients need to be aware of the nuances involved when submitting an innocent spouse application.

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