

COURTNEY & CHRISTOPER
BREEDLOVE
199 BEDWELL LANE
DOTHAN, AL 36301-8371,

Taxpayers,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 05-454

FINAL ORDER

The Revenue Department assessed Courtney and Christopher Breedlove (together “Taxpayers”) for 2001, 2002, and 2003 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on October 27, 2005. The Taxpayers and their attorney, David Johnston, attended the hearing. Assistant Counsel Gwendolyn Garner represented the Department.

ISSUE

The issue in this case is whether Christopher Breedlove is entitled to innocent spouse status for 2001, 2002, and 2003 pursuant to Code of Ala. 1975, §40-18-27(e). That statute provides in pertinent part that an innocent spouse shall be relieved of liability for Alabama income tax to the same extent allowed for federal purposes.

FACTS

Courtney Breedlove (individually “Taxpayer”) worked as a bookkeeper for Jubilee Builders, LLC in 2001, 2002, and 2003. She embezzled money from the business in those years. Her activities were discovered in March 2003. She thereafter pled guilty, and served approximately 16 months in State prison.

The Taxpayers filed joint Alabama income tax returns in the subject years. They

reported the wages they earned in those years, but failed to report the money embezzled by the Taxpayer. The Department subsequently assessed the Taxpayers, jointly, on the unreported income.¹ It also assessed the Taxpayers for the 50 percent fraud penalty in all three years.

The Taxpayers do not contest the amount of tax due as assessed by the Department. They argue, however, that the husband, Christopher Breedlove, should be relieved of liability as an innocent spouse. They also contend that the fraud penalty assessed by the Department should be waived.

The Taxpayer testified that her husband never knew she was embezzling until she was caught in March 2003. She handled the couple's finances, and never used any of the embezzled money to pay the couple's monthly bills or to buy things for her husband or her two small children. Rather, she spent the money on clothes, expensive meals for herself, etc.

The Taxpayer's husband confirmed that he was unaware of his wife's illegal activities. He did not know how much his wife earned, and thought that any extra money she spent on herself came from bonuses she received for doing a good job at work.

ANALYSIS

The Administrative Law Division previously addressed the innocent spouse issue in *Laney v. State of Alabama, Inc.* 02-156 (Admin. Law Div. 8/29/02).

As indicated, an Alabama taxpayer may be allowed innocent spouse status to the same extent allowed under federal law. Section 40-18-27(e). Under current federal law, a person qualifies as an innocent spouse (1) if they file a

¹ The assessments are based on the amount of checks the Taxpayer wrote on the company's account to herself or to cash in the subject years, i.e., \$17,246 in 2001, \$50,587 in 2002, and \$18,551 in 2003.

joint return which has an understatement of income due to erroneous items of the spouse, (2) when they signed the joint return they did not know or have reason to know that there was an understatement of tax, and (3) taking into account all facts and circumstances, it would be unfair to hold the innocent spouse liable for tax on the unreported income. 26 U.S.C. §6015.² Whether the husband is entitled to innocent spouse status in this case turns on whether he knew or had reason to know that his wife had embezzled money during 1999. The “reason to know” standard was discussed in *Kistner v. Commissioner*, 18 F.3d 1521 (11th Cir. 1994), as follows:

A spouse has “reason to know” if 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. *Stevens v. Commissioner of Internal Revenue* [89-1 USTC §9330], 872 F.2d 1499, 1505 (11th Cir. 1989). The test establishes a ‘duty of inquiry’ on the part of the alleged innocent spouse. *Stevens* [89-1 USTC §9330], 872 F.2d at 1505. The courts have recognized several factors that are relevant in determining the ‘reason to know,’ including (1) the alleged innocent spouse’s level of education; (2) the spouse’s involvement in the family’s business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family’s past levels of income, standard of income, and spending patterns; and (4) the culpable spouse’s evasiveness and deceit concerning the couple’s finances. *Stevens* [89-1 USTC §9330], 872 F.2d at 1505.

Kistner, 18 F.3d at 1525.

Laney at 3.

The Taxpayers concede that they omitted the embezzled income from their 2001,

²Before 1998, the federal innocent spouse provision was at 26 U.S.C. §6013(e). That section was repealed and the current innocent spouse provision at §6015(b) was enacted in 1998 as part of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206). That legislation generally made it easier for individuals to qualify for innocent spouse relief. It also allows a spouse to elect for separation of liability treatment, §6015(c), and also equitable relief, §6015(f). However, Alabama law, at §40-18-27(e), only allows for innocent spouse relief. For a good explanation of the current federal statute, see, Harper, *Federal Tax Relief for Innocent Spouses: New Opportunities Under the IRS Restructuring and Reform Act of 1998*, 61 Ala.Law. 204 (May 2000).

2002, and 2003 returns. The husband's innocent spouse status thus turns on (1) whether he knew when he signed the returns that there was an understatement of tax, and (2) would it be unfair under the circumstances to hold the husband liable for tax on the unreported income.

Both Taxpayers testified that the husband did not know about his wife's illegal activities. It is also understandable that the Taxpayer would not want her husband, or anyone else, to know what she was doing. The husband was uninvolved in the couple's day-to-day business, and consequently had no cause to suspect that the extra money spent by his wife came from an illegal source. Importantly, the Taxpayer did not buy extravagant items that would cause her husband to suspect that she was embezzling from her employer.

The above facts confirm that the Taxpayer's husband did not know or have reason to know when he signed the couple's joint 2001 and 2002 returns that his wife had embezzled income in those years. It would also be unfair to hold the husband liable in those years because he did not benefit from the embezzled funds.³

The husband knew, however, when he signed the 2003 return in early 2004 that his wife had embezzled money during the year. The Taxpayers explained that the embezzled income was not reported on their 2003 return because they did not know how much income to report. But they could have estimated the amount and later amended the return after the amount of the stolen funds had been determined. In any case, the husband knew when he signed the 2003 return that there was some income not reported on the return.

³ For a similar result, see, *Laney, supra*.

Consequently, he cannot be relieved of liability as an innocent spouse in that year.

The Taxpayers' representative argued at the October 27 hearing that even if the husband cannot be allowed innocent spouse status, he should be allowed equitable relief. Unfortunately for the husband, Alabama has not adopted the federal equitable relief provisions in 26 U.S.C. §6015. See, *supra*, n. 2.

The Department examiner indicated in his audit report that the fraud penalty was added because restitution had not been ordered by the circuit court. The Taxpayers' attorney thus argued that the fraud penalty should be removed or waived because the Taxpayer is paying \$400 a month in court ordered restitution. I disagree, at least concerning 2001 and 2002.

The fraud penalty does not hinge on whether the Taxpayer is paying restitution to her ex-employer. Rather, it turns on whether the Taxpayer filed the subject years' returns with the willful intent to evade tax. She clearly did concerning 2001 and 2002. The fraud penalty was thus correctly assessed in those years.

Concerning 2003, it was public knowledge when the Taxpayers filed their 2003 return that the Taxpayer had embezzled money from her employer. The Taxpayers thus were not attempting to hide the income when they failed to report the embezzled funds on their 2003 return. Consequently, the fraud penalty should not apply in that year. Rather, the 10 percent failure to timely pay and the 5 percent negligence penalties should be applied.

The 2001 and 2002 final assessments are affirmed against the Taxpayer, Courtney Breedlove. Christopher Breedlove is relieved of liability as an innocent spouse in those

years. The 2003 final assessment, as adjusted, is affirmed against both Taxpayers. Judgment is entered against Courtney Breedlove for 2001 tax, penalty, and interest of \$1,415.24, and 2002 tax, penalty, and interest of \$4,015.71. Judgment is entered against the Taxpayers, jointly, for 2003 tax, penalty, and interest of \$589.37. Additional interest is also due from the date the final assessments were entered, February 18, 2005.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered November 29, 2005.

BILL THOMPSON
Chief Administrative Law Judge