

BILLY R. & PATRICIA A. WALDROP
454 Fall City Road
Jasper, AL 35503,

Taxpayers,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 00-404

FINAL ORDER

The Revenue Department assessed Billy R. and Patricia A. Waldrop (together Taxpayers) for 1993 through 1996 Alabama income tax. Patricia A. Waldrop (individually Taxpayer) appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on November 5, 2002. CPA Grant McDonald represented the Taxpayer. Assistant Counsel Keith Maddox represented the Department.

The issue in this case is whether Patricia A. Waldrop is entitled to innocent spouse status for the subject years 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 purposes to the same extent allowed for federal purposes.

The Taxpayers were married and filed joint Alabama income tax returns in 1993 through 1996. The Taxpayer owned and operated two package stores in Jasper, Alabama during those years. Her husband helped operate the stores.

Mr. Waldrop also ran an illegal bookmaking operation during the subject years. He operated the business out of a trailer he owned near Smith Lake north

of Birmingham, Alabama. He testified at the November 5 hearing that he took approximately \$1 million a year in bets during the subject years. He claimed that he had annual gross gambling income of approximately \$40,000 to \$50,000, and incurred gambling expenses of approximately \$20,000 in each year.

Mr. Waldrop's gambling activities were investigated by the federal government. He subsequently pled guilty to gambling-related criminal charges in 1999. The IRS also estimated his gambling income over a two week period in November 1996, and projected the estimated income over the four years in issue. The IRS did not allow any gambling-related expenses, nor did it consider that its sampling period was during football season, when betting is generally heavier than during the rest of the year.

Mr. Waldrop did not contest the IRS assessment because he has no assets. However, the Taxpayer applied to the IRS for innocent spouse or other relief under 26 U.S.C. ' 6015. That statute was enacted in 1998, and generally made it easier for individuals to qualify for innocent spouse relief. It also allows a spouse to elect for separate liability treatment pursuant to ' 6015(c), and also equitable relief pursuant to ' 6015(f).¹ However, Alabama has not adopted ' ' 6015(c) and 6015(f), and only allows for innocent spouse relief. See, ' 40-18-27(e).

¹The separate liability and equitable relief provisions of ' ' 6015(c) and (f) were first enacted in 1998. The pre-1998 federal innocent spouse provision was at 26 U.S.C. ' 6013(e). For a good discussion 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).

The IRS subsequently granted the Taxpayer separate liability status pursuant to ' 6015(c). As indicated, however, Alabama only recognizes innocent spouse relief, not separate liability relief. The Department denied the Taxpayer innocent spouse status. The Taxpayer appealed.

The Taxpayer's representative first argues that the joint assessments in issue are excessive. He concedes that the Department may estimate a taxpayer's liability in the absence of adequate records. He argues, however, that any estimate must be reasonable under the circumstances, and that the IRS's estimate of Mr. Waldrop's gambling income during the four year period is clearly unreasonable.

The evidence submitted at the November 5 hearing does indicate that the IRS adjustments may be excessive. However, that issue need not be decided because the Taxpayer is entitled to innocent spouse relief.

Alabama's innocent spouse statute was addressed in *Laney v. State of Alabama*, Inc. 02-156 (Admin. Law Div. 8/29/02). In that case, the taxpayer's wife embezzled large sums of money from her employer. The taxpayer claimed that he should be relieved of liability as an innocent spouse because he was unaware that his wife had embezzled from her employer, and he did not benefit from the ill-gotten income. The Final Order in the case reads in pertinent part as follows:

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 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. (footnote omitted)

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, Inc. 02-156 at 2-3.

Applying the above legal standard, the husband was granted innocent spouse status because he did not know or have reasonable cause to suspect that his wife had embezzled money during the subject year. Likewise, in this case, the

evidence shows that the Taxpayer did not know or have reason to suspect that her husband had illegal gambling income during the subject years. She also did not directly or indirectly benefit from his gambling income.

Mr. Waldrop worked at the Taxpayer's package stores and deposited most of his wage income into the couple's joint checking account. The Taxpayer paid all of the couple's bills from that joint account. Mr. Waldrop did not give the Taxpayer any substantial amounts of cash or expensive gifts during the subject years. Rather, the Taxpayer testified that she and Mr. Waldrop were husband and wife in name only. She was aware that her husband had a girlfriend during the subject years, and assumed that he was with her on weekends when he was, in fact, tending to his gambling activities. The Taxpayers finally divorced in 1997.

Based on the above undisputed evidence, the Taxpayer is relieved of liability from the assessments in issue as an innocent spouse.

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

Entered November 22, 2002.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Margaret Johnson McNeill, Esq.
Grant McDonald, CPA
Kim Herman