PacificCPE

COURSE
34456A

Family Tax Liability, Fraud, and Payroll Tax Risks

Some of the most sensitive client situations involve family members, potential fraud exposure, or payroll tax liability. This course addresses innocent spouse relief, same-sex marriage tax considerations, and how to spot whether a client may be under criminal investigation. It also tackles the serious issue of trust fund penalties for small business owners and employees—illustrated through a detailed case history—and explains when attorney-client privilege matters. A must for practitioners working with closely held businesses or clients facing unusual IRS scrutiny.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the ways in which alimony and dependent children are handled by the IRS.
- Identify the characteristics of, and potential penalties for, tax fraud.
- Recall the characteristics of employees and independent contractors.

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TABLE OF CONTENTS

CHAPTER 01

Family, Friends, Heirs, And The IRS 5

1.01 It'S A Family Aff air 5

1.02 Owning Property Jointly 12

1.03 Death And Taxes 14

Test Your Knowledge 20

CHAPTER 02

Fraud And Tax Crimes: Do You Really Have To Worry? 25

2.01 How People Commit Tax Fraud 25

2.02 If You Are Caught Cheating 26

2.03 Fraud Or Negligence? 27

2.04 IRS Criminal Investigations 31

2.05 If You Are Prosecuted 37

Test Your Knowledge 42

CHAPTER 03

Small Business/Self-Employed: When IRS Trouble Comes 46

3.01 Self-Employed—You'Re A Prime Audit Target 46

3.02 Employees Or Independent Contractors? 47

3.03 Payroll Taxes—IRS Dynamite 52

3.04 The Dreaded Trust Fund Recovery Penalty 53

3.05 ***Sample Letter To Appeal Trust Fund Recovery Penalty*** 58

3.06 Cash Transactions Over $10,000 63

Test Your Knowledge 65

Final Exam Copy 71

Glossary 69

Index .....

Chapter 1: FAMILY, FRIENDS, HEIRS, AND THE IRS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the ways in which alimony and dependent children are handled by the IRS.

The tax laws contain special rules affecting folks related by blood or marriage and people who own property together. A taxpayer's responsibilities don't end at death—the taxpayer's family might inherit tax troubles. Maybe the old saying should be changed to "Nothing is certain except death and MORE taxes."

IT'S A FAMILY AFFAIR

If you're married, divorced, or a parent, familiarize yourself with some special tax rules.

Filing Tax Returns—Joint or Separate?

Married couples always have the option of filing joint tax returns or filing separate tax returns. And, if only one spouse has income, the other doesn't have to file a return—although filing jointly will likely result in a tax savings. The only qualification for filing jointly is that the couple be legally married as of December 31 of that year. Occasionally, it pays, taxwise, for married couples to file separate returns. However, taxes are higher in most instances, especially in community property states, because each spouse is considered to have earned 50% of the other spouse's income for tax purposes. If in doubt how to file, calculate your tax liability both ways each year. Computer tax programs can do this very quickly.

Same-Sex Marriage

Same-sex marriages are licensed and recognized in all 50 states. The IRS allows married same-sex couples to file as married for tax purposes. These couples can file their tax returns separately or jointly with their spouse. Generally, joint filing means an overall tax savings, but not always. A tax preparation program such as TurboTax allows you to easily run the numbers both ways and then decide what is better.

Caution!

Each spouse is 100% liable for all the taxes owed on a joint return. But only the spouse in whose name a separate return is filed is liable for that spouse's income taxes. So, another reason some married couples file separate tax returns is to relieve each other of direct financial responsibility if the IRS should audit one of them, or if one can't pay a tax bill.

Example 1

Leon and Margaret are married and always file their tax returns jointly. Leon owns a dry cleaning business, which reported an operating loss on their tax return. The couple was audited, and the IRS discovered that the business income was understated by $50,000. Leon and Margaret didn't pay the resulting $22,000 bill and the IRS filed a lien against both of them. The IRS may collect on it from any jointly or separately owned property of either Leon or Margaret.

Example 2

Now assume that Leon and Margaret file separate tax returns. Leon filed the phony tax return, but Margaret's return showed only her wages as an office manager. Both returns were audited. Margaret's audit resulted in no change. Leon was slapped with a $22,000 bill. The IRS filed a lien, subjecting only his assets to collection. Margaret is in the clear.

The Innocent Spouse Rule The innocent spouse law is the one exception to the law making both currently married or former spouses responsible for an IRS debt. (I.R.C. § 6015.) If the requirements are satisfied, a spouse, or more commonly, an ex-spouse, may be relieved of joint tax debts incurred. There are three tax law remedies available to a spouse seeking a refund or relief of a tax debt.

1. **Innocent spouse relief.** An innocent spouse must meet all of the following IRS requirements:
    - The innocent spouse signed a joint return with a tax understatement due solely to the other spouse's actions
    - At the time the spouse signed the joint return that spouse didn't know, and had no reason to know, that there was an understatement by the other spouse, and

- It would be unfair to hold the innocent spouse liable.

2. **Separation of liability relief.** A spouse must have filed a joint return and meet one of the **following requirements:**
    - Be divorced or legally separated from the other spouse
    - Be widowed, or
    - Not have been living in the same house with the other spouse in the year prior to submitting the claim for relief.

Avoiding Liability for Your Spouse's Dishonesty with the IRS

The innocent spouse rule isn't the only way to avoid liability for your spouse's underreporting or overdeducting to the IRS. The rules differ, depending on what state you lived in when you filed your return. The rules for community property states, non-community property states, and those that apply to all states—including the innocent spouse rule—are briefly described below. For details, see IRS Publication 555, Community Property.

Community Property States

(Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin)

Innocent Spouse Rule:

- You and your spouse did not file a joint income tax return.
- You did not know and did not have reason to know of the unreported income (this means you had no knowledge of the amount of the income, and you had no knowledge of the existence of the item of income itself).
- The income belongs solely to your spouse.
- It would be unfair to include the unreported income in your income.

Abandoned Spouse Rule:

- You and your spouse were married at some time during the calendar year.
- You lived separately and apart during the entire calendar year.
- You did not file a joint return.
- You did not receive any portion of your spouse's income.

Denying Benefit of Community Property Law Rule:

If your spouse acts as if they're solely entitled to a portion of community income and doesn't tell you about that income by the time your tax return is due, your spouse will be solely responsible for reporting the income. This is because even when spouses file separate returns, each must report one-half of the combined community income.

Non-Community Property States (the rest)

Innocent Spouse Rule:

- There is a substantial understatement of tax from income and deductions of the other spouse.

- You did not know and did not have reason to know of the dishonesty. This claim presents a problem because a spouse is required to read a joint return before signing it.
- It would be unfair to hold you liable.
- You did not receive any benefit from the unreported income.

All States

Innocent Spouse Rule:

If you had no income and believed that you were not obligated to file a return, you will not be assumed to have authorized your spouse to sign your name on a joint return. You might be able to claim that your spouse forged your name to a joint return.

On the other hand, if you have your own income and don't file separately, the IRS will assume you intended to file jointly, and you can't claim that your spouse forged your name to a joint return.

Duress Rule:

You must have been unable to resist the demands of your spouse to sign the return, and you would not have signed the return if the pressure had not been applied.

3. **Equitable relief.** If you don't qualify as an innocent spouse or for separation of liability relief under either (1) or (2) above, you might still get out of a tax debt by showing that it would be unfair to be held liable, under all of the following circumstances:
    - You and your spouse filed a joint tax return
    - No assets were transferred between you and your spouse as part of a fraudulent scheme
    - You did not knowingly file a fraudulent tax return
    - All or part of the understatement was due to the other spouse or some of the underpayment was due to the other spouse's income, and
    - You would suffer an "economic hardship" if relief were not granted.

When you owe back taxes and later file a tax return claiming a refund, the IRS usually keeps the refund and applies it to the old debt. The IRS keeps the refund of a jointly filed return even if only one of the spouses owed back taxes. If this happens, the nonowing spouse may submit a request to the IRS as an injured spouse to get their portion of the refund returned. Request relief by filing IRS Form 8379, Injured Spouse

Allocation. A refund isn't automatically granted, and the IRS will likely request further details of your situation.

Usually, innocent spouse claims are made by divorced taxpayers. People who are still married, however, can also use the innocent spouse rule.

Example

Francisco and Imelda filed a joint return, were audited, and were found to have substantially underreported Francisco's business income. Francisco had skimmed about $60,000 from his delicatessen. Imelda convinced the IRS that she was an innocent spouse—she knew nothing about the income, had no reason to know about it (she was in the hospital recovering from surgery when Francisco did their taxes), and did not benefit from it (Francisco blew the money gambling)—and so it would be unfair to hold her liable. Francisco changed his ways, and the marriage survived. Imelda went back to work and, using her good credit, bought a home and obtained a mortgage in her name alone. She and Francisco lived there, and he entered into an installment payment plan with the IRS for the taxes.

To make a claim, file IRS Form 8857, Request for Innocent Spouse Relief, found at the IRS website. You should file Form 8857 as soon as you become aware of a tax liability for which you believe only your spouse or former spouse should be held responsible. There is a two-year time limit to file this form (commencing when the IRS began collection), except where you claim equitable relief.

Tax Court for Innocent Spouses

Were you denied innocent spouse relief by the IRS? You can sue the IRS in Tax Court. (I.R.C. § 6015.) You must file your petition within 90 days of the IRS denial notice date. Until the court decides, the IRS may not take any collection action against you. (See Chapter 2 of course 34453B for details on going to Tax Court.)

Divorce and the IRS

Alimony

Several tax issues arise at divorce. Alimony, sometimes called "maintenance" or "spousal support," is one. For divorces finalized before January 1, 2019, alimony payments are tax deductible to the payer and taxable income to the recipient. The alimony must be specifically ordered by a court or in a legally binding written agreement signed by both spouses. For divorces finalized in 2019 and later, payments