SOLUTIONS TO RESEARCH PROBLEMS

1. Hoffman and Smith CPAs
5191 Natorp Boulevard
Mason, OH 45040

March 6, 2012

Mr. Donald Dewey
4321 Mt. Vernon Road
Dover, DE 19901

Dear Don:

At the recent Chamber of Commerce meeting, you asked me about the tax advantages of having Van, your son, claim Debra, your daughter, as a qualifying child.

If Van can treat Debra as his qualifying child, he qualifies for a dependency exemption, the child tax credit, and the earned income tax credit. On the other hand if you claim Debra, the only benefit available is a dependency exemption—your income is too high to permit the use of either the child tax credit or earned income tax credit. A dependency exemption yields a greater tax benefit to you than to Van, but the tax saving is by far outweighed by the unavailability of the two credits. Consequently, the family would save taxes if Van claims Debra as his qualifying child. In such a case, you would have to forgo the dependency exemption for Debra.

Until 2009, the procedure suggested in the preceding paragraph was permissible. However, in the Emergency Economic Stabilization Act of 2008, Congress changed the rules. Under current law, another eligible taxpayer may claim a person as a qualified child only if he or she has an adjusted gross income (AGI) higher than the highest AGI of any of the person's parents. Clearly, the new condition eliminates Van because his AGI ($16,000) is not higher than the AGI of both you and Mary. Therefore, regardless, of any willingness to waive claiming her, Debra is your qualifying child.

As per our agreement, I am enclosing a statement covering the charge for my personal services. If I can be of further assistance to you in this matter, please feel free to contact me.

Sincerely,

William C, Dodd, CPA

NOTE TO INSTRUCTOR

The relevant Code provisions are: § 24 (child tax credit), § 32 (earned income tax credit), § 151 (dependency deduction), and § 152 (dependent defined). The amendment to the Code referred to in the letter was the addition of § 152(c)(4)(C).

Although not called for by the facts of the problem, Van is not Don's qualifying child (because of the age test) or qualifying relative (due to the gross income test).

2. a.

Hoffman and Smith CPAs
5191 Natorp Boulevard
Mason, OH 45040

March 6, 2012

Mrs. Sophie Durbin
1310 Ash Street
Kearney, NE 68849

Dear Mrs. Durbin:

This letter is in response to the inquiry as to your filing status and related tax matters for tax years 2010 and 2011. According to the information provided to us, you filed for 2010 as married filing separately and are unsure as to what filing status to choose for 2011. Also, for 2010 you did not claim either your son or mother-in law as dependents.

Normally, married persons who do not file a joint return must file as married filing separately. This is an unfortunate result because the tax consequences may be less desirable. There, exists, however, a special classification called abandoned spouse that allows a married person to be treated as being single. Single persons can qualify for head of household filing status. The tax rates applicable to head of household are lower than those relating to married persons filing separately.

One of the requirements for being an abandoned spouse is that the taxpayer maintains a household for a child that is a dependent. The first condition you satisfy as to Ryan for all years involved. With reference to dependency status, however, age and student status makes a difference. If Ryan is 19 years or older, he cannot qualify unless he is also a student. This is the case for 2010 (and probably for 2012) but not for 2011. Thus, you are an abandoned spouse for 2010 (and probably 2012) but not for 2011.

As to the dependency exemptions, your husband has no right to claim either Ryan or Isabella. You provided for their support and maintained the household in which they lived. You may claim Ryan and Isabella for 2010 and Isabella for 2011.

I suggest that we prepare an amended return for you for 2010 which uses head of household rates and claims dependency deductions for both Ryan and Isabella. Not only is this proper resolution

of the problem but it will save taxes. For 2011, moreover, you must use married filing separately status. You however, claim Isabella as a dependent.

Please call for an appointment and I will take care of this matter and review your prospective tax status for 2012.

Sincerely,

B. L. Hunt, Manager

b. March 6, 2012

TAX FILE MEMO

FROM: B. L. Hunt

SUBJECT: Filing status of Sophie Durbin

Mrs. Durbin was abandoned by her husband Karl in April 2010 and his current location remains unknown. Sophia was forced to assume the responsibility of providing support and maintenance for her son, Ryan, and her mother-in-law, Isabella. For tax year 2010, Sophia filed using married filing separately status and claimed *neither* Ryan *nor* Isabella as dependents. She has not yet filed a return for 2011 as she is uncertain of her tax status.

For 2010 and under the definition of "certain married persons living apart" contained in § 7703(b), it appears that Sophia meets the requirements for abandoned spouse. Ryan, although 19 years of age, is a qualifying child under the student exception and can be claimed as a dependent. Because Sophia is now treated as not married, she can meet the definition of head of household contained in § 2(b)(1). For 2010, therefore, Sophia should file an amended return claiming Ryan and Isabella as dependents and using head of household tax rates.

For 2011, the situation is different. Sophia no longer is an abandoned spouse as Ryan is not a dependent child. He is not a qualifying child (age limitation and no student exception) and he is not a qualifying relative (gross income limitation). Consequently, Sophia is married and cannot use head of household rates. She must use married filing separately rates. She can, however, claim Isabella as a dependent.

If Ryan goes to college in 2012, the probability is high that Sophia's tax status will revert to the way it was for tax year 2010.

3. a. The Bakers are limited to two dependency exemptions; Florence and Darin. With regard to Janet's parents, the following table summarizes the components involved.

Support Provided	Calvin	Florence
Funds spent on clothing, transportation, and recreation(1/2 of $8,000)	$4,000	$4,000
Fair rental value of lodging (1/7 X $14,000)	2,000	2,000
Share of food (1/7 X $10,500)	1,500	1,500
Dental bills	—	1,000
Life insurance premium	—	—
Parents' total support	$7,500	$8,500

Of Calvin's total support of $7,500, the Bakers provide only $3,500 ($2,000 + $1,500), which is not more than 50%. Unfortunately, life insurance premiums are not considered to be an item of support. In Florence's case, however, the Bakers furnish $4,500 ($2,000 + $1,500 + $1,000) which is more than $4,250 (50% of $8,500).

As a qualifying child (under age 19), Darin's income is immaterial (as long as he is not self-supporting). Since he satisfies the age requirement, his student status does not matter.

Andrea is not a qualifying child as she meets neither the age or student tests. She is not a qualifying relative because the support test is not met. The facts do not state what other types of support (e.g., clothing, recreation, medical) the Bakers pay for, but it would have to be significant for the total (including room and board) to exceed $21,000.

Morgan could be a qualifying child except that she appears to be self-supporting. Furthermore, she cannot be a qualifying relative due to the support test. As was the case of Andrea, however, the facts do not reflect what other types of support (besides room and board) her parents might provide. It is unlikely that the total would exceed the $20,000 Morgan furnishes herself.

b. A dependency exemption for Calvin could have been salvaged if Janet had not paid the life insurance premium. Instead, she should have applied the funds on Calvin's behalf toward a support item (e.g., help pay for the vacation). Thus, Calvin could pay the premium from his own funds without jeopardizing the support percentage.

In the case of Andrea, her parents would have had a better chance of meeting the support test if the cost of the car had not been so high. In this regard, could leasing, rather than purchasing, the Camaro have accomplished this result? Perhaps the Bakers could have contributed whatever portion of the cost is needed to satisfy the more than 50% requirement for the dependency exemption.

4. When married persons file a joint return, they become jointly and severally liable for all taxes due [§ 6013(d)(3)]. This means that the IRS can assess an income tax deficiency against either or both spouses.

   The joint and several liability consequences of a joint return can lead to harsh and seemingly unfair results in the so-called "innocent spouse" scenario. Here, the IRS chooses to collect the deficiency from the spouse who was unaware of the wrongdoing. Often the culpable spouse is unavailable or, if not, is insolvent. By the time of the IRS audit, the spouses usually are separated and even divorced. Invariably, the culpable spouse is the one who prepared the return and the one who handled the family's financial affairs.

   Code § 6015 was enacted to provide relief from the joint and several liability of a joint return. To be eligible for relief, however, the innocent spouse must not have actual knowledge of the understatement. Actual knowledge has been defined as being "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)." [See *Kathryn Cheshire*, 115 T.C. 183 (2000) at page 195.] As to the actual knowledge element of the innocent spouse provision, the burden of proof is on the IRS (*Evelyn M. Martin*, 80 TCM 665, T.C.Memo. 2000-346). The quantum of this burden is measured by a preponderance of the evidence [*Michael G. Culver*, 116 T.C. 189 (2001)].

   How do these rules apply to the situation presented in Research Problem 3? Daniel should qualify for innocent spouse relief unless the IRS can establish by a preponderance of the evidence that he had actual knowledge of Lucy's embezzlement activities. It seems unlikely that the IRS can meet this burden of proof. As the family maintained a modest lifestyle, the only indicia of a source of additional funds would have been the generous treatment Lucy provided for their children. This was, as Daniel was led to believe, handled by credit card financing and bank loans. As Lucy took care of the family finances, Daniel had no reason to suspect otherwise. Consequently, Daniel should not be liable for the income tax attributable to the embezzlement income.

5. See Ch. 2 Solutions to Research Problems, #10, "Internet Activity Comment" (p. 2-6).

6. See Ch. 2 Solutions to Research Problems, #10, "Internet Activity Comment" (p. 2-6).

7. See Ch. 2 Solutions to Research Problems, #10, "Internet Activity Comment" (p. 2-6).

8. See Ch. 2 Solutions to Research Problems, #10, "Internet Activity Comment" (p. 2-6).

9. See Ch. 2 Solutions to Research Problems, #10, "Internet Activity Comment" (p. 2-6).