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CERTIFIED PUBLIC ACCOUNTANTS | CONSULTANTS CLIENT PLANNING ADVISORY SUMMER 2017

Dealing with an IRS Audit

IRS data indicates that fewer than 1% of all individual income tax returns are audited each year. That's true, but some taxpayers are more vulnerable than others. For starters, the IRS is more likely to audit taxpayers who report high incomes because that's where larger amounts of underpaid taxes might be found.

In addition, certain taxpayers face more scrutiny because of how they earn their living. Self-employed individuals— generally, those who file Schedule C, Profit or Loss From a Business—may be audited more than other taxpayers. The same is true for professionals and business owners, who could see their business as well as their individual tax returns examined. The bottom line is that taxpayers with relatively high incomes as well as those who have control over their workplace bookkeeping can expect to face IRS queries at some point.

TRIPLE THREATS

If you're wondering how you should respond when you're audited, the answer is straightforward: Call our office. We'll let you know how to proceed, and offer assistance if professional help is warranted. Nevertheless, receiving correspondence from the IRS (or from your state's tax authority) can be a stressful experience. The following summary of audit types may ease the pressure a bit, by spelling out what will be required:

- Correspondence audit. These audits are the most common. Generally, they relate to a relatively minor discrepancy, such as faulty paperwork. You often can respond by mail to verify an item on your tax return and never have to meet anyone from the IRS.
- Office audit. These examinations involve a visit to an IRS office, where you'll meet with someone from the agency. In a typical situation, you'll be informed of the issue involved and instructed to bring documents to support what you reported on your tax return. If you've deducted substantial charitable contributions, for example, you could be asked to bring canceled checks, acknowledgment letters from the recipients, and other required materials.

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TRUSTED ADVICE

AUDIT RIGHTS

- Notices must include the amount (if any) of the tax, interest, and certain penalties you owe and must explain why you owe these amounts.
- If the IRS fully or partially disallows a refund claim, it must explain the specific reasons why.
- If the IRS proposes to assess tax against you, it must provide a letter with an explanation of the entire process from examination (audit) through collection, and explain that the Taxpayer Advocate Service may be able to assist you.
- This IRS letter must tell you about a possible review by an independent Office of Appeals.
- Help with Understanding Your IRS Notice or Letter is available online at IRS.gov.

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Social Security Strategies that Still Work

Recent legislation has reduced Social Security claiming strategies for married couples. For example, if you failed to initiate a "file-and-suspend" plan before April 30, 2016, that opportunity is no longer available.

STILL AVAILABLE

Another popular approach for married couples—filing restricted applications for spousal benefits—is still viable, but only for those who reached age 62 on or before January 1, 2016. The people who were grandfathered for this tactic have age 66 as their full retirement age (FRA). At FRA, someone in this age group can apply for Social Security retirement benefits, restricting the claim to a benefit that's based on the other spouse's work record.

Example 1: Nick and Paula Robinson are married. Nick worked for more years than Paula, earning higher pay, so Nick has the larger Social Security benefit.

Suppose Paula is now age 64. She can file a restricted application to get a spousal benefit at age 66, her FRA. Paula's spousal benefit could equal 50% of Nick's benefit. Paula could collect this spousal benefit while her own benefit, based on her work history, continues to grow at 8% a year under current law.

Paula can collect a spousal benefit until age 70, the latest possible starting date. Assuming that Paula's own benefit at some point will exceed the spousal benefit she receives on Nick's work record, Paula would eventually receive her own, larger benefit.

Example 2: Assume the same facts as in example 1. If Nick meets the age requirement, he can file a restricted application to start his spousal benefit at age 66, his FRA. At this time, he could collect a benefit based on Paula's work record. Meanwhile, Nick's own retirement benefit can keep growing at 8% a year until as late as age 70. (A restricted application by one spouse requires the other spouse to be receiving benefits.) If you meet the age requirement for a restricted benefit, our office can help you calculate the method that will likely have the greater payout.

NO RESTRICTIONS

Such restricted applications are available only to certain people who are 63 and older in 2017. Even so, there are other opportunities for all married couples to consider in their planning for Social Security.

Example 3: Steve and Vicki Baker are married, with both reaching age 61 this year. They can't use the restricted application strategy, as explained previously. Suppose both Steve and Vicki have substantial work histories, so they'll both receive sizable Social Security benefits, but Vicki's benefit would be larger. One plan is for Steve to begin his own benefits at age 62, the earliest date possible, while Vicki waits until age 70.

Assuming Steve is retired (so he won't have earnings that reduce his Social Security benefits), Steve's benefits would provide eight years of cash flow while the couple is in their 60s. This would make it easier for the Bakers to wait until Vicki reaches age 70 to start benefits; her larger benefit would increase by approximately 8% a year while she waits to start.

Moreover, if Vicki is the first spouse to die, Steve would receive the amount Vicki was receiving, as a surviving spouse. If Steve dies first, Vicki would continue to receive her larger benefit.

UNEVEN BENEFITS

Among married couples, there may be one spouse who will get a much larger Social Security retirement benefit, often because the other spouse focused on raising the children and managing the household. How might such couples proceed?

Example 4: Jim Lawson has contributed much more to Social Security than his wife, Marie. Therefore, Jim will be entitled to a $2,600 monthly benefit at his FRA, but Marie's FRA benefit will be only $800 a month. One approach is for Jim to claim benefits at his FRA and begin receiving $2,600 a month. Marie, who is the same age as Jim, also could claim at her FRA. If so, Marie would receive a spousal benefit that's 50% of Jim's benefit—$1,300 a month, in this example—which would be larger than her own. Here, Marie will get a large increase in benefits if she's the surviving spouse.

Another strategy might work for spouses of different ages.

Example 5: Suppose that Marie Lawson is a few years younger than her husband, Jim. If Jim can wait to start benefits until he's age 70, he'll get the maximum monthly benefit. Marie could start at age 62, the earliest possible date, claiming benefits on her own work record. Marie would receive a reduced benefit because she started so early, but she'd still obtain some cash flow.

Marie could wait until Jim is 70 and claims his maximum benefit then claim a spousal benefit, which might increase her Social Security checks. Again, increasing Jim's Social Security benefit will also increase Marie's survivor's benefit, if Jim predeceases her.

Deciding when to start Social Security will depend on many factors, such as health and the need for income. Our office can crunch the numbers for you to help you proceed. ❍

Dealing with an IRS Audit continued from page 1

- Field audit. Here, the IRS will visit your home or office for the audit. These audits might be more far-reaching, or the examiner might want to check on something specific, such as home office deductions you've claimed.

KNOW YOUR RIGHTS

For any type of audit, professional assistance can be valuable. Indeed, you're entitled to have a CPA, an attorney, or an enrolled agent represent you at an office or a field audit. In such a situation, it may be possible for the audit to take place at your CPA's office.

You also can receive help in requesting a postponement, if you need time to gather your records. If you must be present during the audit, you should answer all questions accurately, but there's no need to volunteer any information that the IRS does not request. If an appeal of IRS findings seems warranted, your CPA can handle that as well.

PRACTICE PRUDENCE

Avoiding an audit may be difficult if you're self-employed, a business owner, or a highly-compensated employee. Probability may put you under the IRS spotlight someday.

Recognizing your vulnerability, take steps to minimize your financial exposure in case the IRS selects you for an audit. Report your income and your justifiable deductions accurately. Don't overlook income reported on various 1099 Forms. In case of grey areas, discuss the matter thoroughly with the professional preparing your tax return and carefully consider extremely aggressive positions.

Keep in mind that the IRS communicates first by U.S. mail. If you receive an email purporting to be from the IRS, or a phone call demanding immediate payment, it's a fake. ❍

With Retirement Plans, Simple may be Better

In 2017, if a company sponsors a profit-sharing plan, the company could make a contribution on behalf of the business owner of as much as $54,000. With a SIMPLE IRA, the maximum amount this year is $31,000. If that's the case, why would you consider the latter choice?

One reason can be found in the plan's name; a SIMPLE (savings incentive match plan for employees) IRA has less paperwork as well as lower start-up and operating costs, compared with many other types of retirement plans. As long as your company is eligible (it must have no more than 100 employees and must not sponsor another retirement plan), you can set up the plan by filling out IRS Form 5304-SIMPLE or 5305-SIMPLE.

Subsequently, there is no annual filing requirement and no testing for discrimination in favor of highly-compensated employees. The only other requirement is annual notification, which you can meet by sending each employee a copy of the original 5304-SIMPLE or 5305-SIMPLE.

A SIMPLE IRA can also work if you are just starting a company and have no employees. With other retirement plans, adding workers may require some extensive paperwork. With a SIMPLE IRA, the company just sets up an IRA for each employee who joins the plan. A SIMPLE IRA must be offered to all employees who were paid at least $5,000 in any prior two years and who are expected to earn that much in the current year.

CONTRIBUTION CONSIDERATIONS

Eligible employees can defer up to $12,500 of their compensation in 2017, deferring the income tax as well. Those 50 or older can defer up to $15,500.

With a SIMPLE IRA, employers must make certain contributions to employees' accounts. All money that goes into a SIMPLE IRA is totally vested for the employee.

One option is to match each employee's contribution, up to 3% of pay. (An employer may choose to match as little as 1% of employees' contributions, for one or two years during the five-year period that ends with [and includes] the year for which the employer chooses the lower match percentage.)

Example 1: Sue Taylor, who works for ABC Corp., earns $60,000 a year. She contributes $6,000 to her SIMPLE IRA in 2017. ABC, which chose the matching option, contributes $1,800 (3% of $60,000). Therefore, the total amount moving into Sue's account in 2017 is $7,800.

Continuing with the ABC Corp. example, suppose that Richard Palmer, the chief shareholder, is 54 years old. Richard defers the maximum $15,500 of his salary to his SIMPLE IRA. If he earns more than $516,667 in 2017, a 3% match would be another $15,500, bringing Richard the maximum $31,000 SIMPLE IRA contribution this year.

Instead of matching, a company sponsoring a SIMPLE IRA can make non-elective contributions of 2% of pay for each eligible employee, even for those who don't contribute.

Example 2: Walt Vincent works for XYZ Corp., where he earns $50,000 a year. XYZ has chosen to make non-elective contributions to its employees' SIMPLE IRA. Even though Walt does not contribute this year, XYZ must make a contribution of $1,000 (2% of $50,000) to Walt's SIMPLE IRA. These non-elective contributions are capped by an annual compensation limit, which is $270,000 in 2017. As a result, with this method a company's contribution to any employee's SIMPLE IRA can't exceed $5,400 this year (2% of $270,000).

FINE POINTS

During the first two years they are in the plan, SIMPLE IRA participants owe a 25% penalty for in-service withdrawals before age 59½. After two years have passed, the regular 10% early withdrawal penalty applies. During those first two years, rollovers from a SIMPLE IRA to a traditional IRA are prohibited.

Eligible companies generally must establish a SIMPLE IRA by October 1 in order to have the plan in effect for the current year. However, different rules apply to new companies that came into existence after October 1 in a year, and existing companies that previously maintained a SIMPLE IRA plan. ❍

Deciding about a Vacation Home

Whether you live in the thawing North or in the always mild South, the onset of spring leads to thoughts of summer vacations. At this time, you might be weighing the purchase of a second home specifically for vacations. Here are some of the issues to think about, so you can make a well-reasoned decision.

EXTENT OF USE

If you buy a vacation home, how often will you use it? A quaint mountain cabin located in Colorado may be just the thing you're looking for. On the other hand, if you live in New Mexico and buy a place in California, travel constraints may limit the amount of time you'll spend at your vacation home.

In the same vein, buying a second home requires a certain investment, emotional as well as financial. Are you sure you'll want to spend frequent vacations in the same place, year after year?

Family circumstances also play a role in deciding on a vacation home. You might envision a place where children and grandchildren come during summer vacations and school holidays. Such visits can be memorable, but younger family obligations can make scheduling time together difficult.

COST CONSIDERATIONS

As is the case with any real estate purchase, the top two considerations are location and price. Be aware that the cost of a vacation home goes well beyond the initial outlay. Things to consider include furnishings, utilities, HOA fees and internet connectivity.

In addition, typical expenses include property tax, homeowners' insurance, and maintenance (both regular and unexpected). Comparing costs with expenses you incur by renting a house for annual vacations or going to hotels, can help make your decision easier.

TAX TREATMENT

To modify the familiar saying, you shouldn't let the tax tail wag the vacation home dog. Any tax savings you'll enjoy from a purchase will be a pleasant byproduct. Downplaying the tax aspects is especially important now, with uncertainty about future tax legislation.

With that in mind, you should be aware of the current tax treatment of second homes. Taxpayers who itemize deductions typically can include their costs for property tax and any mortgage interest. However, different tax treatments may apply depending on if you rent your second home for **less than or more than 15 days during the year.** Also, consider state income tax ramifications. Typically, if your rental property is located in another state, an income tax filing for that state will be required.

The tax exclusion for capital gains on a home sale (up to $250,000, or $500,000 on a joint return) does not apply to second homes. However, you can sell your primary residence and move into your vacation home for at least two years before selling the vacation home, but current tax law will limit you to counting only a portion of the home sale gain on the former vacation home when calculating the exclusion. ❍

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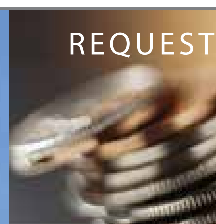

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