CPA

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* **Trusted Business Advisor**SM

April 2017

Dealing With an IRS Audit

IRS data indicate 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.

The latest numbers from the IRS reveal that about 1.5% of all taxpayers with income in the $200,000-$500,000 range are audited. With income from $500,000 to $1 million, the percentage increases to around 3.8%, while more than 8.4% of taxpayers with seven-figure incomes may face IRS questions.

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

What's Inside

Happier Returns
Of the 152 million individual income tax returns filed in 2016, about 110 million generated refunds, averaging $2,857.

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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.

■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.■

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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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. After all, next month will be May, which includes Memorial Day, often considered the unofficial beginning of weekend and weeklong getaways.

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

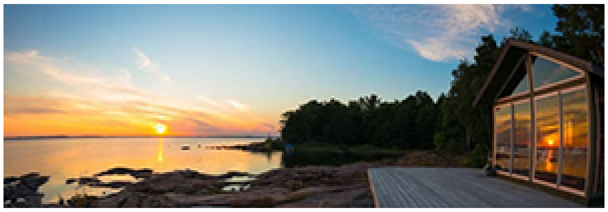
If you buy a vacation home, how often will you use it? A beach house or a lakefront cabin that's, say, 50 miles from your primary residence may offer an opportunity for regular visits. On the other hand, if you live in Pennsylvania and buy a place in Maine, travel constraints may limit the amount of 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? You may be comfortable going away to your own home, where you'll be assured of sleeping on your sheets and eating the food you've stored in your refrigerator. Some people will value the familiarity; however, others may prefer the excitement and adventure of seeing new places, when they take time off from their year-round routine.

Family circumstances also can play a role in deciding about a vacation home. You might envision a place where children and grandchildren come during summer vacations and school holidays. Such visits can be memorable.

In today's world, though, youngsters often have other obligations and opportunities, from soccer practice to wilderness tours. Again, be realistic about how often you can expect "same time, next year" family gatherings.

Cost considerations



As is the case with any real estate purchase, you'll want to buy a desirable vacation home at a reasonable price, one that's not higher than comparable places in the area. Be aware that the cost of a vacation home goes well beyond the initial outlay. You'll probably need to furnish the home, from bedding to bookcases. If you buy a place that's fully or partially furnished, that likely will add to the purchase price —and you'll be living with someone else's taste.

If you own your primary residence, you'll realize the other costs involved in owning a second home. They include property tax, homeowners insurance, utilities, maintenance, and possibly dues to a community association. You can compare those costs with the expense you'd incur by renting a house for annual vacations or going to hotels, when and where you decide to travel.

Of course, buying your own vacation home offers a chance to benefit from property appreciation. Long term, many people have enjoyed gains from real estate, and that's certainly the case if you buy in the right area, at the right price. However, real estate markets are not easy to predict: some home prices have soared in recent years, whereas others have not recovered from the trauma of the 2008-2009 housing crisis. Profits from a vacation home purchase may result, but you can't count on them.

Tax treatment

To modify the familiar saying, you shouldn't let the tax tail wag the vacation home dog. Buy (or decide not to buy) a second home because of how you'll use it and your cost-benefit outlook. Any tax savings you'll enjoy from a purchase will be a pleasant byproduct. Downplaying the tax aspects is especially important now, with such uncertainty about future tax legislation. President Trump and the Republicans in Congress have said they want major changes, but as of this writing, we don't know precisely what will be in any new tax law, or what the effective dates will be.

With that in mind, you should know the current tax treatment of second homes. Taxpayers who itemize deductions typically can include their costs for property tax and any mortgage interest. 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.

Different tax treatment may apply depending on if you rent your second home for less than or more than 15 days during the year. Again, the numbers may be changing, depending on what happens this year in Washington. ■

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ESOPs as Retirement Plans

Among the retirement plans that small businesses can offer to their workers are employee stock ownership plans (ESOPs). As the title indicates, an ESOP is a process for transferring ownership of the company to employees. How does that work as a retirement plan?

In some ways, an ESOP is similar to a profit-sharing plan (see the CPA Client Bulletin, January 2017), in which the company makes cash contributions. With a "vanilla" or unleveraged ESOP, the company funds the plan by contributing shares of its stock, or cash to buy those shares.

Uniquely among retirement plans, ESOPs can be leveraged. In one scenario, the ESOP borrows money from a financial institution or from another party, then uses the borrowed funds to purchase shares of the employer's stock. Once the shares are in the plan, they are allocated to accounts of participating employees, generally all full-time workers over age 21. Assuming the company's shares are not publicly traded, annual independent appraisals track the value of the company's shares, which in turn determine the value of each participant's ESOP holdings.

Current law calls for gradual vesting of all employer contributions over six years, or complete vesting at three years. When employees leave the company, at retirement or sooner, they receive their vested shares. The employer is required to buy back the shares, at the currently appraised price. Therefore, a long-time ESOP participant could retire with a substantial amount from the plan.

Advantages to owners

Why should business owners consider an ESOP? Some studies indicate that employees become motivated to excel when they become employee-owners. They know that good corporate results will boost the annually appraised value of their shares, and ultimately provide a bigger payout. Strong results will benefit major shareholders as well.

What's more, ESOPs offer some exceptional tax benefits to the sponsoring company and its principals.

Example 1: A local bank lends money to an ESOP, which uses those dollars to buy common stock from ABC Corp, the ESOP sponsor. Going forward, ABC makes tax-deductible contributions to the ESOP, which uses that money to repay the bank loan. With such an arrangement, ABC effectively borrows money through the ESOP, then deducts the principal and interest payments made on the ESOP loan, rather than just the interest payments.

In addition to such tax advantages, an ESOP provides a way for business owners to sell their shares at appraised value, if there are no other obvious buyers. In some situations, the owners may be able to defer taxes on a profitable sale of shares to an ESOP, perhaps indefinitely.

Example 2: Alice Baker sells 50% of her Alice Baker Co. stock to her company's ESOP for $2 million. Her basis in those shares is $200,000, giving her a taxable gain of $1.8 million. Alice reinvests the sale proceeds in qualified replacement property, which includes stock in other U.S. corporations. Alice can defer tax on that $1.8 million gain until she sells her qualified replacement property.

If her company is an S corporation, however, Alice won't qualify for the tax deferral on the gain from the sale of her stock to the ESOP. However, ESOPs may offer other tax benefits to S corporations, such as tax exemption for any profits attributable to ESOP ownership.

ESOPs can be expensive

Business owners sponsoring ESOPs may realize advantages, but there are drawbacks as well. Payouts to departing employees, for share buybacks, can be a cash drain. The same is true for regulatory requirements, including annual appraisals. In addition, ESOP participants lack diversification in their retirement plans because the primary holding is the sponsoring company's stock. Therefore, companies that sponsor ESOPs also may offer a retirement plan such as a 401(k), where employees can defer some of their salary (and the tax on that income) in order to acquire other investments.

If the idea of using an ESOP as a retirement plan appeals to you, our office can help you evaluate the costs and the potential benefits. ■

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TAX CALENDAR

APRIL 2017

April 18

Individuals. File a 2016 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. Then, file Form 1040, 1040A, or 1040EZ by October 16.

If you are not paying your 2016 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2017 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of $2,000 or more in 2016 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2015 or 2016 to household employees. Also, report any income tax you withheld for your household employees.

Corporations. File a 2016 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

Corporations. Deposit the first installment of estimated income tax for 2017.

MAY 2017

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2017. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

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