

GRANITE POINT TAX GROUP, LLC



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An approaching presidential election has Congress playing it safe by leaving the tax code largely unchanged. Our focus for this year's Newsletter, then, will be audits; especially how to prepare for one. Full audits remain rare, and the number IRS is initiating has declined due to budget cuts, but they still occur and there are certain things you can do to best prepare yourself for this unnerving experience. Next, we provide our usual tax law update section and some insight into the problems the IRS budget cuts have created for all of us.

An Audit Primer

Types of Audits

Occasionally, and certainly with more frequency than a full audit, IRS (or state or local agency) will ask for information on a specific item reported on a tax return. This is referred to as a correspondence audit, and they are generally resolved by mail or telephone in a short amount of time. As computer systems and information returns improve, notices from IRS informing you they adjusted your return automatically are becoming more common. While technically not an audit, they are typically resolved in a similar manner to the correspondence audit.

The more dreaded form, the type most taxpayers recognize as "being audited," is the tax return examination. Here a revenue agent is tasked with reviewing the tax return for accuracy and is given wide latitude in deciding which items to review and how stringently to investigate them. These audits typically include at least one face-to-face meeting between the agent and the taxpayer (and/or the taxpayer's representative) and are characterized by brief flurries of activity interspersed with weeks or months of silence.

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The Audit Process

The initial correspondence you receive from IRS or ODR initiating a tax return examination will provide an extensive list of documentation for you to provide in order to prove the positions you have reported on your tax return(s). They are well within their rights to request this information and adjust or eliminate any unsubstantiated item on the tax return. We *highly* recommend you retain the services of a tax professional (us or someone like us) as soon as possible; the audit process is littered with procedures and jargon that even the most intelligent taxpayer cannot be expected to know. Furthermore, with a signed Power of Attorney form we can correspond, and even negotiate, directly with the revenue agent on your behalf.

As the audit proceeds, there is usually some back and forth communication with the examiner on issues they are concerned about. Even in the best circumstances, you should expect a full audit to last months. Eventually they will issue an examination letter that states the results of the audit and any adjustment to the tax liability. This letter will usually also include a rough calculation of any applicable penalties and interest. If you agree to the adjustments that are made (or simply wish to capitulate in order to end the ordeal), this will close the audit and the results will be forwarded to the accounts division where a bill or refund check will be issued.

If you cannot reach agreement with the examiner or their manager on a particular issue, the audit result (after closing) can be contested at the Appeals division within IRS. The appeals process involves responding to the auditor's assessment findings in writing to point out the item(s) you disagree with and why. Most appeals are handled by telephone, but you may request a conference at the nearest Appeals office. You might think the IRS Appeals division would be partial to the auditor's findings, but we have not found this to be true in any real sense; they review the strength of each case and have complete authority to adjust or negate any and all findings of the auditor. If you still disagree with the position IRS has taken on an issue after the Appeals stage, you have the option of going to Tax Court, or in some circumstances, to Federal District Court or an obscure court called the Court of Claims. If an appeal to one of these Courts is required, an outside attorney that specializes in tax litigation will need to be retained.

Limiting Your Risk

In recent years, the "leading attack" of a typical audit has shifted from deductions to income. While deductions are still reviewed at a later stage, auditors have generally found it more productive to verify the amount of income reported. Unfortunately, at least in our experience defending such audits, this is because it is extremely difficult and time-consuming for the taxpayer to respond to the methods IRS uses to re-compute income. Here is how it works: First, the auditor requests copies of all monthly bank statements (bear in mind that audits usually span the previous three years of tax returns) for all bank accounts controlled by either spouse. They add up all the deposits to all the accounts for the entire year and this is their starting point. Next they prepare a large spreadsheet that totals all "explained" deposits: paychecks, transfers, gifts from parents, loan proceeds, etc. and compare the total of these deposits to their initial total of all deposits. If total deposits are higher than explained deposits, the difference is assumed to be unreported income and is added to the tax return. While this in itself is bad, it is only half the danger. On the "back end" of the audit, deductions reported on the return are also compared against the bank deposits; any excess is assumed to have been paid with funds received and never deposited. In other words, unreported income. As you can see, this "prove-it-didn't-happen" audit format is extremely difficult to defend.

Proper documentation and certain protocols will be your best defense to any issue that comes up in an audit. To prove your income from a business you should retain copies of all the 1099s you receive from your clients and customers. For retailers point of sale software is essential to track sales income as well as returns and credits. If you maintain inventory you will need to be able to document all your purchases and all returns. You will also need to document your annual beginning and ending inventory as these amounts are used to compute your costs of goods sold.

If you have a small operation, do not be tempted to deposit business income into your personal account. You should be able to easily trace income deposits to your business account and draws of profits you have taken out and deposited into your personal account. If you add personal money to the business account for any reason you should be able to document the source of this money to prove it is not income. On the flip side, you should never use the business account to pay personal expenses. Take a draw first and pay personal bills from your personal account.

For both personal and business deductions, you should have a receipt or access to a receipt for every expenditure. Although credit card or bank statements can work to prove expenses in an audit, the auditor technically can deny any deduction without a matching receipt or invoice from the vendor.

Proving your deduction for business use of your vehicle may be the biggest challenge you will have in an audit. IRS rules require every business trip be documented in some way *at the time it is made*. A mileage log kept in your glove compartment is a good system to use for tracking your mileage. There are also apps available for your smart phone you can use. Unfortunately, the bottom line on business use of a vehicle is that if you estimate your mileage you will most likely lose this deduction in an audit.

A fundamental issue for any audit is maintaining credibility with the auditor. Your record keeping does not have to be spotless or perfect, but if you can show the auditor that you tried to maintain good records and that the missteps were few and inadvertent then you are well on your way to a decent outcome. The first question an auditor will ask is whether you know about any problems with the return. Your instinct will be to try to hide all your mistakes. However, one of the best things you can do to build credibility with an auditor is to voluntarily reveal the errors you know about. They will probably find out about them anyway, so you might as well get it out in the open at the beginning. You would be surprised how often the response is to thank you for your honesty and to *not* make an adjustment (or at least mitigate the impact) for the error you fess up to!

Even if your records are spotless, don't be surprised if there are unresolved disagreements toward the end of the audit. It is not uncommon for taxpayers to eventually reach a point they'd rather just pay the remaining tax adjustment and be done than continue to fight. It can be an emotional, and sometimes even degrading, experience. Proper perspective is critical; remember that the audit process *will* eventually end.

With few exceptions, our experience has been that auditors are at least trying to be fair and that the overall audit process has safeguards (like the appeals division and the Taxpayer Advocate Service) to override an overzealous auditor. We know it is hard not to panic when you receive an audit notice or other correspondence from IRS, but hopefully this information will help you understand a little about the process and what to expect and provide some comfort that there are safeguards in place to make the process fair.

2015 Tax Law Changes.

There were remarkably few changes made to our tax laws this year. In keeping with the very poor practices of prior years, Congress did not address what we call the “extender legislation” until the last half of December. This means we learned a week ago which major elements of the tax code will be applicable to the 2015 tax year (that is not a typo!).

Tax Breaks that Became Permanent

One thing the 2015 legislative session got right was to make certain tax savings provision we have come to rely on permanent. In prior years these provisions were just extended for another year (hence the name “extender legislation”). Here is a list of the provisions that apply commonly to our clients which were made permanent: The ability to direct up to \$100,000 from your IRA to charity tax free; the option to deduct state sales tax on Schedule A; the \$250 above-the-line deduction for teacher supplies; the research and development credit; the generous Section 179 equipment expensing provisions (now with a \$500,000 annual cap); and the American Opportunity tuition credit.

Tax Breaks that were Extended

Some other tax breaks were extended as follows: 50% bonus depreciation is extended through 2017 and will then fall to 40% in 2018 and 30% in 2019; the exclusion of up to \$2 million of personal residence debt forgiveness as income is extended for 2015 and 2016, as is the tuition and fees deduction. Solar system and other energy credits were also extended through 2022.

Other Important Changes

Computer purchases are now allowed as a tax free distribution from a 529 college savings plan.

Penalties under the Affordable Care Act for not having insurance have ratcheted up for 2015. For each taxpayer and dependent claimed on a return the penalty will be the greater of a fixed dollar amount or 2% of income (after some adjustments). The fixed dollar amount and likely the minimum penalty for 2015 will be \$325 for each uninsured family member reported on the return. The penalties will be much, much higher for 2016, so everyone that can afford it should be getting insurance. Those that cannot afford it can apply for an exemption based upon their income level and the cost of insurance in their area, and there are other exemptions available as well. If you have a modest household income, the credits available through the insurance exchanges can be very generous, so we encourage anyone without coverage to apply on the federal or state exchange available in your area. You must file your application before January 31 to purchase insurance through one of the exchanges.

Portland City and Multnomah County Business Tax

Here is a reminder that for partnership and S-corporation returns, no adjustment is allowed for health insurance premiums paid for owners that are used as an above the line deduction on their 1040. We refer to this deduction as the self-employed health insurance deduction. The same rules apply to the deduction for ½ of any self-employment tax paid by owners. The justification for disallowing this adjustment is that they are not expenses of the partnership or S-corporation. Here is some good news on the local tax front, though: Partnerships can deduct

from net taxable income unreimbursed expenses paid by the partners individually. An election to do this must be made each year. Don't worry about these rules if you file Schedule C, as all these expenses are already available to reduce your net income.

Special Issue for S-Corp Health Insurance Reimbursement Plans

On the subject of business owner health insurance deductions, the uncertainty continues over whether a reimbursement arrangement for this insurance cost violates Affordable Care Act provisions that impose a \$100 per day penalty (no typo here). IRS had previously created transitional rules that allowed these arrangements to continue through 2015, and according to available sources this transitional relief will continue until IRS issues "further guidance." With potential penalties this high, we like to make sure our clients are on absolutely sound footing and we are not so sure this bandaid approach by IRS provides it. But for now it is all we have to work with. One source feels a good solution is to simply add the insurance reimbursement amount to officer wages and deduct it like normal wages without taking the special self-employed health insurance deduction. The only problem with this is that the SE health insurance deduction is worth quite a bit of money on most of the returns that use it. So, we are still faced with much uncertainty on what to do for our clients using this deduction. As soon as we know more, you'll know more.

New Filing Date for Foreign Asset Reporting.

We have a new due date for one of the foreign asset reporting forms. Beginning with this filing season Form 114 is due April 15 instead of June 30. For the first time an extension is available for this form with a due date of October 15.

Good News from the State of Oregon - A Kicker is Coming!

We have not seen an Oregon income tax kicker in a few years, but apparently state revenue exceeded expenses by enough in 2014 to trigger an automatic return of a portion of those monies. You can find out how much your kicker will be on the Oregon Department of Revenue's website. The formula for calculating it is your 2014 tax liability before credits (but after the credit for taxes paid to another state) multiplied by 5.6 percent. For most of us it is just 5.6% of the Oregon tax we paid last year (Line 32 of Form 40). Unfortunately, they will not be sending checks as was done in the past. We will claim the kicker amount as a credit on the 2015 tax return.

Gift and Estate Tax Items.

The federal gift and estate tax exemption amount will be \$5,450,000 for deaths in 2016. This means spouses can together shelter \$10,900,000 from estate tax. Using both exemption amounts is easier than it used to be under our relatively new "portability" rules that basically provide an automatic election to preserve the first spouse to die's exemption amount. A new rule for 2016 requires that executors filing a Form 706 (the federal estate tax reporting form) must give the estate's heirs notice of the adjusted basis in inherited assets. Assets usually receive an upward basis adjustment that is equal to their fair market value on the date of death. This will reduce or eliminate gain on the sale of inherited assets. The adjustment can be downward as well when an asset has depreciated. This adjustment will reduce or eliminate the losses available from the disposition of an inherited asset. Knowing the correct basis in inherited assets is obviously important so the added burden this notice creates is worth shouldering. The gift tax exclusion amount remains at \$14,000 for 2016. Oregon's estate tax

exemption amount remains at \$1,000,000. The very generous pre-death gift planning we have discussed in prior Newsletters also remains available and can be used to eliminate not only any tax due, but the filing requirement as well.

Is IRS on the Ropes?

It all started when IRS targeted nonprofit organizations that looked like they were cheating by hiding their political fundraising under the umbrella of a not-for-profit, charitable organization. Congressmen, who by the way receive lots of money from these political groups, got angry that IRS was singling out these groups for investigation and ended up cutting IRS' budget. We are seeing and feeling the impact these budget cuts have had on IRS right now. And it looks like things will get worse before they get better.

Before you think maybe this is a good thing, consider the impact to you and your fellow Americans. What if the person that reviews your return is poorly trained, or makes a mistake when calculating your tax after an adjustment? Or what if no one is available to process your refund claim for four months because of staff cuts? Or what if you (or we) have a simple question to ask about your return or the tax law and want to call IRS. Well, you can forget about that last one. There isn't even a wait time for some IRS phone lines anymore. The message simply informs you they are not answering the phone!! As for the other examples, we have seen all of them occur in the last year.

To give you a sense of the scale of their cuts, one source reports they have lost almost 20% of their 2010 funding level after adjustments for inflation and have 13,000 fewer employees. There was a slight increase in their budget allocations for 2016 (\$290 million), but nothing close to the \$2 billion increase they requested to try to restore services and service quality. All of this occurs at a time when IRS is taking on more responsibilities, most notably policing compliance with the Affordable Care Act.

Our expectation is that things will be getting worse over the next few years as the IRS deals with both a freeze on hiring and attrition from retirement and has to cut back on training and investment in new programming. As much as we may grumble about the IRS, we used to at least admire them for their efficiency and very low error rates in the adjustments they made. This, we fear, is in the past and now we need to look carefully at the notices IRS sends to check for errors and take the time and, regrettably, incur the expense of correcting any errors we see through lengthy mail responses.

Thank You

As always, we close our newsletter with a heartfelt Thank You! Your continued patronage is a sign of trust that we do not take lightly. We hope you have a fulfilling and successful 2016 and we look forward to seeing or hearing from everyone.

