Freddi Eberhart & Associates Inc.
CERTIFIED PUBLIC ACCOUNTANTS

Newsletter

MARCH 2020

Freddi Eberhart & Associates Inc. would like to thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time. Also, thank you for recommending us to your family, friends, and associates. We truly appreciate your referrals.

This Month:

March 16

- Due date for partnership and S corporation tax returns (Forms 1065, 1120S)

Reminders

- Daylight saving time begins Sunday, March 8

The tax filing deadline is right around the corner! As you're busy gathering your tax documents or reviewing your tax return, included here is a caution concerning the security of IRS online applications and websites. Also included is information regarding the tax gap, tax returns that may be selected by the IRS for an audit and useful tax tips for individuals.

Please call if you would like to discuss how this information could impact your situation. If you know someone who can benefit from this newsletter, feel free to send it to them.

The IRS Data Theft Problem

Here's how to minimize your risk

What better place for online thieves to target than a database that contains 300 million+ Social Security numbers and a treasure trove of financial information?

The IRS has 52 Internet applications to help U.S. citizens comply with their tax obligations. But these online portals, which collect, process and store large amounts of personal information and tax data, are also a potential gateway for online criminals and identity thieves.

While the IRS's electronic authentication security controls have improved, the Treasury Inspector General recently said that the IRS's internet applications are not yet compliant with the National Institute of Standards and Technology guidelines.

Here's what you can do to protect your tax-related identity and information while the IRS tries to improve its security controls:

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The IRS Data Theft Problem (Cont'd)

- **Use the IRS's Internet applications judiciously.** Think you need to use one of the IRS's online applications? Consider requesting or obtaining certain information via the U.S. Postal service. Simply decide if you're willing to take a risk using an application that isn't compliant with the National Institute of Standards and Technology.
- **Get an IP PIN.** An Identity Protection PIN (IP PIN) is a six-digit number that helps prevent your Social Security number from being used on fraudulent federal income tax returns. If you are a confirmed victim of identity theft, the IRS will mail you an IP PIN after the fraudulent tax issue has been resolved. If you haven't been the victim of tax-related identity theft, you can voluntarily ask the IRS to issue you an IP PIN if you live in certain states. Additional states will be added until the IP PIN program is available nationwide.
- **Review your credit report once a year.** Check your credit report for any unauthorized activity or errors. This periodic review can often be the earliest warning that your private information is compromised.

The Tax Gap

The "tax gap" is a concept developed by the Internal Revenue Service to measure voluntary compliance with the tax laws by taxpayers. The tax gap is the difference between what taxpayers should have paid and the amount that is actually paid voluntarily and timely.

According to the latest tax gap figures, about 83% of all taxes owed are paid as due. That leaves a 17% noncompliance rate for a tax gap of about $450 billion. IRS enforcement activities, including tax return audits, collect about $65 billion of this tax revenue shortage.

There are three components to the tax gap: nonfiling, underreporting, and underpayment. The tax gap does not include taxes that should have been paid on income from illegal activities.

Underreporting accounts for about 84% of the tax gap. The largest sub-component for underreporting involves individual taxpayers understating their income, taking improper deductions, and overstating business expenses. Noncompliance is highest where there is no third-party reporting and/or withholding such as there is with W-2s and 1099 information slips.

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The Tax Gap (Cont'd)

The current IRS measurement of the tax gap was done using tax returns from a few years ago. The information on the tax gap assists the IRS in selecting tax returns for audit. The intent is to select those tax returns that will lead to the greatest amount of additional tax. This not only improves IRS efficiency, but it also demonstrates to taxpayers that others will be paying according to the tax laws.

What does all this mean to you? If a large portion of your income is not subject to third-party reporting, you may be in a group that is on a potential tax return audit list this year.

Will Your Tax Return be Audited?

Few things are more unnerving than having your tax return selected for an IRS audit. The IRS uses that "audit anxiety" to help keep taxpayers honest on their tax returns.

DIF scores count

The IRS evaluates tax returns based on their "DIF" scores, a set of IRS formulas known as the "Discriminate Inventory Function System." About three-quarters of all returns audited are selected by the DIF computer, which compares deductions, credits, and exemptions with the norms for taxpayers in each income bracket.

While these formulas are kept very secret by the IRS, you can count on having a higher audit probability if you fall into certain categories or report certain things on your tax return.

What interests the IRS?

Some higher risk areas include the following -

1. **Tax protests.** Both the IRS and tax courts are getting fed up with what they consider frivolous tax protests. If you file a return stating that you owe no tax because the dollar is worthless or make some other such protest, you'll probably be audited.

2. **High income.** Because auditing higher-income taxpayers is likely to produce more additional tax revenue than auditing lower-income taxpayers, this category is targeted by the IRS.

3. **Certain occupations.** Taxpayers whose occupations produce cash income, such as taxi drivers and waiters, run a higher risk of being audited. Self-employed individuals, particularly independent contractors, are IRS targets for the same reason; they are more likely to have unreported cash income.

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Will Your Tax Return be Audited (Cont'd)

4. **No preparer or a problem preparer.** If you have a complex return and prepared it yourself, or if your return was prepared by someone on the IRS's problem-preparer list, you are more likely to be audited.

5. **Certain deductions.** The IRS has found it profitable to audit returns that claim office-in-the-home deductions, travel and entertainment deductions, and certain other write-offs where they feel taxpayers stretch the truth.

6. **Related party transactions.** Taxpayers who involve family members in their financial operations are more likely to be scrutinized by the IRS. Paying wages to your children, lending money to relatives, splitting income among family members, or running a family business will make the IRS more interested in your returns.

7. **Abusive tax shelters and offshore accounts.** In the last few years the Internal Revenue Service has detected a proliferation of abusive trust tax evasion schemes. It also believes some people are using offshore credit cards to evade paying U.S. income taxes. The IRS intends to expand its efforts to crack down on abuses in these areas.

Your best audit defense

Unless there is suspicion of fraud or substantial understatement of income, the IRS has three years from the due date of your return to initiate an audit. Typically, most returns are selected within two years of their filing date.

The best defense in an audit is a two-part strategy:

1. Have supporting documentation for all deductions and credits.

2. See your accountant immediately upon notification that you're being audited.

A professional can put your mind at ease, find the information that the IRS wants more quickly than you can, and very likely will save you money in the long run by getting a faster and more favorable conclusion to the audit.

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Ten Tax Tips for Individuals

Frequent tax law changes have made the tax code very complicated; only the informed taxpayer can take advantage of tax-cutting opportunities that remain.

Here are some suggestions you should consider if you're interested in cutting your taxes.

1. **Reduce your consumer debt.** The interest you pay on consumer debt is not deductible. Consider shifting consumer debt to a home-equity loan (where available and not to exceed $100,000) to maintain deductibility for the interest. Don't rush into anything, however. Consider loan origination costs and points you may have to pay. Also, realize that if you can't make the payments on the home-equity loan, you could lose your house.

2. **Rehabilitate an old building.** One tax break that may be attractive to you is the credit for rehabilitating old buildings - either commercial or certified historic structures. If you don't want to do the work yourself, consider investing in partnerships that rehabilitate old structures.

3. **Watch for AMT liability.** The alternative minimum tax (AMT) is the one you pay when too many tax preference items reduce your regular tax below a certain amount. If you use preference items to reduce your taxes - such as accelerated depreciation, private activity bond interest, etc. - you may want to shift income and deductions to keep the alternative minimum tax from applying to you.

4. **Time any change in marital status with a view to minimizing taxes.** Among the areas that could be affected are deductibility of IRA contributions, lost itemized deductions, and a shift to a different tax bracket. You might be able to cut your tax bill by delaying or accelerating a marriage or divorce.

5. **Contribute to a retirement plan. Retirement plans are still an excellent tax shelter.** Consider a retirement account strategy to reduce your self-employed income, even part-time or in a second business. If you're an employee, find out if your company has a 401(k) or other plan and make contributions to it. If you qualify, you should also consider an IRA.

6. **Use your vacation home wisely.** If you own a second or vacation home, find out whether you get a better tax break by treating the property as a second residence or as a rental property. The number of days you personally use the home is crucial, so get details immediately.

7. **Avoid the "kiddie" tax.** Check the income of any children under the age of 19 (24 for full-time students). Unearned income beyond a certain amount will be taxed at your highest rate. Shifting investments or making other adjustments may be appropriate.

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Tax Tips for Individuals (Cont'd)

8. **Make your hobby a business.** If you're making money from a hobby, turn your hobby into a business so that you can write off your expenses. You must be able to demonstrate that you engaged in the activity for a profit. To do that, conduct the activity as a business. Keep records, and get a separate bank account for the activity. The IRS will expect your sideline business to show a profit in three out of five years, or you'll have to prove your profit motivation in order to deduct losses.

9. **Don't overlook medical deductions.** If you help to support an elderly relative who lives in a nursing home for medical reasons, the cost of the nursing home may qualify for the medical deduction. If you make improvements to your home for medical reasons, the cost of such improvements are medical expenses to the extent the improvements do not increase the value of your home. That includes such things as widening doorways for wheelchair use or modifying the home to accommodate an individual with a medical problem.

10. **Take the child care credit if you qualify.** If you pay for child care services while you work or go to school, you may qualify for the child care credit. The credit is allowed only for children under the age of 13. You must report on your tax return the name, address, and taxpayer identification number of the care provider.

There are other tax-cutting strategies in addition to those mentioned here. If you would like assistance in selecting tax-saving strategies that make the most sense in your situation, please call.

As always, should you have any questions or concerns regarding your tax situation please feel free to call.

This newsletter provides business, financial, and tax information to clients and friends of our firm. This general information should not be acted upon without first determining its application to your specific situation. For further details on any article, please contact us.

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