Precision Monthly

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Five Red Flags That Raise the Odds of an Audit

The IRS audited about 1 million tax returns in fiscal year 2018, and nearly 75% of those examinations were conducted entirely through correspondence.[1] Taxpayers selected for an official audit are notified by mail.

Confusing matters, the IRS also mails other types of compliance notices, which may propose additional tax based on math errors, the automated detection of underreported income, or other factors. The National Taxpayer Advocate calls these notices "unreal" audits, because the IRS doesn't count them as audits. But their impact is real — so the frequency and effectiveness of IRS compliance contacts are somewhat understated. About 8.5 million taxpayers experienced "unreal" audits during fiscal year 2016, and if they were included the audit rate would jump from 0.7% to more than 6.0%.[2]

When the IRS gets real

If selected for a correspondence audit, you may be asked to mail specific information to the IRS. Some examinations require an in-person interview, which could take place in an IRS office (referred to as an office audit). A comprehensive field audit would be conducted at your home, place of business, or accountant's office.

How is a return selected for examination? When your federal income tax return is processed, a computer program called the Discriminant Inventory Function System (DIF) screens for anomalies, compares deductions to those of taxpayers with similar incomes, and assigns a DIF score. The higher the DIF score, the greater the potential that an audit will result in the collection of additional taxes. In some cases, a return is examined because it's related to a transaction with another taxpayer who has been audited.

Risky returns

There's no way to know exactly what will trigger an audit, but one or more of the following red flags could make it more likely that the IRS will take a closer look at your tax return.

1. Missing income. Don't forget sources of income not reported on a Form W-2, which might include investment income, interest, royalties, rent, compensation as an independent contractor, forgiven debt, alimony, tips, gambling winnings, health insurance reimbursements for expenses deducted in a previous year, and proceeds from selling goods online. These types of income may or may not be reported by the payer to the IRS, but you must include all income, whether you receive a Form 1099 or not.

2. Overdoing deductions. Even if they are allowed by law, deductions that are unusually large for your income level can appear suspicious. For this reason, high-value charitable donations require specific documentation.

3. Filing a Schedule C. Thorough recordkeeping is critical for self-employed taxpayers, especially when claiming deductions for a home office or vehicle expenses (which require a written log).

4. Keeping money in foreign accounts. Foreign assets worth at least $50,000 at year-end or greater than $75,000 at any time during the year must be reported. (These thresholds are $100,000 and $150,000, respectively, for married joint filers.) Other complicated rules apply. Many overseas financial institutions are required to provide information about U.S. asset holders to the IRS, so even though the reporting of foreign assets (by you or the institution) may invite IRS scrutiny, noncompliance can result in penalties or legal problems.

5. Reporting a high (or very low) income. Audit rates are higher for wealthier taxpayers as well as for those with little or no income (possibly due to questionable tax deductions). Even though these situations are more complicated, they are often perfectly valid. Still, it might be wise to consult a trusted tax or legal professional if you receive any type of compliance-related communication from the IRS.

1 Internal Revenue Service, 2019

2 Taxpayer Advocate Service, 2018

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Is It Time to Review Your IRA Estate Planning Strategies?

The SECURE Act ushered in changes that may have a dramatic impact on IRA estate planning strategies. Account owners may want to review their plans with their financial professionals.

There are costs and ongoing expenses associated with the creation and maintenance of trusts.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, which was passed in December 2019 as part of a larger federal spending package, included a provision that warrants special attention from those who own high-value IRAs. Specifically, the "stretch" IRA provision — which permitted nonspouse beneficiaries who inherited IRAs to spread distributions over their lifetimes — has been substantially restricted. IRA owners may want to revisit their estate planning strategies to help prevent their heirs from getting hit with higher-than-expected tax bills.

The old "stretch" rules

Under the old rules, a nonspouse beneficiary who inherited IRA assets was required to begin minimum distributions within a certain time frame. Annual distributions could be calculated based on the beneficiary's life expectancy. This ability to spread out taxable distributions over a lifetime helped minimize the annual tax burden on the beneficiary. In the past, individuals could use this stretch IRA strategy to allow large IRAs to continue benefiting from potential tax-deferred growth for possibly decades.

Example: *Consider the hypothetical case of Margaret, a single, 52-year-old banking executive who inherited a million-dollar IRA from her 85-year-old father. Margaret had to begin taking required minimum distributions (RMDs) from her father's IRA by December 31 of the year following her father's death. She was able to base the annual distribution amount on her life expectancy of 32.3 years. Since she didn't really need the money, she took only the minimum amount required each year, allowing the account to continue growing. Upon Margaret's death at age 70, the remaining assets passed to her 40-year-old son, who then continued taking distributions over the remaining 13.3 years of Margaret's life expectancy. The account was able to continue growing for many years.*

The new rules

As of January 2020, the rules for inherited IRAs changed dramatically for most nonspouse beneficiaries.[1] Now they generally are required to liquidate the account within 10 years of the account owner's death. This shorter distribution period could result in unanticipated and potentially large tax bills for high-value inherited IRAs.

Example: *Under the new rules, Margaret would have to empty the account, in whatever amounts she chooses, within 10 years. Since she stands to earn her highest-ever salaries during that time frame, the distributions could push her into the highest tax bracket at both the federal and state levels. Because the account funds would be depleted after 10 years, they would not eventually pass to her son, and her tax obligations in the decade leading up to her retirement would be much higher than she anticipated.*

Notable exceptions

The new rule specifically affects most nonspouse designated beneficiaries who are more than 10 years younger than the original account owner. However, key exceptions apply to those who are known as "eligible designated beneficiaries" — a spouse or minor child of the account owner; those who are not more than 10 years younger than the account owner (such as a close-in-age sibling or other relative); and disabled and chronically ill individuals, as defined by the IRS. The 10-year distribution rule will also apply once a child beneficiary reaches the age of majority and when a successor beneficiary inherits account funds from an initial eligible designated beneficiary.

A word about trusts

In the past, individuals with high-value IRAs have often used what's known as conduit — or "pass-through" — trusts to manage the distribution of inherited IRA assets. The trusts helped protect the assets from creditors and helped ensure that beneficiaries didn't spend down their inheritances too quickly. However, conduit trusts are now subject to the same 10-year liquidation requirements, so the new rules may render null and void some of the original reasons the trusts were established.

What can IRA account owners do?

IRA account owners should review their beneficiary designations with their financial or tax professional and consider how the new rules may affect inheritances and taxes. Any strategies that include trusts as beneficiaries should be considered especially carefully. Other strategies account owners may want to consider include converting traditional IRAs to Roths; bringing life insurance, charitable remainder trusts, or accumulation trusts into the mix; and planning for qualified charitable distributions.

[1] For account owners who died prior to December 31, 2019, the old rules apply to the initial beneficiary only (i.e., successor beneficiaries will be subject to the 10-year rule).

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Evaluating College Acceptances

Comparing college costs

To compare college costs in an apples-to-apples way, calculate your out-of-pocket cost, or net price, at each college and then compare them. Your out-of-pocket cost is the total cost of a particular college minus any grant or scholarship aid offered by that school. Once you know your out-of-pocket cost at each college, you can then determine how much, if anything, you or your child will need to borrow.

For most high school seniors, spring is crunch time. College acceptances have been arriving, and a deposit must be received by the college the student plans to attend by May 1. The period of time between acceptances and deposit can be intense as students and their parents weigh a number of factors. Here are two questions to ask as your family evaluates college acceptances.

How well does the college meet your child's needs?

Presumably, all the colleges your child applied to would do a good job of meeting your child's needs; otherwise he or she wouldn't have applied there in the first place. But now that your child has a definite list of options, it's time to look at things a little more closely.

Most colleges host an accepted students day geared exclusively to incoming students. Even if your child has already visited the college, visiting again might be helpful. Your child will meet other accepted students; hear in more detail about the offerings related to academics, extracurricular activities, and campus life; and possibly notice things on campus that might have been missed the first time around. Some colleges even offer overnight stays in the dorms. You and your child might also get a chance to explore the surrounding area and see what it would be like to travel back and forth from home. After visiting again, does the college still have the same appeal that it did when your child applied? If not, why?

If your child can't visit in person, there are other ways to do additional research. Your child might email a particular department, professor, or student ambassador with specific questions or browse the college's website to dive deeper into major requirements, campus events, or fitness classes. Your child might also browse online forums and read student reviews of the college. Keep in mind that no college is immune from an occasional negative review, but a similar, consistent complaint or perspective across multiple forums might mean there is a ring of truth to a particular issue. At the very least, a cluster of negative reviews might prompt your child to investigate further.

Finally, don't overlook academic flexibility. Many college students end up changing their majors down the road. If your child decides to change majors, would he or she be able to find another one relatively easily? Another consideration might be the ease of double majoring or minoring, and the ability to earn a master's degree at the same institution in one year versus two by taking graduate-level courses in senior year.

How much will it cost you *and* your child?

Even if a college meets your child's needs, you should consider its affordability. The news is filled with stories about skyrocketing student debt and the debilitating effects — on students and parents — of taking on too much debt.

A college acceptance packet should include a detailed breakdown of any financial aid the college is offering, including loans, grants, scholarships (need-based or merit-based), and a work-study job. Make sure to read the fine print carefully and understand *exactly* what the college is offering. For example, a college might say, "Congratulations! You've been awarded $30,000...," which you might think is a scholarship but actually includes $5,500 in loans and $2,000 in work-study. As you review the award, keep in mind that if a college says it is meeting "100% of your demonstrated need," the college is the one that defines your need, not you.

The goal is to compare your out-of-pocket cost at each college. To do this, look at the total cost of attendance for each school (this figure includes tuition and fees, room and board, plus a discretionary sum for books, personal expenses, and transportation). Next, list any grants or scholarships that the college is offering. If the grant or scholarship is merit-based, find out whether it's guaranteed for all four years and if there are any requirements that must be met to qualify each year (e.g., a 3.0 minimum GPA or participation in a certain activity). If the grant or scholarship is need-based, find out whether you can expect a similar amount each year as long as your income and assets stay roughly the same (and you'll have the same number of children in college), and ask whether it increases each year to match any annual increase in tuition.

The difference between a college's total cost of attendance and any grant or scholarship aid is your out-of-pocket cost or "net price." Compare your net price across all colleges. Next, with your net price in hand, determine how much, if anything, you and your child will need to borrow. Multiply this figure by four to get an idea of what your total borrowing costs might be over four years. Then use a loan repayment calculator to show your child what the monthly loan repayment would be over a standard 10-year term at a fixed interest rate for the amount he or she will need to borrow (and do the same for yourself). Armed with these numbers, you and your child can make an informed college decision.

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Is there any way to stop getting unwanted robocalls?

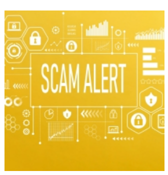
Whether it's a helpful announcement from your child's school or an appointment reminder from a doctor's office, getting robocalls has become an everyday occurrence. Unfortunately, robocalls are also used by criminals to collect consumers' personal and financial information and/or conduct various scams.

The good news is that consumers have won additional protections against unwanted robocalls under the Telephone Robocall Abuse Criminal Enforcement and Deterrence (TRACED) Act. One of the main goals of the law is to make it easier for consumers to avoid unwanted robocalls by:

- Requiring all carriers to implement caller-ID technology at no additional cost to consumers
- Making it easier for law enforcement to prosecute illegal robocallers and increasing penalties for robocall violations
- Creating an interagency task force to study and improve government prosecution of robocall violations

Even when these new protections are implemented, it will take some time to eliminate unwanted robocalls. In the meantime, here are some things you can do to protect yourself:

- Don't answer calls when you don't recognize the phone number.
- If you pick up an unwanted robocall, hang up right away and avoid answering "yes" or "no" questions, providing personal information, or pressing a number to "opt out."
- Consider signing up for a robocall blocking service. Many phone service providers now offer robocall blocking solutions at no additional charge, or you can download additional robocall protection through a third-party app.
- Register your phone number on the National Do Not Call (DNC) Registry, which removes your number from the call lists used by legitimate telemarketing companies. Keep in mind that registering with the DNC Registry will result in your getting fewer calls from legitimate telemarketers, but it won't stop illegal robocallers from contacting you.



How can I avoid becoming a victim of a social engineering scam?

Imagine that you receive an email with an urgent message asking you to verify your banking information by clicking on a link. Or perhaps you get an enticing text message claiming that you've won a free vacation to the destination of your choice — all you have to do is click on a link you were sent. In both scenarios, clicking on the link can accidentally result in revealing your sensitive personal and financial information to a cybercriminal.

In a social engineering scam, a cybercriminal psychologically manipulates victims into divulging sensitive information. Cybercriminals "engineer" believable scenarios designed to evoke an emotional response (curiosity, fear, empathy, or excitement) from their victims. As a result, people often react without thinking first due to curiosity or concern about the message that was sent. Since social engineering scams appear in many forms and appeal to a variety of emotions, they can be especially difficult to identify.

Fortunately, there are steps you can take to protect yourself from a social engineering scam:

- If you receive a message conveying a sense of urgency, slow down and read it carefully before reacting. Don't click on suspicious or unfamiliar links in emails, text messages, and instant messaging services.
- Never download email attachments unless you can verify that the sender is legitimate. Similarly, don't send money to an email that requests charitable help unless you can follow up directly with the organization.
- Be wary of unsolicited messages. If you get an email or a text that asks you for financial information or passwords, do not reply, delete it.
- Remember that social engineering scams can also be used over the phone. Use healthy skepticism when you receive phone calls that demand money or request sensitive personal and financial information.