# Hess & Hess, LLP

*Quarterly Tax Newsletter*

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**2020 - Q2**

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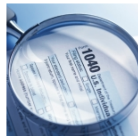
## Five Red Flags That Raise the Odds of an Audit



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


See disclaimer on final page

## The SECURE Act Offers New Opportunities for Individuals and Businesses

The SECURE Act (Setting Every Community Up for Retirement Enhancement Act) is major legislation that was passed by Congress as part of a larger spending bill and signed into law by the president in December. Here are a few provisions that may affect you. Unless otherwise noted, the new rules apply to tax or plan years starting January 1, 2020.

### If you're still saving for retirement

To address increasing life expectancies, the new law repeals the prohibition on contributions to a traditional IRA by someone who has reached age 70½. Starting with 2020 contributions, the age limit has been removed, but individuals must still have earned income.

### If you're not ready to take required minimum distributions

Individuals can now wait until age 72 to take required minimum distributions (RMDs) from traditional, SEP, and SIMPLE IRAs and retirement plans instead of taking them at age 70½. (Technically, RMDs must start by April 1 of the year following the year an individual reaches age 72 or, for certain employer retirement plans, the year an individual retires, if later).

### If you're adding a child to your family

Workers can now take penalty-free early withdrawals of up to $5,000 from their qualified retirement plans and IRAs to pay for expenses related to the birth or adoption of a child. (Regular income taxes still apply.)

### If you're paying education expenses

Individuals with 529 college savings plans may now be able to use account funds to help pay off qualified student loans (a $10,000 lifetime limit applies per beneficiary or sibling). Account funds may also be used for qualified higher-education expenses for registered apprenticeship programs. Distributions made after December 31, 2018, may qualify.*

### If you're working part-time

Part-time workers who log at least 500 hours in three consecutive years must be allowed to participate in a company's elective deferral retirement plan. The previous requirement was 1,000 hours and one year of service. The new rule applies to plan years beginning on or after January 1, 2021.

### If you're an employer offering a retirement plan

Employers that offer plans with an automatic enrollment feature may automatically increase employee contributions until they reach 15% of pay (the previous cap was 10% of pay). Employees will have the opportunity to opt out of the increase.

Small employers may also benefit from new tax credit incentives. The tax credit that small businesses may take for starting a new retirement plan has increased. Employers may now take a credit equal to the greater of (1) $500 or (2) the lesser of (a) $250 times the number of non-highly compensated eligible employees or (b) $5,000. The previous maximum credit amount allowed was 50% of startup costs up to a maximum of $1,000 (i.e., a $500 maximum credit).

In addition, a new tax credit of up to $500 is available to employers that launch a new SIMPLE IRA or 401(k) plan with automatic enrollment.

These credits are available for three years, and employers that qualify may claim both credits.

*There are generally fees and expenses associated with 529 savings plan participation. Investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free if used for qualified higher-education expenses. For withdrawals not used for qualified higher-education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. Discuss the tax implications of a 529 savings plan with your legal and/or tax advisors; these can vary significantly from state to state. Most states offer their own 529 plans, which may provide advantages and benefits exclusively for residents and taxpayers, including financial aid, scholarship funds, and protection from creditors.

*Before investing in a 529 savings plan, consider the investment objectives, risks, charges, and expenses carefully. Obtain the official disclosure statements and applicable prospectuses — which contain this and other information about the investment options, underlying investments, and investment company — from your financial professional. Read these materials carefully before investing.*

# Key Retirement and Tax Numbers for 2020

Every year, the Internal Revenue Service announces cost-of-living adjustments that affect contribution limits for retirement plans and various tax deduction, exclusion, exemption, and threshold amounts. Here are a few of the key adjustments for 2020.

## Employer retirement plans

- Employees who participate in 401(k), 403(b), and most 457 plans can defer up to $19,500 in compensation in 2020 (up from $19,000 in 2019); employees age 50 and older can defer up to an additional $6,500 in 2020 (up from $6,000 in 2019).
- Employees participating in a SIMPLE retirement plan can defer up to $13,500 in 2020 (up from $13,000 in 2019), and employees age 50 and older can defer up to an additional $3,000 in 2020 (the same as in 2019).

## IRAs

The combined annual limit on contributions to traditional and Roth IRAs is $6,000 in 2020 (the same as in 2019), with individuals age 50 and older able to contribute an additional $1,000. For individuals who are covered by a workplace retirement plan, the deduction for contributions to a traditional IRA phases out for the following modified adjusted gross income (MAGI) ranges:

| | 2019 | 2020 |
|---|---|---|
| **Single/head of household (HOH)** | $64,000 - $74,000 | $65,000 - $75,000 |
| **Married filing jointly (MFJ)** | $103,000 - $123,000 | $104,000 - $124,000 |
| **Married filing separately (MFS)** | $0 - $10,000 | $0 - $10,000 |

***Note:*** *The 2020 phaseout range is $196,000 - $206,000 (up from $193,000 - $203,000 in 2019) when the individual making the IRA contribution is not covered by a workplace retirement plan but is filing jointly with a spouse who is covered.*

The modified adjusted gross income phaseout ranges for individuals to make contributions to a Roth IRA are:

| | 2019 | 2020 |
|---|---|---|
| **Single/HOH** | $122,000 - $137,000 | $124,000 - $139,000 |
| **MFJ** | $193,000 - $203,000 | $196,000 - $206,000 |
| **MFS** | $0 - $10,000 | $0 - $10,000 |

## Estate and gift tax

- The annual gift tax exclusion for 2020 is $15,000, the same as in 2019.
- The gift and estate tax basic exclusion amount for 2020 is $11,580,000, up from $11,400,000 in 2019.

## Standard deduction

| | 2019 | 2020 |
|---|---|---|
| **Single** | $12,200 | $12,400 |
| **HOH** | $18,350 | $18,650 |
| **MFJ** | $24,400 | $24,800 |
| **MFS** | $12,200 | $12,400 |

***Note:*** *The additional standard deduction amount for the blind or aged (age 65 or older) in 2020 is $1,650 (the same as in 2019) for single/HOH or $1,300 (the same as in 2019) for all other filing statuses. Special rules apply if you can be claimed as a dependent by another taxpayer.*

## Alternative minimum tax (AMT)

| | 2019 | 2020 |
|---|---|---|
| **Maximum AMT exemption amount** | | |
| **Single/HOH** | $71,700 | $72,900 |
| **MFJ** | $111,700 | $113,400 |
| **MFS** | $55,850 | $56,700 |
| **Exemption phaseout threshold** | | |
| **Single/HOH** | $510,300 | $518,400 |
| **MFJ** | $1,020,600 | $1,036,800 |
| **MFS** | $510,300 | $518,400 |
| **26% rate on AMTI* up to this amount, 28% rate on AMTI above this amount** | | |
| **MFS** | $97,400 | $98,950 |
| **All others** | $194,800 | $197,900 |
| *Alternative minimum taxable income | | |

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Health reimbursement arrangements (HRAs) are employer-sponsored accounts that help employees pay for health-care expenses on a tax-advantaged basis. An employer establishes HRA accounts on behalf of employees and allocates a certain amount of money to them each year. Funds accumulate tax-free and are used to reimburse employees for qualified medical expenses such as health insurance premiums, routine medical bills, deductibles, and prescription drugs. Beginning in January 2020, employers can offer two new types of HRAs — an Individual Coverage HRA and an Excepted Benefit HRA.

**Individual Coverage HRA (ICHRA).** Employees can use funds allocated by their employer to buy their own health insurance on the individual market, subject to certain conditions. ICHRAs can also satisfy the Affordable Care Act (ACA) employer mandate as long as they provide sufficient funding to be considered "affordable." (Per the ACA, employers with 50 or more full-time employees are required to offer affordable health coverage that meets certain minimum standards.) ICHRAs may be especially appealing to small employers that want to offer health coverage but have found traditional group plans to be cost-prohibitive. The U.S. Departments of Health and Human Services, Labor, and the Treasury, which issued the new rules in June 2019, estimate that approximately 800,000 small businesses will offer ICHRAs to their employees.

**Excepted Benefit HRA (EBHRA).** This type of HRA must be offered in conjunction with a traditional health plan. It allows employers to set aside a limited amount of funds ($1,800 per employee in 2020) to help pay for qualified medical expenses, including premiums for vision and dental insurance, COBRA coverage, and short-term, limited-duration insurance (not offered in all states). It is available even if the employee declines to participate in the primary plan.

Employees cannot be offered both an ICHRA and an EBHRA. Certain rules (including nondiscrimination rules), requirements, and conditions apply. For more information, review the new rules carefully and visit the FAQ page on the IRS website.

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Retirement health-care costs will vary depending on your health and longevity, but it may help to have a guideline. These are the estimated savings required for an individual or couple who turned 65 in 2019 to have a 90% chance of meeting expenses for Medicare Part B health insurance, Part D prescription drug coverage, Medigap Plan F, and out-of-pocket drug costs, assuming median prescription drug expenses.* These estimates do not include services not covered by Medicare or Medigap.

*Medigap Plan F is used for these estimates because it is the most comprehensive coverage available and simplifies the calculation. However, this plan may not be available for new beneficiaries after January 1, 2020. Current enrollees may keep Plan F, and most other plans will remain available for new enrollees.

Source: Employee Benefit Research Institute, 2019

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