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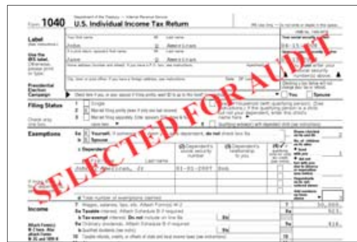
10 Reasons For The IRS To Flag Your Return

What sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 "red flags" that could increase the chance you'll be tapped for an audit.



1. High income. The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of $200,000 or more. That's almost one out of every 25 returns. The IRS tends to chase the "big money," and while that's no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

2. Unreported income. The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You're likely to draw IRS scrutiny if you don't report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

3. Large charitable gifts. Besides providing personal satisfaction, deductions for charitable gifts can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

4. Home office deductions. If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office "regularly and exclusively" as your principal place of business. Simply doing work at home when your main office is elsewhere won't cut it.

5. Rental real estate losses. Generally, "passive activity" rules prevent investors from deducting losses on rental real estate. But a special exception allows a loss deduction of up to $25,000 for "active participants," subject to a phase-out between $100,000 and $150,000 of adjusted gross income (AGI). Another exception applies to qualified real estate professionals. The IRS may zero in on taxpayers claiming losses under either exception.

6. Travel and entertainment expenses. This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

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Some Things Change, Some Stay The Same

We're pleased to let you know about two changes in our practice.

New Office

We've moved. After six years we outgrew our old office (which we loved). Our new office is located just across the hall in the same building. Our lease was up for renewal and we had an opportunity to get a slightly larger space. Our new suite has an extra office and a larger conference room – two things we were looking for. We took our suite number, 207, with us. We're easy to find.

New Name (Just Colleen's)

Colleen got married and is changing her last name. It turns out that this is more of a process than an event and is more involved than one would expect. At any rate, her last name is now Askew. In spite of Rob's suggestion, she is keeping the same first name. The name of our firm will continue to be Knopinski & Fauver Financial Advisors until we come up with something pithier. Rob's name will remain the same.

Unchanged

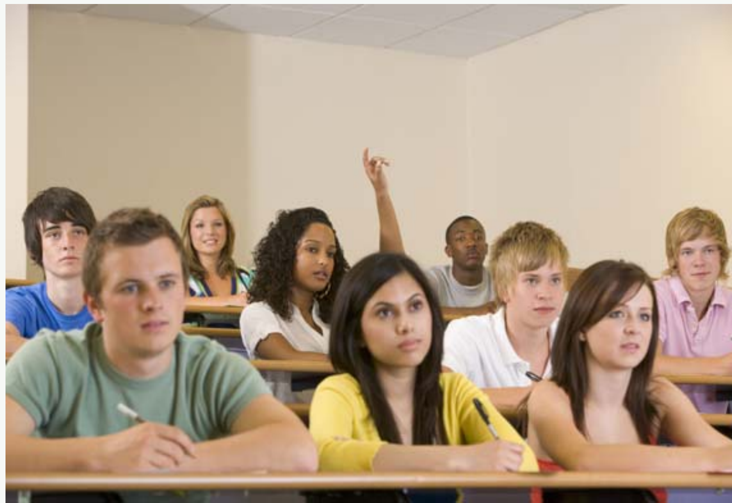
What hasn't changed is our commitment to providing excellent service to our clients. If you're interested in learning more about how we can help you meet your financial goals, give us a call or check out our website. You can even watch our videos, but keep in mind that we look much younger in person.

Colleen & Rob

Crash Course On Paying For College

There's good news in the mail: Johnnie or Susie just got accepted into a top college. Naturally, you're proud of your child. But now comes the hard part—figuring out how to pay for four years of education at an elite school.

Tuition costs at private institutions, in particular, can seem staggering. Still, there are ways to send your son or daughter to a great college without bankrupting your financial future. Start with these five steps:



1. Compare and contrast financial aid offers. There's no standard format for the wording of award offers, so carefully review the information in each one your child receives. Typically, the offers will list financial aid from several sources, including school scholarships, work-study programs, and federal loans, and also will note your "expected family contribution," calculated from the information you provide on the Free Application for Federal Student Aid (FAFSA). But some schools provide more information than others, so try to compare apples to apples.

2. Do the math. Once you determine how much aid each school will provide, figure out how much *you* will have to provide. Incorporate the amounts you expect your child will be able to cover—perhaps for such things as books, meals, and entertainment—into your calculations. That will give you a better handle on what you're really facing.

3. Expand the hunt for financial aid. Don't give up just because your child isn't a star athlete or a computer genius. You can find scholarships to fit a wide range of niches and groups on websites such as Fastweb.com, SchoolSoup.com, and SallieMae.com. In addition, students may qualify for state aid. Also, many corporations offer scholarships to children of employees. And remember to reach out to civic, religious, and ethnic groups within your community.

4. Consider a payment plan. Frequently, colleges provide tuition payment plans that charge little or no interest. You may have to pay just a small up-front fee. Contact the school for the necessary arrangements.

5. Explore loan options. If your family must borrow money, start with federal loans, which typically have the lowest interest rates. Currently, a subsidized federal Stafford Loan offers a fixed interest rate of 3.4%, while the federal PLUS loan features a 7.9% rate and Perkins loans have a fixed interest rate of 5%. Apply for these when you fill out the FAFSA. As a last resort, you might turn to private loans, but be aware that the interest rates on those tend to be higher.

This is just a quick lesson on navigating the financial aid waters. The schools your son or daughter is considering also may be able to provide ideas for reducing the financial burden on your family. ●

Find Extra Benefits In DI Insurance

The odds that you'll suffer a disabling injury or illness are far greater than the likelihood of you dying prematurely. A disability income (DI) insurance policy, used to supplement life insurance coverage, could help protect you from loss of income if you're unable to work. Indeed, a DI insurance policy might provide even more benefits than you expect.

Typically, a private DI insurance policy can pick up some of the slack if you're disabled for an extended time. Should you no longer be able to work, you will begin receiving a monthly disability benefit. Normally, the benefit is a predetermined amount, unlike employer-provided coverage, in which the benefit equals a percentage of compensation.

As with life insurance, DI terms can vary widely from policy to policy. Some key variables include the amount of the benefits you'll receive; the length of the coverage; the requirements for receiving full benefits; the definition of "disability"; the length of the waiting period before benefits begin; any cost-of-living adjustments; availability of partial benefits; and possible non-cancellation features. Naturally, the cost of the premiums also will vary, depending mainly on those variables.

But don't assume that you must be bedridden to collect any benefits. Frequently, a DI insurance policy will provide "residual benefits" in the event you can work some of the time or if you're slowly getting back on your feet. Some policies even offer benefits after you've returned to work if you are earning less than you did before your disability.

The residual benefits generally kick in when the loss of income is greater than 20% of previous earnings and the decline is due to the medical condition underlying the disability. This feature could be especially

Two More Key Choices For Retirement Living

Choosing a town to live in after you retire and deciding whether you want to be completely independent or to live in a retirement community are both crucial parts of planning for your life after work. But there are also other factors to weigh, and two of the most important may be the proximity of medical care and how far you'll be from your children, grandchildren, and other members of your family.

Aging almost inevitably brings a need for more medical care, and having top-quality physicians and hospitals nearby could help you enjoy a longer and healthier retirement. Some retirement communities and private retirement locations—such as a single-family home in a small town—may be exactly what you're looking for in other regards but aren't located near specialized medical care. A retiree with heart disease, for instance, is likely to want quick access to a cardiologist and a hospital capable of performing angioplasty or open-heart surgery.

It may cost less to live in a remotely located retirement village than in a city that gives you access to top medical facilities. But having lower living expenses will be little consolation if you're not able to get the care you need.

Consider the case of a Florida couple who decided to retire to the mountains of northern Arkansas—where it's beautiful, remote, serene, and inexpensive to live. They purchased a two-story, 2,000-square-foot home built into the side of an Ozark Mountains foothill for $68,500 in late 2004. The nearest hospital, not to mention the nearest cardiologist, is an hour's drive away, however. And the closest hospital may not be the best hospital.

The two retirees had a second hospital choice that had a better-trained, more qualified staff, better equipment, and a greater ability to handle trauma and heart attack victims in the emergency room. That second hospital is almost an hour and a half drive away from their home, however.

The husband suffered a heart attack in 2006 and was taken to the closer of the two hospitals. He received a stent, recovered, and is alive and well today. He knows, however, that he was lucky, and the incident played a role in the couple's decision to leave their beautiful mountain abode, located in the middle of a hardwood forest, and move back to Florida, close to top-notch doctors and health-care facilities.

The other factor in their decision to move back to Florida was the distance from their family. Together they have seven sons, a daughter, 13 grandchildren, and seven great-grandchildren—and all but three of them live in Florida. It was a two-day drive from northern Arkansas to the Tampa Bay area of Florida, where the couple had lived before they relocated and where two of their sons still live.

They were jolted into reality when one son was divorced in 2008 and was awarded joint custody of his two children. That was a development the parents hadn't anticipated when planning their retirement. It also was something that would change their lives, again.

To add to the urgency of the situation, the son now was working six days a week and needed someone to care for his children on the days that he had custody. His mother was the most logical choice, but she now lived in Arkansas.

Hence, the couple decided to move back to the Tampa Bay area, not only to be near the divorced son but also so they'd have a good team of cardiologists and one of the best heart hospitals in the region close at hand. Finding a suitable retirement home set off a frantic search that ended rather quickly when the couple bought a duplex in an over-55 community.

Selling their home in Arkansas didn't go quite so smoothly, however. They had bought their mountain hideaway when real estate prices were still rising steeply, and by the time they were ready to sell, the local market was slumping. They were fortunate that their retirement home had not cost that much in the first place. By being patient, and not accepting low-ball offers, they were able to recoup their investment in the house a year after they'd offered it for sale. Meanwhile, they'd done well at the other end of their relocation, selling their first Florida home in 2004, near the top of the boom, and returning in 2008, when home prices were plunging.

Your situation won't be exactly like theirs, of course. But you could well face some of the same considerations in choosing where to spend your retirement. Having access to good health care and being able to reach out and touch your loved ones are very important, especially as you grow older. ●

valuable to small business owners, including self-employed entrepreneurs, and professionals in fee-based practices, such as physicians, attorneys, and accountants.

For example, suppose a surgeon recovering from a severe illness returned to practice but was able to see fewer patients. If the surgeon's income was reduced from $50,000 a month to $30,000, the residual benefit could restore income to 80% of the pre-disability level—in this case, $40,000 a month. Similarly, if the side effects of chemotherapy make it too hard for a litigator to appear in court or for a CPA to handle a company's books, the residual benefits can soften the economic blow.

To see what your coverage may or may not include, take a close look at existing DI policies or any new policy you're considering and have your insurance agent explain the residual benefits section. The policy might be more valuable than you imagined or the residual benefits may be too restrictive. Those provisions could be a key component of your DI insurance coverage. ●

Roundup Of New Estate Tax Changes

For more than a decade, estate planning has harkened back to the “wild, wild west,” a time when even the best hired guns didn’t know what would happen next. Now, finally, there’s more certainty, thanks to the estate tax provisions in the American Taxpayer Relief Act (ATRA). The new law, signed as the country teetered on the brink of the “fiscal cliff,” extends several favorable tax breaks, with a few modifications.

Before we explore ATRA’s main provisions, let’s recap the events dating back to 2001, the year the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted. Among the changes, EGTRRA gradually increased the federal estate tax exemption from $1 million to $3.5 million in 2009 while decreasing the top estate tax rate from 55% to 45%. It also severed the unified estate and gift tax systems, creating a lifetime gift exemption of $1 million unrelated to the estate tax exemption. Then the law repealed the estate tax completely, but just for 2010. After that year, the estate tax provisions were scheduled to “sunset,” restoring more onerous rules that had been in effect before EGTRRA unless new legislation dictated otherwise.

The Tax Relief Act of 2010 generally postponed the sunset for two years. It hiked the estate tax exemption to $5 million (indexed for inflation), lowered the top estate tax rate to 35%, and reunified the estate and gift tax systems. That law also allowed “portability” of exemptions between spouses.

Now, at long last, ATRA brings permanent clarity. Here are the key estate changes:

- The estate tax exemption remains at $5 million with inflation indexing. For 2013, the exemption is $5.25 million. Also, portability of exemptions between spouses is made permanent, so a married couple can effectively pass up to $10.5 million tax-free to their children or other non-spouse beneficiaries, even if the exemption of the first spouse to die isn’t exhausted.
- The top estate tax rate is bumped up to 40%. Not as low as the 35% rate in 2011 and 2012, but still better than the 55% rate slated for 2013 prior to ATRA.
- The estate and gift tax systems remain reunified. This means that the lifetime gift tax exemption is equal to the estate tax exemption of $5.25 million in 2013. (That’s now the maximum exemption for combined taxable lifetime gifts and estate bequests.) Other provisions, including the generation-skipping tax that applies to most bequests and gifts to grandchildren, are coordinated within the system.

As a result of these changes, now is a good time to examine wills, trusts, and other aspects of your estate plan. Depending on your situation, revisions may be required or you might create a new trust to take advantage of the current estate tax law. ●

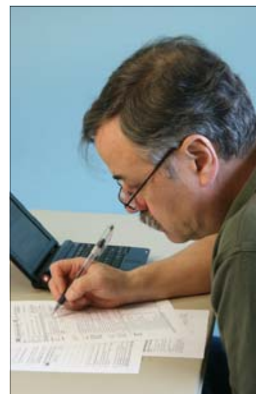
Reasons For The IRS

(Continued from page 1)

7. Business use of cars. Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called “luxury car” rules. IRS agents have been trained to ferret out taxpayer records that don’t measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn’t available for personal use.

8. Hobby losses. As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can’t claim a loss for the activity, unless your involvement rises to a level of abona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

9. Foreign bank accounts. The IRS has started clamping down on taxpayers with offshore accounts in “tax havens” in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.



10. Cash businesses. Finally, if you operate a small business in which you’re generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don’t mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●

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