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MAY 2019

TAX BREAK FOR INVENTORIES

As a result of the Tax Cuts and Jobs Act, taxpayers who have average annual gross receipts of less than $25 million are no longer required to account for inventories under the accrual method. They may use an accounting method that allows for immediate deduction of inventory purchases. In other words, a small business may now elect to expense inventory purchases at the time of purchase rather than deferring the deduction until the time of sale. The election is a change of accounting method and requires a filing with the Internal Revenue Service (IRS), which is subject to automatic approval.

The IRS has issued procedures and guidance concerning the new law. If a small business adopts this change, the cost of the beginning inventory of the year of the change is deducted as an expense along with all of the current year inventory purchases without the requirement of allocation to an ending inventory asset (cost) resulting in a one-time increase of deductible cost equal to the amount that would have been, under the old method of accounting, the ending inventory. In subsequent years, all purchases are deductible as made.

An adopter of this new, immediate inventory expensing must keep inventory accounting records consistent with this expensing treatment. In other words, a small business cannot expense inventory purchases on its tax return if the taxpayer's financial statements, books, and records include an ending inventory balance. This treatment prevents a small business from issuing future financial statements that report an inventory amount on its balance sheet. While the IRS may issue future announcements that explain its position in more detail, we believe that the present guidance does not prevent a small business from keeping inventory records for management purposes, which are not a part of its general ledger and financial statements.

To adopt this new accounting method requires the filing of an abbreviated IRS Form 3115 with the tax return by its due date (including any extensions) and the filing of a copy of the Form 3115 separately with the IRS by the tax return filing date.

A small business eligible for inventory expensing might want to consider its adoption as the tax savings can be significant. We would be pleased to answer any questions you might have about this new procedure.

HEALTH SAVINGS ACCOUNTS

A Health Savings Account (HSA) is an opportunity for eligible individual taxpayers to lower their federal and Louisiana income taxes for many years. If you are eligible, now might be a good time to consider an HSA.

An HSA permits eligible taxpayers to pay (or reimburse themselves at a later time for having paid) out-of-pocket medical expenses using pretax dollars. Amounts remaining in an HSA at year-end can be carried over to the next year and beyond. There are no income phase-out rules, so HSAs are available to high-earners and low-earners alike.

An HSA is only available to an individual who carries health insurance coverage with a relatively high annual deductible. For 2019, the individual's health insurance coverage must include a deductible not less than $1,350 for single coverage or $2,700 for family coverage. For many self-employed individuals, small business owners, and employees of small and large companies alike, these thresholds will not be a problem. In addition, the insurance plan is not required to impose a deductible for preventative care (such as annual checkups). Other requirements for setting up an HSA are that an individual cannot be eligible for Medicare benefits or claimed as a dependent on another person's tax return.

Taxpayers who meet these requirements can make tax-deductible HSA contributions in 2019 of up to $3,500 for single coverage or $7,000 for family coverage. The contribution for any tax year can be funded as late as April 15 of the following year. An account beneficiary who is age 55 or older by the end of the tax year for which the HSA contribution is made may make a larger deductible (or excludible) contribution. Specifically, the annual tax-deductible contribution limit is increased by $1,000.

When an employer contributes to an employee's HSA, the contributions are exempt from federal income, social security, Medicare, and unemployment taxes.

The individual deduction is made in arriving at adjusted gross income allowing eligible taxpayers to benefit even if not itemizing. The deduction does not, however, reduce self-employment income.

An HSA can generally be set up at a bank, insurance company, or other institution the IRS deems suitable. The HSA must be established exclusively for the purpose of paying the account beneficiary's qualified medical expenses. These include uninsured medical costs incurred for the account beneficiary, spouse, and dependents but exclude health insurance premiums.

As mentioned above, current disbursement from the HSA is not required. You can contribute to an HSA and deduct the contribution, but you are not required to use the funds to currently pay your medical expenses. Said differently, the HSA can result in additional tax-deferred savings. Further, assuming that the HSA owner pays medical expenses from funds other than from the HSA and maintains records, bills, statements, etc. to show that the medical expenses were paid with the other funds and were not deducted as itemized deductions, the account owner can be reimbursed at any time up to one year after death, and the reimbursements will be tax-free. If, however, the account owner does experience significant medical expenses after having established an HSA, the funds can still, as necessary, be withdrawn tax-free from the accumulated HSA savings to pay the bills with previously deducted contributions and earnings on those contributions. Those contributions and earnings have, of course, borne no income tax.

As with most tax rules, HSAs are complex and require planning to maximize the benefits that they afford. We will be happy to help you with your questions about these highly beneficial accounts.

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Tax & Business Alert

MAY 2019

INNOCENT SPOUSE RULES OFFER PROTECTION UNDER SOME CIRCUMSTANCES

Must one spouse pay the tax resulting from a fabrication or omission by another spouse on a jointly filed tax return? It depends. If the spouse qualifies, he or she may be able to avoid personal tax liability under the "innocent spouse" rules.

JOINT FILING STATUS

Generally, married taxpayers benefit overall by filing a joint tax return on the federal level. This is particularly the case when one spouse earns significantly more than the other. Filing jointly may also help the couple maximize certain income tax deductions and credits.

But joint filing status comes with a catch. Each spouse is "jointly and severally" responsible for any tax, interest and penalties attributable to the return. And this liability continues to apply even if the couple gets a divorce or one spouse dies. In other words, the IRS may try to collect the full amount due from one spouse, even if all the income reported on the joint return was earned by the other spouse.

BASIC RULES

However, the tax law provides tax relief for an "innocent spouse." Under these rules, one spouse may not be liable for any unpaid tax and penalties, despite having signed the joint return.

To determine eligibility for relief, the IRS imposes a set of common requirements. The spouses must have filed a joint return that has an understatement of tax, and that understatement must be attributable to one spouse's erroneous items. For this purpose, "erroneous items" are defined as any deduction, credit or tax basis incorrectly stated on the return, as well as any income not reported.

From there, the other ("innocent") spouse must establish that, at the time the joint return was signed, he or she didn't know — or have reason to know — there was an understatement of tax. Finally, to qualify, the IRS needs to find that it would be unfair to hold one spouse liable for the understatement after considering all the facts and circumstances.

ADDITIONAL NOTES

For many years, innocent spouse relief had to be requested within two years after the IRS first began

WHAT DOES THE IRS CONSIDER?

The IRS considers "all facts and circumstances" in determining whether it would be inequitable to hold an "innocent" spouse liable for taxes due on a jointly filed tax return. One factor that may increase the likelihood of relief is that the taxes owed are clearly attributable to one spouse or an ex-spouse who filled out the errant return.

If one spouse was deserted during the marriage, or suffered abuse, it may also improve the chances that innocent spouse relief will be granted. In some cases, the IRS may examine the couple's situation to determine whether the spouse applying for relief knew about the erroneous items.

its collection activity against a taxpayer. But, in 2011, the IRS announced that it would no longer apply the two-year limit on collection activities.

In addition, by law, when one spouse applies for innocent spouse relief, the IRS must contact the other spouse or former spouse. There are no exceptions even for victims of spousal abuse or domestic violence.

HELP AVAILABLE

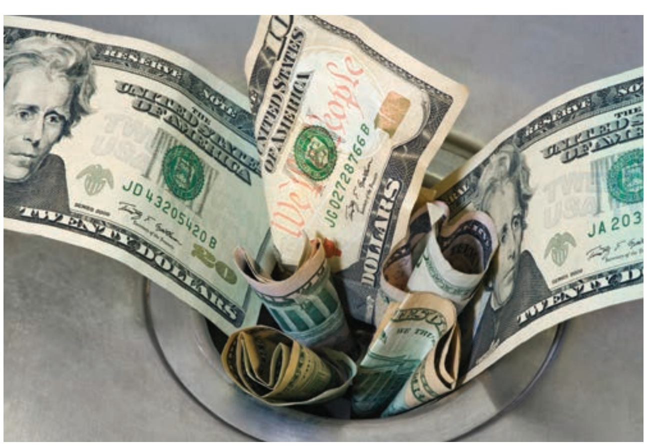
Historically, courts haven't been particularly generous about upholding claims under the innocent spouse rules. State laws can also complicate matters. If you're wondering whether you'd qualify for relief, please contact us for help. ■

DEDUCTING BUSINESS LOSSES FOR PASS-THROUGH ENTITIES

It's not uncommon for businesses to sometimes generate tax losses. But the tax law limits *deductible* losses in some situations. And the Tax Cuts and Jobs Act (TCJA) further restricts the amount of losses that sole proprietors, partners, S corporation shareholders and, typically, limited liability company (LLC) members can now deduct. If your company operates under one of these business structures, it's important to bear all these limitations in mind as the year rolls along.

BEFORE AND AFTER

Under pre-TCJA law, an individual taxpayer's business losses could usually be fully deducted in the tax year when they arose unless the passive activity loss



(PAL) rules or some other provision of tax law limited that favorable outcome. Another restriction was if the business loss was so large that it exceeded taxable income from other sources, creating a net operating loss (NOL).

The TCJA temporarily changes the rules for deducting an individual taxpayer's business losses. If your pass-through business generates a tax loss for a tax year beginning in 2018 through 2025, you can't deduct an "excess business loss" in the current year.

An excess business loss is the excess of your aggregate business deductions for the tax year over the sum of your aggregate business income and gains for the tax year, plus $250,000 ($500,000 if you're a married taxpayer filing jointly). The excess business loss is carried forward to the following tax year and can be deducted under the rules for NOLs.

WHAT IT MEANS

For business losses passed through to individuals from S corporations, partnerships and LLCs treated as partnerships for tax purposes, the new excess business loss limitation rules apply at the owner level. In other words, each owner's allocable share of business income, gain, deduction or loss is passed through to the owner and reported on the owner's personal federal income tax return for the owner's tax year that includes the end of the entity's tax year.

Keep in mind that the new loss limitation rules kick in after applying the PAL rules. So, if the PAL rules disallow your business or rental activity loss, you don't get to the new loss limitation rules.

PRACTICAL IMPACT

The rationale underlying the new loss limitation rules is to restrict the ability of individual taxpayers to use current-year business losses to offset income from other sources, such as salary, self-employment income, interest, dividends and capital gains.

The practical impact is that your allowable current-year business losses can't offset more than $250,000 of income from such other sources (or more than $500,000 for joint filers). The requirement that excess business losses be carried forward as an NOL forces you to wait at least one year to get any tax benefit from those excess losses.

POTENTIAL EFFECT

If you're expecting your business to generate a tax loss in 2019, we can help you determine whether you'll be affected by the new loss limitation rules. ■

SEND YOUR KIDS TO DAY CAMP AND YOU MAY GET A TAX BREAK

Among the many great challenges of parenthood is what to do with your kids when school lets out. Do you keep them at home and try to captivate their attention yourself or with the help of sitters? Or do you send them off to the wide variety of day camps now in operation? There's no one-size-fits-all answer, but if you choose the latter option, you might qualify for a tax break!

DOLLAR-FOR-DOLLAR SAVINGS

Day camp — but, to be clear, not overnight camp — is a qualified expense under the child and dependent care tax credit, which is worth 20% of qualifying expenses (more if your adjusted gross income is less than $43,000), subject to a cap. For 2019, the maximum expenses allowed for the credit are $3,000 for one qualifying child and $6,000 for two or more.

Remember that tax credits are particularly valuable because they reduce your tax liability dollar-for-dollar — $1 of tax credit saves you $1 of taxes. This differs from deductions, which simply reduce the amount of income subject to tax. For example, if you're in the 24% tax bracket, $1 of deduction saves you only $0.24 of taxes. So, it's important to take maximum advantage of the tax credits available to you.

QUALIFYING FOR THE CREDIT

A qualifying child is generally a dependent under age 13. (There's no age limit if the dependent child is unable physically or mentally to care for him- or herself.) Special rules apply if the child's parents are divorced or separated or if the parents live apart.

Eligible costs for care must be work-related. This means that the child care is needed so that you can work or, if you're currently unemployed, look for work.

If you participate in an employer-sponsored child and dependent care Flexible Spending Account (FSA), also sometimes referred to as a Dependent Care Assistance Program, you can't use expenses paid from or reimbursed by the FSA to claim the credit.

DETERMINING ELIGIBILITY

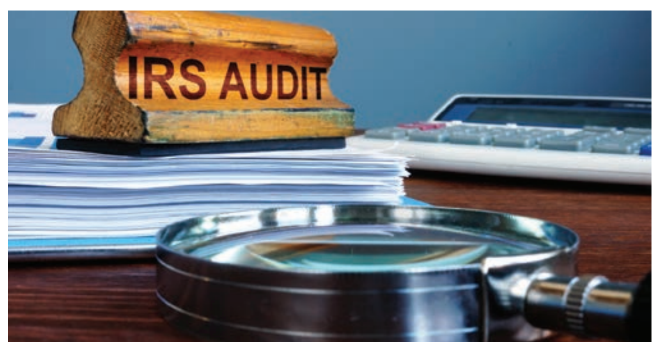
Additional rules apply to the child and dependent care credit. If you're not sure whether you're eligible, contact us. We can assist you in determining your eligibility for this credit and other tax breaks for parents. ■

SHOULD YOU BE WORRIED ABOUT AN IRS AUDIT?

Now that you've likely filed your 2018 tax return, one troubling afterthought may come to mind: Could I get audited? The mere notion strikes fear into most people's hearts. And for good reason — under a worst-case scenario, an audit could take up lots of your time, create an enormous amount of stress and leave you with a hefty bill from the federal government in unpaid tax, penalties and interest.

Now let's take a deep breath. An audit can also be a rather routine process that results in zero additional liability or even a refund. What's more, the IRS is performing audits much less frequently than it used to.

Basically, the higher your income and more complex your return, the greater the likelihood that it will be audited. The IRS uses something called a Discriminant Inventory Function (DIF) score to rate the potential for change in a return, based on past IRS experience with similar returns. The agency also uses an Unreported Income Discriminant Index Formula (UIDIF) score to rate each tax return's potential to indicate unreported income.



If you happen to be a business owner, the IRS may subject your return to intensified scrutiny in years it decides to target a category that your company falls into. Examples might include sole proprietorships with many cash transactions or companies that rely heavily on independent contractors.

By and large, the answer to the question posed in our headline is: Probably not. The best way to prevent a targeted audit or prepare for one you can't avoid is to get sound guidance from a CPA before filing your return every year. ■