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MAY 2017

EXCELLENT REPORT ON PEER REVIEW

We are relieved that our triennial peer review is over. We received the best possible report. After an independent on-site study of our accounting and auditing procedures, policies, and work practices, our reviewers concluded that our firm meets the quality standards established by the American Institute of Certified Public Accountants (AICPA). We are pleased that for each of our last eleven reviews (covering thirty-three years), we have received the best possible report.

We have undergone continuing peer reviews because we want confirmation of our practice judgements and because we believe that our clients and other users of the financial statements that we prepare or audit deserve independent assurance that our firm is providing quality services.

We are delighted with the results of our review and would be happy to answer any questions you might have.

2017 LAW CHANGES?
(UNCERTAINTY ABOUNDS)

Those of us working in tax planning and compliance and those facing significant decisions crave certainty in the rules as a wrong choice often results in significant additional time, effort, taxes and other costs, etc. Unfortunately, we are now over one-third through this year and do not know for 2017 how taxpayers will be required to compute taxable income or what the income tax rates will be. Both the Administration and the Congressional majority have asserted that we would have tax rate reduction and tax reform this year. The Administration released in late April a very short outline of its proposal.

Individuals

The outline includes reducing the top individual bracket to 35 percent from the current statutory rate of 39.6 percent and the removal of the add-on 3.8 percent net investment income tax (applicable to single taxpayers above $200,000 and joint filers above $250,000). The plan would also remove the alternative minimum tax. Two lower brackets would be set at 10 percent and 25 percent and the standard deduction for all individuals would be doubled. Only home-mortgage interest and charitable contributions would remain as itemized deductions.

Corporate and Pass-Through Entities

The top corporate rate would be cut from the current 35 percent to 15 percent. Pass-through entities (S corporations, partnerships, LLCs, etc.) do not, under current law, with only very limited exceptions, pay federal income taxes. Rather, the income tax consequences of their activities "pass through" by an information return (Schedule K-1) and the resulting taxes are paid by the owner of the entity at the owner's applicable tax rate. The Administration's plan would continue the pass-through system but would cap the tax rate on business income reportable on individual returns at 15 percent. As the result of "the double tax" (a tax on earnings paid by the corporations and a second tax paid by the individuals on receipt of the dividends or at liquidation), most successful non-public business

(Continued on reverse)

entities have obtained the "pass-through" entity tax status – that is, S corporations, partnerships, LLC, etc.

Estate and Gift Taxes

The plan, which makes no mention of gift taxes, would repeal the federal estate tax.

Two Problems

If the tax law is changed to cap the tax rate on pass-through business income at 15 percent, the change would create what might be a politically unacceptable situation in which employees pay income tax at the same or a higher tax rate than the business owner. One might expect the plan to be revised to a cap of 20 or 25 percent – the Reagan tax reform of 1986 capped the tax rate on all ordinary income at 28 percent.

A second major political problem with the plan is the elimination of the deductibility of state and local income and property taxes in the computation of federal taxable income. (State and local sales taxes are currently deductible only by electing their deduction in lieu of deducting state and local income taxes.) As mentioned above, the plan doubles the standard deduction and eliminates all itemized deductions, excepting only mortgage interest and charitable contributions. Middle and high income taxpayers residing in the states with high state income taxes (for example, New York, New Jersey, California) and who have mortgage interest and charitable deductions in excess of the standard deduction amount will see a significant increase in taxable income (albeit taxed at a lower rate) and probably will work to prevent the removal of this deduction, which might defeat the plan.

Our Conclusion

The same as our opening – uncertainty abounds.

COMPOUNDING THE PROBLEM
(MULTIPLE IRS NOTICES)

We consider the effect of long-term compounding of income on accumulated savings an almost magical benefit for those seeking financial security. Conversely, problems can also be compounded.

One example of a compounding problem is that of the Internal Revenue Service (IRS) generating second computer notices asserting deficiencies in payments, taxpayer inaccuracy in tax returns, etc. (frequently in error) while failing to "open their mail" and consider the taxpayer's responses to the earlier notice prior to sending a second error notice of deficiency, notice of intent to levy, or of collection action, etc. The IRS issues approximately 200 million notices and letters to taxpayers each year. Almost all allow the taxpayers 10 to 30 days to reply. The IRS considers correspondence it has received in response to such letters and notices not to be overaged if resolved within 45 days. According to a report released March 8, 2017 by the Treasury Inspector General for Tax Administration (IG), about one half of all correspondence received by the IRS from taxpayers required more than 45 days for an IRS response. Accordingly, taxpayers who promptly responded to the first IRS notice will have a high probability of receiving a second computer notice requiring a second response before the taxpayer's timely response to the first notice is considered by the IRS. This extreme difficulty in obtaining corrections in a cost-effective matter to an IRS notice issued in error has caused us to suggest, and many taxpayers to conclude, that the only cost-effective response to a notice asserting an immaterial amount of tax and interest is to promptly pay the amount of the notice. As one might expect, payments are processed much more rapidly and easily than errors are corrected. The IG also pointed out in the report that the failure of the IRS to respond within 45 days had increased from 40 percent of taxpayer correspondence to 49 percent over the three years ended in 2015, the most recent period studied.

This report by the IG confirms what we have long understood – that is, many problems with the IRS are compounded because second notices, notices of intent to levy, notices of deficiency, etc. are, as often as not, generated before the taxpayer's explanations are read and acted upon.

If you receive a notice from the IRS (or from the Louisiana Department of Revenue, which also often compounds its errors), you should promptly respond (or have your tax preparer do so) to, hopefully, resolve the issue without the necessity of multiple letters.

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Tax & Business Alert

MAY 2017

COULD A COST SEGREGATION STUDY SAVE YOUR COMPANY TAXES?

If your business has acquired, constructed or substantially improved a building recently, consider a cost segregation study. One of these studies can enable you to identify building costs that are properly allocable to tangible personal property rather than real property. And this may allow you to accelerate depreciation deductions, reducing taxes and boosting cash flow.

OVERLOOKED OPPORTUNITIES

IRS rules generally allow you to depreciate commercial buildings over 39 years (27½ years for residential properties). Often, businesses will depreciate structural components (such as walls, windows, HVAC systems, elevators, plumbing and wiring) along with the building.

Personal property — such as equipment, machinery, furniture and fixtures — is eligible for accelerated depreciation, usually over five or seven years. And land improvements — fences, outdoor lighting and parking lots, for example — are depreciable over 15 years.

Too often, companies allocate all or most of a building's acquisition or construction costs to real property, overlooking opportunities to allocate costs to shorter-lived personal property or land improvements. Items that appear to be part of a building may in fact be personal property. Examples include:

- Removable wall and floor coverings,
- Detachable partitions,
- Awnings and canopies,
- Window treatments,
- Signage, and
- Decorative lighting.

In addition, certain items that otherwise would be treated as real property may qualify as personal property if they serve more of a business function than a structural purpose. Examples include reinforced flooring to support heavy manufacturing equipment, electrical or plumbing installations, and dedicated cooling systems for server rooms.

A STUDY IN ACTION

Let's say you acquired a nonresidential commercial building for $5 million on January 1. If the entire purchase price is allocated to 39-year real property, you're entitled to claim $123,050 (2.461% of $5 million) in depreciation deductions the first year.

IT MAY NOT BE TOO LATE: LOOK-BACK STUDIES

If your business invested in depreciable buildings or improvements in previous years, it may not be too late to take advantage of a cost segregation study. A "look-back" cost segregation study allows you to claim missed deductions in qualifying previous tax years.

To claim these tax benefits, we can help you file Form 3115, "Application for Change in Accounting Method," with the IRS and claim a one-time "catch-up" deduction on your current year's return. There will be no need to amend previous years' returns.

A cost segregation study may reveal that you can allocate $1 million in costs to five-year property eligible for accelerated depreciation. Reallocating the purchase price increases your first-year depreciation deductions to $298,440 ($4 million × 2.461%, plus $1 million × 20%).

IMPACT OF TAX LAW CHANGES

Bear in mind that tax law changes may occur this year that could significantly affect current depreciation and expensing rules. This in turn could alter the outcome and importance of a cost segregation study. Contact our firm for the latest details.

On the other hand, any forthcoming tax law changes likely won't affect your ability to claim deductions you may have missed in previous tax years. (For more on this concept, see "It may not be too late: Look-back studies" above.)

WORTHY EFFORT

As you might suspect, a cost segregation study will entail some effort in analyzing your building's structural components and making your case to the IRS. But you'll likely find it a worthy effort. ■

VIATICAL SETTLEMENTS: A FUNDING MECHANISM FOR MEDICAL COSTS

Someone who's terminally or chronically ill may lack the funds to cover significant medical costs. Although insurance policies have historically been held for the death benefits, it may be possible to sell a policy to a viatical settlement provider. This way, the individual can secure much-needed and generally tax-free cash while still alive.

BUYERS AND SELLERS

Viatication allows a terminally ill person to sell an existing life insurance policy to an investor for more than its cash surrender value but less than its net death benefit. The buyer continues to pay the premiums and receives the life insurance proceeds upon the death of the insured. Many companies currently either buy the policies themselves or serve as brokers to match buyers and sellers for a fee.

In identifying a potential seller, many viatical companies limit their selection to terminally ill individuals with a certain remaining life expectancy (for example, 24 months or less). This is because the company wants to minimize its risk that the individual will outlive his or her life expectancy, resulting in a lower return from the purchase of the life insurance policy for the company.

FACTORS TO CONSIDER

To determine whether it would be advantageous to sell a policy, the insured should consider factors such as:

- His or her cash needs,
- The discount in the value of the death benefit,
- The possibility that payments will disqualify him or her for Medicaid benefits, and
- Access to the payments by his or her creditors.

(Regarding the last point, the cash value while it remains in a life insurance contract may not be subject to the claims of creditors.)

TAX CONSEQUENCES

Amounts received under a life insurance contract on the life of terminally ill (or within limits, chronically ill) individuals are excluded from gross income for federal income tax purposes. A similar exclusion applies to the sale or assignment of any portion of a death benefit to a viatical settlement provider if the insured is chronically or terminally ill and the payments in question are funded by and diminish the life insurance policy's death benefit.

However, the exclusion doesn't apply if the accelerated death benefits are paid to someone other than the insured individual and the recipient has a business or financial relationship with the insured.

RULES AND ISSUES

Viatication is a complex and sensitive topic. Let us help you navigate the applicable rules and issues. ■

WATCH OUT FOR IRD ISSUES WHEN INHERITING MONEY

Once a relatively obscure concept, income in respect of a decedent (IRD) can create a surprisingly high tax bill for those who inherit certain types of property, such as IRAs or other retirement plans. Fortunately, there are ways to minimize or even eliminate the IRD tax bite.

HOW IT WORKS

Most inherited property is free from income taxes, but IRD assets are an exception. IRD is income a person was entitled to but hadn't yet received at the time of his or her death. It includes:

- Distributions from tax-deferred retirement accounts, such as 401(k)s and IRAs,
- Deferred compensation benefits and stock option plans,
- Unpaid bonuses, fees and commissions, and
- Uncollected salaries, wages, and vacation and sick pay.

IRD isn't reported on the deceased's final income tax return, but it's included in his or her taxable estate, which may generate estate tax liability if the deceased's estate exceeds the $5.49 million (for 2017) estate tax exemption, less any gift tax exemption used during life. (Be aware that President Trump and congressional Republicans have proposed an estate tax repeal. It hasn't been passed as of this writing, but check back with us for the latest information.)

Then it's taxed — potentially a second time — as income to the beneficiaries who receive it. This income retains the character it would have had in the deceased's hands. So, for example, income the deceased would have reported as long-term capital gains is taxed to the beneficiary as long-term capital gains.

WHAT CAN BE DONE

When IRD generates estate tax liability, the combination of estate and income taxes can devour an inheritance. The tax code alleviates this double taxation by allowing beneficiaries to claim an itemized deduction for estate taxes attributable to amounts reported as IRD. (The deduction isn't subject to the 2% floor for miscellaneous itemized deductions.)

The estate tax attributable to IRD is equal to the difference between the actual estate tax paid by the estate and the estate tax that would have been payable if the IRD's net value had been excluded from the estate.

Suppose, for instance, that you're the beneficiary of an estate that includes a taxable IRA. If the estate tax is $150,000 with the retirement account and $100,000 without, the estate tax attributable to the IRD income is $50,000. But be careful, because any deductions in respect of a decedent must also be included when calculating the estate tax impact.

When multiple IRD assets and multiple beneficiaries are involved, complex calculations are necessary to properly allocate the income and deductions. Similarly, when a beneficiary receives IRD over a period of years — IRA distributions, for example — the deduction must be prorated based on the amounts distributed each year.

WE CAN HELP

If you inherit property that could be considered IRD, please consult our firm for assistance in managing the tax consequences. With proper planning, you can keep the cost to a minimum. ■

REVIEWING THE INNOCENT SPOUSE RELIEF RULES

Married couples don't always agree — and taxes are no exception. In certain cases, an "innocent" spouse can apply for relief from the responsibility of paying tax, interest and penalties arising from a spouse's (or former spouse's) improperly handled tax return. Although it isn't easy to qualify, potentially affected taxpayers should review the rules.

Applicants may qualify for various forms of relief if they can meet the applicable IRS conditions. One factor that's considered is whether the applicant received any significant direct or indirect benefit from the tax understatement. For instance, an applicant's case could be weakened if he or she had used unreported income to pay extraordinary household expenses.

The IRS will also look at the distinctive aspects of the case. The fact that a spouse applying for relief has already divorced his or her partner is significant. Whether the applicant was abused physically or mentally will also play a role, as will whether he or she was in poor mental or physical health when the return(s) in question was signed. In addition, the IRS will consider whether the applicant would experience economic hardship without relief from a significant tax debt.

Generally, an applicant must request innocent spouse relief no later than two years after the date the IRS first attempted to collect the tax. But other forms of relief may still be available thereafter. Please contact our firm for more information. ■