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APRIL 2022

A TIME FOR APPRECIATION

"Gratitude is not only the greatest of virtues, but the parent of all others"

Marcus Tullius Cicero

As is our tradition, we will celebrate the Monday, April 18, 2022 end of the tax season (the 18th is the last day to file as the 15th falls on a Washington, D.C. holiday) by closing for our traditional post-season holiday on Tuesday, April 19, 2022. We will express our gratitude for our staff with an Appreciation Luncheon and will close at 11:30 a.m. on Friday, April 22, 2022. The Computer Center will be open on Tuesday, April 19, 2022 and will close at 11:30 a.m. on Friday, April 22, 2022. We are grateful to our clients for the opportunity of working for them and to our staff for their excellent performance. To both – we say ***THANK YOU!***

TWELVE IN A ROW

It is rare for any contest of two participants to result in a consecutive-year losing streak of 12. However, for 2021, the majority of stock-picking fund managers failed for the 12th consecutive year to outperform the results of a passive investment in the S&P 500 Index. For 2021, 85 percent of the U.S. actively managed, large-cap (stock-picking) mutual funds failed to equal or exceed the S&P 500 Index. According to a *Wall Street Journal* article of March 16, 2022, the average return for 2021 of large cap U.S. funds was more than five percentage points lower (23.3 percent) than the S&P 500 Index, which returned 28.60 percent. In other words, on average, active management earned about 20 percent less than passive investing earned.

In addition to the higher pre-tax return, passive index investing also adds value by deferring almost all of the income tax on capital appreciation. Active stock picking results in current recognition of capital gains (frequently short-term capital gains) as managers trade stocks in their attempts (usually futile) to out-perform the market by more than their fees.

A frequent comment (and, until recently for some investors, a criticism) about investing in broad based U.S. equity indexes has been their omission of equities from emerging and international markets. Although only U.S. listed equities are included, broad-based equity indices such as a Total Stock Market Index Fund or an S&P 500 Index Fund include

(*Continued on reverse*)

significant (over one-third) business activity in foreign countries because they include the large international stocks listed on the U.S. exchanges.

Because of the higher returns of passive indexing and their income tax advantages, it is almost conventional wisdom that long-term indexing is appropriate for core, equity investing. In summary, "stock picking and market timing" will almost never return more to a saver/investor than long-term "buying and holding" of broad-based, low fee U.S. equity indexes.

INCOME TAX LITIGATION

"There is no way to sugarcoat the year 2021 in tax administration: From the perspective of tens of millions of taxpayers, tax administration did not work for them."

Erin M. Collins, National Taxpayer Advocate

Most taxpayers and their advisors are able to avoid litigation with the Internal Revenue Service. The IRS internal appeal procedures will, where the taxpayer has the better facts, usually work to reach a settlement acceptable to the taxpayer. Even when unable to reach agreement within the IRS appeals process, settlement usually works well (80 percent or more) once the initial Tax Court petition has been filed. Nonetheless, the Tax Court remains busy. Erin M. Collins, national taxpayer advocate for the IRS, has released her fiscal year 2021 list of the 10 most frequently litigated income tax issues.

1. Gross income issues (what constitutes gross income?) have long been the most litigated issues and ranked number one for 2021 with 66 substantive Tax Court opinions issued.
2. Trade or business deductions litigation (is this cost/expense deductible?) was the second most prevalent category in dispute.
3. Collection due process
4. Charitable contribution deductions. For 2021, the IRS's perceived abuse of syndicated conservation easement added to this category.
5. Itemized deductions.
6. Penalties for failure to file and failure to pay estimated tax penalties.
7. Determinations of whistle blower awards.
8. Family status related issues. This category includes filing status, eligibility for earned income tax credit and child tax credit, and determination of parents, children and others as dependents.
9. Innocent spouse relief from joint tax return liability.
10. Frivolous tax return submissions. This was a new top 10 issue related to IRS identification of more filings as frivolous.

As mentioned above, the IRS settled most Tax Court cases for 2021 before trial (81.9 percent) where it concluded that the taxpayer had a possible winning position. The taxpayer dismissed or defaulted on 17 percent. As a result, only 1.1 percent of the cases actually went to trial.

The results of 2021 litigation continue to indicate that taxpayers are usually best served by making their best arguments and presentations, etc. at the lower levels of the IRS and avoiding litigation whenever reasonably possible.

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Tax & Business Alert

APRIL 2022

COULD YOU BE HIT WITH THE TRUST FUND RECOVERY PENALTY?

There's a harsh tax penalty that you could be personally responsible to pay if you own or manage a business with employees. It's called the Trust Fund Recovery Penalty. It applies to the Social Security and income taxes required to be withheld by a business from the wages of its employees.

Because taxes are considered property of the government, the employer holds them in "trust" on the government's behalf until they're paid over. The penalty is also sometimes called the "100% penalty" because the person liable and responsible for the taxes can be penalized 100% of the taxes due. Accordingly, the amounts the IRS seeks when the penalty is applied are usually substantial, and the IRS is aggressive in enforcing the penalty.

A WIDE-REACHING PENALTY

The Trust Fund Recovery Penalty is among the more dangerous tax penalties because it applies both to a broad range of actions and to a wide range of people involved in a business.

Here are some questions and answers to help you avoid incurring the penalty.

What actions are penalized? The Trust Fund Recovery Penalty applies to willful failures to collect or truthfully account for and pay over Social Security and income taxes required to be withheld from employees' wages.

Who is at risk? The penalty can be imposed on anyone "responsible" for collection and payment of the tax. This has been broadly defined to include corporate officers, directors and shareholders who are under a duty to collect and pay the tax, and a partnership's partners or any employee of the business with such a duty. Even voluntary board members of tax-exempt organizations, who are generally exempt from responsibility, may be subject to this penalty under certain circumstances. In some cases, responsibility has even been extended to family members close to the business, and to attorneys and accountants.

According to the IRS, responsibility is a matter of status, duty and authority. Anyone with the power to see that the taxes are (or aren't) paid may be responsible. There's often more than one responsible person in a business, but each is at risk for the entire penalty. You may not be directly involved with the payroll tax withholding process in your business. But if you learn of a failure to pay over withheld taxes and you have the power to pay them but instead you make payments to creditors and others, you become a responsible person.

Although a taxpayer held liable can sue other responsible people for contribution, this action must be taken after

the penalty is paid, entirely on his or her own. It isn't part of the IRS collection process.

What is considered "willful?" For actions to be willful, they don't have to include an overt intent to evade taxes. Simply bending to business pressures and paying bills or obtaining supplies instead of paying over withheld taxes that are due to the government is willful behavior. The IRS specifically defines "willfully" in this instance as "voluntarily, consciously and intentionally" paying other expenses instead of the withholding taxes.

Just because you delegate these responsibilities to someone else doesn't necessarily mean you're off the hook. Your failure to deal with the task yourself can be treated as the willful element.

NEVER BORROW FROM TAXES

Under no circumstances should you ever fail to withhold taxes or "borrow" from withheld amounts. All funds that have been withheld from employee paychecks should be paid over to the government in full and on time. Contact us with any questions about making tax payments. ■

TAKING CASUALTY LOSS TAX DEDUCTIONS IS NOW HARDER

Unexpected disasters such as severe storms, flooding and wildfires can happen anywhere, causing damage to your home and personal property. Before the Tax Cuts and Jobs Act (TCJA), eligible casualty loss victims could claim a deduction on their tax returns. But restrictions make it tougher to qualify for these deductions.

What's considered a casualty for tax purposes? It's a sudden, unexpected or unusual event, such as a hurricane, tornado, flood, earthquake, fire, act of vandalism or terrorist attack.

HIGHER HURDLES TO QUALIFY

The TCJA generally eliminates deductions for personal casualty losses through 2025, unless the losses are due to a federally declared disaster. So, victims in several presidentially declared major disaster areas in 2021 would be eligible for casualty loss tax deductions.

Note: An exception to the general rule states that if you receive insurance proceeds that result in a personal casualty gain, you can deduct personal casualty losses up to the amount of the gain, even without a federal disaster declaration.

SPECIAL ELECTION

If your casualty loss is due to a federally declared disaster, a special election allows you to deduct the loss on your tax return for the *preceding* year and claim a refund. If you've already filed your taxes for that year, you may file an amended return and elect to claim the deduction for the earlier year. This may help you get extra cash when you need it.

The election must be made no later than six months after the due date (without extensions) for filing your tax return for the year in which the disaster occurs. However, the election itself must be made on an original or amended return for the preceding year.

CALCULATING THE DEDUCTION

These three steps must be taken to calculate the casualty loss deduction for personal-use property in an area declared a federal disaster:

1. Subtract any insurance proceeds,
2. Subtract $100 per casualty event, and
3. Combine the results from steps 1 and 2, then subtract 10% of your adjusted gross income for the year you claim the loss deduction.

Be aware that another factor that complicates your ability to claim a casualty loss is that you must itemize deductions to do so. The TCJA raised the standard deduction through 2025 (for 2022, it is $12,950 for single filers, $19,400 for heads of household and $25,900 for married couples filing jointly). A higher standard deduction means fewer individuals will itemize deductions. So, even if you qualify for a casualty loss deduction, you might not see a tax benefit if you don't have enough itemized deductions.

CONTACT US

The rules described here are for personal property. Keep in mind, the rules for business or income-producing property are different. It's easier to secure a business property casualty loss deduction. If you're a victim of a disaster — business or personal — we can help you navigate the complex rules. ■

SHIELD YOUR LIFE INSURANCE FROM FEDERAL ESTATE TAX

If you have a life insurance policy, be aware that the proceeds your beneficiary receives could be subject to federal estate tax. That is, unless you take steps to ensure that the policy isn't part of your estate.

WHAT TO DO

Life insurance proceeds will be included in your taxable estate if:

- Your estate is the beneficiary of the insurance proceeds, or
- You possessed certain economic ownership rights (called "incidents of ownership") in the policy at your death (or within three years of your death).

The first situation is avoidable simply by making sure your estate isn't the designated beneficiary of the policy. The second situation is more complicated. If you possess any of the incidents of ownership of the policy, the proceeds will be included in your estate regardless of the beneficiary, even if someone else has legal title to the policy. To avoid that result, you must not retain the right to:

- Change beneficiaries,
- Assign the policy (or revoke an assignment),
- Borrow against the policy's cash surrender value,
- Pledge the policy as security for a loan, and
- Surrender or cancel the policy.

Note: Merely *having* any of the above powers will result in the proceeds being included in your estate, even if you never exercise the powers.

POSSIBLE SOLUTIONS

To shield life insurance proceeds from estate tax, here are two options:

1. Buy-sell agreement. Life insurance may be purchased to fund a buy-sell agreement for a business interest under a "crosspurchase" arrangement. The proceeds won't be taxed in your estate unless the estate is the beneficiary. Let's say two business partners agree that the partnership interest of the first to die will be purchased by the survivor. To fund the obligation, each partner buys, pays all premiums for and retains all ownership rights on a policy on the life of the other partner. When the first partner dies, the insurance proceeds aren't taxed in the estate of the deceased.

2. Irrevocable life insurance trust (ILIT). An ILIT can be established and be the owner of a life insurance policy, purchased with assets from the insured. As long as the insured has no rights of ownership in the policy, the proceeds of the policy won't be taxed to his or her estate.

THREE-YEAR RULE

If you're considering establishing an ILIT or assigning away rights in a policy you own, we can help. However, unless you live for at least three years after taking these steps, the proceeds will be taxed in your estate. For policies in which you never held incidents of ownership, the three-year rule doesn't apply. Don't hesitate to contact us with any questions about your situation. ■

TAX CALENDAR

April 18
Last day to file (or extend) your 2021 personal return and pay any tax that is due.

- First quarter 2022 estimated tax payments for individuals, trusts and calendar-year corporations are due (the states of Maine and Massachusetts have an April 19th federal deadline).
- 2021 returns are due for trusts and calendar-year estates and C corporations.
- FinCEN Form 114 ("Report of Foreign Bank and Financial Accounts") is due — but an automatic extension applies to October 15.
- Any final contribution you plan to make to an IRA or Education Savings Account for 2021 is due.
- SEP and profit-sharing plan contributions are also due today if your return is not being extended.

May 2
Employers must file Form 941 ("Employer's Federal Quarterly Tax Return") for the first quarter (May 10 if all taxes are deposited in full and on time). Also, employers must deposit FUTA taxes owed through March if the liability is more than $500.

May 16
Calendar-year exempt organizations must file (or extend) their 2021 Forms 990, 990-EZ or 990-PF returns.

June 15
Second quarter 2022 estimated tax payments are due for individuals, calendar-year corporations, estates and trusts.

WHAT DO IRS AUDITORS KNOW ABOUT YOUR BUSINESS INDUSTRY?

Has your business been audited by the IRS? It may be stressful, especially if you don't know what to expect. It might help to know what information IRS auditors have about your industry. To prepare for an audit, IRS examiners generally research a specific industry, plus issues on a tax return. One tool they often use is the Audit Technique Guide (ATG).

A LITTLE-KNOWN SECRET

It's not widely known, but the public can also access these same guides on the IRS website. In other words, your business can use the guides to gain insight into what the IRS is looking for in terms of compliance with tax laws and regulations.

Many ATGs target specific industries or businesses, such as construction, aerospace, architecture or veterinary medicine. Other ATGs address issues that frequently arise in audits, such as executive compensation, passive activity losses and capitalization of tangible property.

IRS auditors examine many business types, plus individuals and tax-exempt organizations. Each type of return might

have unique industry issues, business practices and terminology that auditors need to understand. Using a specific ATG, an auditor may be able to reconcile discrepancies when reported income or expenses aren't consistent with industry norms, or identify anomalies within the geographic area in which the business is located.

GET A HEADS-UP

Although ATGs were created to help IRS examiners uncover common methods of hiding income and inflating deductions, they also can help businesses ensure they aren't engaging in practices that could raise audit red flags. Some guides were written several years ago and others are relatively new, or recently revised or updated. Be aware, not every industry has a guide.

You can find a complete list of available ATGs on the IRS website: https://www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs ■