TaxUpdate

2023 MID-YEAR NEWSLETTER

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Stop the Audit Clock!

In a tax court decision, a judge ruled that a joint tax return not signed by both spouses is not a validly-filed tax return.* The true reason for the ruling: to keep the statute of limitations open to give the IRS the authority to audit this couple's prior year tax returns.

The lesson here: Close out past tax returns from the possibility of audit.

The rules

- **Three (3) year rule.** The IRS can audit a tax return for up to three years after the tax return is filed or the original filing due date, whichever is later.
- **Six (6) year rule.** The three year audit window doubles if you understate your income by 25% or more. This includes understating the taxable value of property transferred to you.
- **The forever rule.** There is no time limit if you fail to file a tax return, there is fraudulent activity, or if certain unreported foreign assets are involved.
- **Amended returns.** If you amend your federal tax return, the IRS generally has sixty days to review the revision. This may add time to the audit window, but only if the amended tax return is filed near the end of the audit window.

Some tips

- **Keep the time as short as possible.** For most of us, this is filing on or before April 15th. If you have not yet filed a return, get it done as soon as possible. Keep records that document the timing of your filing either by using certified mail or keeping copies of e-file confirmations.
- **Start the clock.** Remember, until you file your tax return the audit clock never starts. This is the problem our couple had with their unsigned tax return.
- **Understand the permission to extend.** On occasion, the IRS may ask you for permission to extend the audit period. They will do this to buy time to finish an audit. If you refuse, the audit window is closed, but the IRS may present you with a tax bill based upon incomplete information. Should this request be delivered to you, ask for assistance before agreeing to an extension.

While many look at the April filing deadline with dread, remember each deadline also closes the ability to audit a timely-filed prior year tax return.

**Reifler v. Commissioner, T.C. Memo. 2015-199*

New College Savings Option
without reducing need awards

Beginning in 2023, grandparents can open up 529 savings plans without hurting the student's ability to get financial aid!

Background

529 college savings plans are a means to put after-tax money in an account designated for a beneficiary (student). The plan is controlled by the account holder for the benefit of the student. As the balance grows through earnings, any gains on the deposits are tax-free as long as they are used for qualified educational expenses. Funds not used for qualified education have their gains subject to ordinary income tax AND a 10% penalty.

The problem

Any time a distribution is made to the student from a non-parent account, up to 50% of it could impact the student's ability to receive other aid through the Free Application for Federal Student Aid (FAFSA).

The new opportunity

Now a grandparent can open up a 529 savings plan without it hurting the future student's ability to get federal aid. In the eyes of the new FAFSA, this funding is now virtually invisible to them as they calculate a student's financial needs because they are no longer asking the questions about grandparent contributions.

Considerations

- **Coordination is key.** Have grandparents provide gifts to a 529 account instead of giving cash to your child. Remember, they can contribute up to $17,000 per person per year.
- **No college? No problem.** If the grandchild doesn't need the funds, you can change the beneficiary to another grandchild or family member.
- **Need to pull the money?** If you need to pull the money, remember the original contributions are tax and penalty free. Only earnings in the account are subject to tax penalties.
- **Consider other applications.** Individual schools may still require disclosure, so plan accordingly.

Understanding the Marriage Penalty

The marriage penalty is still alive and well. While it is now in fewer areas of the tax code, you should know where it is and try to plan accordingly. Here is what you need to know.

What is the marriage penalty?

The marriage penalty occurs when married taxpayers are taxed more than they'd be as two single filers. It usually occurs when applying filing status to differing income limits.

Marriage penalty situations

Social Security taxability. A single person starts getting their Social Security benefits taxed when income exceeds $25,000. If there was no marriage penalty, the married couples' taxability threshold should start at $50,000. Unfortunately it is only $32,000. This creates perhaps the most egregious marriage penalty in all the tax code, as divorcing your long-term spouse in retirement would potentially save millions of low-income taxpayers money every year. Even worse, the taxability threshold is not increasing with inflation, so more and more people are seeing up to 85% of their Social Security retirement benefits subject to tax.

Tax bracket penalties. Fortunately, the marriage penalty built into the tax brackets is now eliminated for most taxpayers except those in the 35 percent and 37 percent tax bracket. While this will impact those who are affluent, the rule inadvertently snags many small business owners in flow-through entities that have their business profits taxed on their individual tax returns. This can create a tax obligation with no cash to pay for it unless it is distributed by the company.

Local taxes over $10,000. Legislation also limits the itemized deduction for state and local tax (SALT) payments to $10,000 for BOTH single and married tax filers. This built-in marriage penalty of $10,000 is keeping many married couples from itemizing deductions, creating yet another built-in penalty.

Please call if you would like a review of your situation.

Understanding the Gift Giving Tax Return

In an effort to keep taxpayers from transferring wealth from one generation to the next tax-free, gifts from one person to another that exceed certain limits must be reported to the IRS by filing an annual gift tax return. For most of us, this is not something we need to worry about, but if handled incorrectly it can create quite a surprise.

The Gift Giving Rule

You may give up to $17,000 (up $1,000) to any individual (donee) within the calendar year 2023 and avoid any gift tax filing requirements. If married, you and your spouse may transfer up to $34,000 per donee.

Gift Tax Reporting

Amounts given in excess of this annual amount are subject to potential gift tax reporting. The amount of tax is currently unified with estate taxes with a maximum rate of 40%. When you exceed the annual gift giving amount, this triggers the need to file a gift tax form with your individual tax return. The excess gift amounts are netted against your lifetime unified credit. Here are some instances when you may need to file a gift tax return and ways to manage the problem:

- ☐ **Gifts for college.** Consider making your gift directly to the college as this form of payment can be excluded from the annual gift giving limit AS LONG AS the funds are not used to pay for books, room or board on behalf of the student.
- ☐ **Be careful with 529 plan funding.** Deposits into 529 accounts are considered a gift and are subject to the annual gift giving limits.
- ☐ **Gifts to cover medical expenses.** Giving money directly to an individual who incurs medical bills may create a gift tax obligation. Instead, consider making payments directly to health care providers for medical services on behalf of the patient.
- ☐ **Gifts to help make a down payment.** It is becoming more common to have family members help their kids with the down payment on a first home. Care must be taken to provide the correct audit trail to prove the gift does not exceed the annual amounts.
- ☐ **Gift of real estate.** If you give property to a relative for little or nothing in return, you may also need to file a gift tax return.

Other things to consider

- ☐ **You may provide gifts to or receive gifts from ANYONE.** There are no limits or restrictions on who you may give a gift to or who may provide a gift to you. Creative gift giving can be a useful tool to help someone in need without creating a gift tax filing obligation.
- ☐ **Be careful of gifts that are equal to the annual limit.** If you provide a gift to an individual that's equal to the annual limit, any other gifts to this person during the same year will trigger a gift tax return filing requirement. For example, a grandmother gives $17,000 to her granddaughter for college, and also pays to send the family on vacation. The additional gifts would be considered in excess of the annual limit and would need to be reported to the IRS.

The IRS is paying attention to the massive non-compliance in the timely filing of the annual gift tax form. So much so, that it is actively researching property transfers in key states to ensure the gift tax filing is taking place. So avoid the risk by being tax savvy in your gift giving.

This publication provides summary information regarding the subject matter at time of printing. Please call with any questions on how this information may impact your situation.

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