



Issued June 15, 2011

## What Are the Chances of Being Audited?

Each year, the IRS releases a publication entitled the “Data Book.” The 2010 version of the book was released in early March, which provides statistical data on its fiscal year (FY) 2010 audit activities. The book provides valuable information that include how many tax returns the IRS examines (audits), how they examine them, and what categories of returns IRS is focusing its resources on.

Keep in mind that audits usually occur one to two years after the return is filed. The data found in the 2010 Data Book is based upon returns filed in calendar year 2009, which will be predominantly 2008 returns, and audited in fiscal year 2010. Year-to-year changes are compared to returns filed in 2008, and audited in fiscal year 2010, which are predominantly 2007 returns.

*Overall chance of being audited* – Out of 142,823,105 total individual income tax returns filed in 2009, 1,581,394 were audited. This works out to roughly 1.1%, a bit higher than the 1% rate for the previous year. But the overall audit percentage can be misleading because certain types of returns are audited more frequently than others. For example, 473,999 (30%) were for returns that included an earned income tax credit (EITC) claim.

Of the total, only 21.7% of the individual audits were conducted by face-to-face meetings with IRS personnel. The bulk of the audits (about 78.3%) were conducted by mail.

The IRS, like any good business, concentrates their efforts where they produce the best results (revenue)! Thus, their audit selection process favors returns that claim the EITC (where a lot of fraud is prevalent) and higher-income taxpayers. As a result, their Data Book presents the statistics in the format. In addition, the audit percentages shown below are based on returns with the same category rather than overall returns filed.

### Returns with Net Positive Income under \$200,000

• Returns That Do Not Claim EIT	Percent
o Returns without Schedules C, E, F or Form 2106	0.5
o Returns with Schedule E or 2106	1.2
o Non-farm Business Returns with gross receipts:	
• Under \$25,000	1.2
• \$25,000 under \$100,000	2.5
• \$100,000 under \$200,000	4.7
• \$200,000 or more	3.3
o Farm returns	0.4
• Business & Non-Business Returns That Claim EITC	
o Tax Credit by size of total gross receipts	
• Under \$25,000	2.4
• \$25,000 or more	1.8

## In This Issue

[What Are the Chances of Being Audited?](#)

[Read This Before Tossing Old Tax Records](#)

[Can You Write Off a Bad Debt?](#)

[Surprised By the Kiddie Tax? There Are Ways To Avoid It!](#)

[Parents Can Get Credit for Sending Kids to Day Camp](#)

[Limited Window of Opportunity for Extended Tax Breaks](#)

[Taking Your Business Home](#)

[Since You Asked...](#)

[Tax Calendar](#)

## Returns with Total Positive Income of \$200,000 under \$1M

- Non-Business Returns 2.5
- Business Returns 2.9

Returns with Total Positive Income of \$1M or more 8.4

## Small C-Corporation Returns (other than 1120-C and 1120-F)

- Balance Sheet Returns by size of total assets:
  - o No Balance Sheet 0.4
  - o Under \$250,000 0.8
  - o \$250,000 under \$1,000,000 1.4
  - o \$1,000,000 under \$5,000,000 1.7
  - o \$5,000,000 under \$10,000,000 3.0
  - o \$10,000,000 under \$50,000,000 13.4

Partnership Returns 0.4

S Corporation Returns 0.4

Tax Exempt Orgs. and related returns\* 1.5

\* Exempt organization audit percentage methodology varies slightly from others.

Many returns end up being audited due to incorrect reporting on the tax return. CapinCrouse is aware of these concerns and strives to properly report income and deductions so as to minimize audits. We caution our clients to not respond to IRS correspondence without first contacting us for counsel.

## Read This Before Tossing Old Tax Records

Now that your taxes have been completed for 2010, you are probably wondering what old records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. It would be helpful to understand why the records needed to be kept in the first place.

Generally, we keep "tax" records for two basic reasons: (1) in case the IRS or a state agency decides to question the information reported on our tax returns, and (2) to keep track of the tax basis of our capital assets so that the tax liability can be minimized when we actually dispose of them.

With certain exceptions, the statute for assessing additional tax is **three years** from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal. In addition to lengthened state statutes clouding the recordkeeping issue, the federal three-year assessment period is extended to six years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return. And, of course, the statutes don't begin running until a return has been filed. There is no limit where a taxpayer files a false or fraudulent return in order to evade tax.

If an exception does not apply to you, for federal purposes, most of your tax records that are more than three years old can probably be discarded; add a year or so to that if you live in a state with a longer statute.

**Examples** Sue filed her 2010 tax return before the due date of April 18, 2011. She will be able to dispose of most of her records safely after April 15, 2014. On the other hand, Don files his 2010 return on June 2, 2011. He needs to keep his records at least until June 2, 2014. In both cases, the taxpayers may opt to keep their records a year or two longer if their states have a statute of limitations longer than three years. *Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.*

**The big problem!** The problem with the carte blanche discarding of records for a particular year because the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets. They need to be separated and the basis records should not be discarded before the

## Upcoming Events

### Webcasts

Please visit our website at [www.capincrouse.com](http://www.capincrouse.com) to register today!

**Thursday, June 23**

**1:00 pm EDT**

Unrelated Business Activities: Setting up Efficient System of Accountability for Your Organization

### Save the Date!

Stay tuned for more information about these upcoming events.

### Fall Church Seminars

**Wednesday, September 7**

Dallas, TX

**Tuesday, September 20**

Indianapolis, IN

**Tuesday, October 18**

Fort Lauderdale, FL

### Fall Financial Forums

**Tuesday, October 11**

Atlanta, GA

**Tuesday, November 8**

Brea, CA

**Wednesday, November 9**

San Diego, CA

**Wednesday, November 9**

Lombard, IL

**Thursday, November 10**

Livermore, CA

statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into that category:

- **Stock acquisition data** – If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed in order to prove the amount of profit (or loss) you had on the sale.
- **Stock and mutual fund statements** – Where you reinvest dividends. Many taxpayers use the dividends that they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gain when it is finally sold. Keep statements at least four years after the final sale.
- **Tangible property purchase and improvement records** – Keep records of home, investment, rental property, or business property acquisitions AND related capital improvements for at least four years after the underlying property is sold.

For example, when the large \$250,000 and \$500,000 home exclusion was passed into law several years back, homeowners became lax in maintaining home improvement records thinking that the large exclusions would cover any potential appreciation in the home's value. Now that the exclusion may not always be enough, records of home improvements are vital. Records can be important, so please use caution when discarding them.

Have questions about whether or not to retain certain records? Give this office a call first; it is better to make sure before discarding something that might be needed down the road.

---

## Can You Write Off a Bad Debt?

Most small businesses have receivables that cannot be collected. These receivables can be from the sale of products, providing services to customers, or a combination of the two.

Whether or not a bad debt deduction will apply generally depends upon which accounting method is used (either the cash or accrual method). Why does this make a difference? Let's look at what happens under both methods of accounting.

- **Accrual** – If the accrual method is used, all of your billings must be treated as income whether or not they have been collected. This means that the taxable income already includes the income from your deadbeat customers. Therefore, these items are considered a bad debt when those receivables become uncollectible and can be deducted. If the accrual method of accounting is used, bad debts are deductible.
- **Cash** – On the other hand, if the cash method of accounting is used, income is not reported until it is received (unlike the accrual method). Since the income was never reported in the first place, a deduction cannot be taken if payment was never made for the goods or services that were provided. However, if you made a loan to a customer or supplier and there is a business reason for the loan, you may have a business bad debt.

**Proof of Worthlessness** – Proving a debt (or receivable) is worthless requires the taxpayer or business to show that the debt has become worthless and that reasonable steps were taken to collect the debt.

**Non-Business Bad Debts** – Some bad debts may actually be personal debts, such as personal loans to individuals. In those cases, the bad debt is not deducted as a business expense but is treated as a short-term capital loss on Schedule D subject to the \$3,000 annual loss limit.

Please give us a call if you would like additional information or have any questions about your situation.

## We Can Help!

The staff at CapinCrouse LLP works with hundreds of churches and not-for-profit organizations. This experience base allows us to quickly identify areas for improvement in many organizations. If your organization desires to improve its efficiency, please contact your Capin Crouse representative or one of our offices to discuss how we may help you.

## About CapinCrouse LLP

With more than 700 not-for-profit organizations and 1,500 tax clients, CapinCrouse is the country's leading accounting and advisory firm primarily serving the Christian not-for-profit community.

Since 1972, CapinCrouse has been serving not-for-profit entities including megachurches, institutions of higher education and secondary schools, and international missions agencies by providing a full range of audit, review, tax, and advisory services.

CapinCrouse is dedicated to helping our clients operate with financial integrity so that they can dedicate themselves to fulfilling their mission.

## Surprised By the Kiddie Tax? There Are Ways To Avoid It!

To prevent parents from placing investments in their children's names to take advantage of the child's lower tax rate, Congress created, several years back, what is referred to as the "Kiddie Tax". Under the Kiddie Tax, a child's investment income in excess of \$1,900 is taxed at the parent's tax rate rather than the child's. These rules do not apply to married children who file a joint return with their spouse or self-supporting children.

Depending upon your circumstances, this can be either a tax return preparation nuisance or a penalty tax – or maybe both. Many insightful parents seek tax-advantaged ways to put money aside for their children's education, first home, etc. They should not be deterred by the Kiddie tax, as there are legal ways to avoid it. This is generally accomplished by making investments that produce tax-free income or that defer income until a year the child is no longer subject to the Kiddie Tax. If, at that time, the child is in school or just starting in the work force with little or no other income, the deferred income could then be realized with little or no income tax.

The following are examples of investments that either defer income or generate tax-free income. However, you must also consider that some of these might have a lower rate of return than a taxable investment and may not always be appropriate in the current economic climate:

- **U.S. savings bonds** – Interest can be deferred until the bonds are cashed.
- **Municipal bonds** – Generally produce tax-free interest income for Federal taxes. Most states with a state income tax also permit tax-free treatment of interest from bonds of that state or local governments within that state.
- **Growth stocks** – Stocks that focus more on capital appreciation than current income. The child could wait to sell them until he or she is no longer subject to the Kiddie tax.
- **Mutual funds** – Mutual funds that focus on growth stocks or municipal bonds. Although they might throw off some taxable income, their primary goal is capital appreciation or tax-free income.
- **Unimproved real estate** – That provides appreciation without current income.

If the family has a business, that family business could employ the child. The child's earned income is not subject to the Kiddie tax rules and will generate a deduction for the family business (assuming the wages are reasonable for work actually performed). The child's earned income can be offset by the standard deduction for a dependent, and the excess income will be taxed at the child's rate (not the parent's). In addition, the child would also qualify for a Traditional or Roth IRA, which provides additional income shelter.

---

## Parents Can Get Credit for Sending Kids to Day Camp

With summer just around the corner, there is a tax break that working parents should know about. Many working parents must arrange for care of their children under 13 years of age during the school vacation period. A popular solution — with a tax benefit — is a day camp program.

The cost of day camp can count as an expense towards the child and dependent care credit. But be careful, expenses for overnight camps do not qualify. If your childcare provider is a sitter at your home or a daycare facility outside the home, you will get some tax benefit if you qualify for the credit.

The credit is generally 20% to 35% of non-reimbursed expenses; up to \$3000 in expenses for one child and up to \$6000 for two or more children. The actual credit is also based on your income. The credit is 35% of the child care expense if your income is under \$15,000. The credit percentage gradually decreases as the income gets higher, but remains at a fixed 20% rate once your income exceeds \$43,000.

Tax Department  
**317.885.2620**

Atlanta  
**678.518.5301**

Chicago  
**630.682.9797**

Colorado Springs  
**719.528.6225**

Dallas  
**214.624.5077**

Denver  
**720.283.7326**

Indianapolis  
**317.885.2620**

Los Angeles  
**714.671.9300**

Orlando  
**407.883.4671**

San Diego  
**858.638.7220**

## Limited Window of Opportunity for Extended Tax Breaks

Last December, Congress extended a number of the Bush era tax breaks, but only for a limited amount of time. And considering the size of the national debt, it is probably a safe bet to say that most will not be extended further. Although numerous breaks were extended, only a certain few provide you with an opportunity to take actions that can reduce your tax bite. But if you want to take advantage of those tax breaks, you need to act this year or the next. The following is a list of those extended tax breaks and what will happen when they expire.

**Individual Tax Rates** – The Bush era tax cuts reduced and replaced individual tax rates with six tax brackets that increase with income: 10, 15, 25, 28, 33 and 35 percent. They will revert to their original higher levels of 15, 28, 31, 36 and 39.6 percent, beginning in 2013. That will result in the lowest bracket increasing by 5 percentage points and the highest bracket 3.6 percentage points, affecting all taxpayers from the low- to the high-income. In certain circumstances, it may be appropriate to accelerate income to take advantage of the lower rates.

**Capital Gains & Qualified Dividends** – Under the Bush era tax cuts, the maximum tax on long-term capital gains (assets owned for more than one year) was reduced from a 20 percent rate to 15 percent for taxpayers in the 25% and higher tax brackets. The tax cuts also provided for a zero tax rate to the extent a taxpayer is in the 10 and 15 percent income tax brackets. These lower rates will revert to the higher rates in 2013, impacting taxpayers in all tax brackets. Do you have potential capital gains that you might sell before 2013 to take advantage of the current lower rates?

**American Opportunity Tax Credit** – The American Opportunity Tax Credit (AOTC) replaced the Hope Education Credit in 2009 and provides a maximum tuition credit of \$2,500, of which up to 40% can be refundable and applies to the first four years of post-secondary education. This enhanced credit will expire after 2012 and is set to be replaced by the Hope Education Credit that provides a reduced maximum credit of \$1,800, of which none is refundable; the Hope credit is only applicable to the first two years of post-secondary education. This will primarily impact lower- income families. Note: The administration wants to make the AOTC permanent so watch for further developments.

**Home Energy-Savings Improvement Credit** – This on-again, off-again credit has been extended for one additional year, 2011. However, the 2011 credit has been substantially reduced and only provides a credit up to \$500 (was \$1,500 in 2010) and a reduced credit percentage of 10% (down from 30% in 2010). In addition, the \$500 credit limit is reduced by any credit taken after 2005. To take advantage of this credit for energy-saving exterior windows, skylights, doors, insulation, heating systems, etc., you need to act before the end of 2011.

**Coverdell Education Accounts** – The \$2,000 maximum contribution to Coverdell education accounts will revert to a \$500 maximum after 2012. So if you want to maximize the contributions for a child's future education needs, you need to do so before 2013.

**Sales Tax Deduction** – If you are planning to make a big ticket purchase and want to deduct the sales tax as part of your itemized deductions, you need to act before the end of 2011. The option to deduct the larger of state and local income tax or sales tax expires after 2011.

**Tax-Free IRA to Charity Distributions** – The provision that permits taxpayers age 70½ and over to make direct distributions (up to \$100,000 per year) from their Traditional or Roth IRA account to a charity will expire at the end of 2011. The distribution is tax-free, but there is no charitable deduction. This provision can be very beneficial to taxpayers who have social security income and/or do not itemize their deductions.

If you have questions related to how these or other tax benefits might fit into your tax planning, please give us a call.

## Taking Your Business Home

In the current economic environment, many smaller firms are looking for ways to cut costs. One such possible move would be to relocate from a rented office space to a home office. With today's modern means of communications and virtual marketplace, this may be a good option for your business.

The advantages include the ability for you to deduct from your business income some home expenses, such as utilities and certain maintenance costs that are not otherwise deductible. Those expenses will include a depreciation allowance for the part of your home that is the office. A portion of your mortgage interest and real property taxes will be deducted on your business schedule rather than as itemized deductions. You will be eliminating the costs of your non-deductible commuting travel, while business travel will now generally be measured from your front door.

There are two significant downsides to a home office. First, to the extent of the depreciation taken on the home, gain when you sell it cannot be excluded under the home sale rules. Secondly, if the home office is in a separate structure, then the separate business portion does not qualify for the home gain exclusion. You should also note that the home office deduction is limited in any year that your business operates at a loss.

Generally, a self-employed individual will qualify for a home office deduction if the office is a place where the taxpayer meets with customers, patients or clients, or is used on an exclusive and regular basis for administrative or management activities of his or her trade or business, and there is no other fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. Even if a taxpayer conducts administrative activities at a fixed location outside the home, he or she is still eligible to claim a deduction as long as the administrative activities conducted at the outside location aren't substantial. Space in the home used to store inventory for a wholesale or retail business also qualifies as business use of the home.

If you would like to learn more about how the business use of your home might affect your taxes, please give us a call.

---

## Since You Asked...

**YOU ASKED:** Since I have been unemployed for quite a while and need some funds to carry me over, I am thinking of tapping into my IRA for some cash. What are the tax ramifications?

**ANSWER:** Withdrawals from tax-deferred retirement accounts, such as Traditional IRAs, are generally taxable and will be added to your other income for the year and taxed at your highest marginal rate. In addition, if you are under 59½ years of age, the distribution will also be subject to a 10% federal penalty (and possibly a state tax penalty depending where you live), unless you meet one of the penalty exceptions such as payment of unreimbursed medical expenses, medical insurance and higher education expenses. So the actual tax cost to you will depend upon your tax bracket for the year, your age, if you are subject to the early withdrawal penalty, and whether one of the penalty exceptions applies.

**YOU ASKED:** I know that in 2010 I was able to convert my Traditional IRA into a Roth IRA, regardless of income, and had the option to pay the taxes on the conversion in 2010 or pay taxes on half the income in each of the years 2011 and 2012. Can I make a conversion in 2011?

**ANSWER:** Yes, you can still make a conversion of your Traditional IRA to a Roth IRA in 2011 and subsequent years without regard to income restrictions. However, the conversion tax must be paid in full for the year of the conversion.

## Tax Calendar

For the complete 2011 Tax Calendar, see IRS Publication 509 at [www.irs.gov/pub/irs-pdf/p509.pdf](http://www.irs.gov/pub/irs-pdf/p509.pdf).

### June 15, 2011

- U.S. citizens living abroad on April 18, 2011 must file a 2010 income tax return (if not already filed) or file for an extension.
- The second installment of 2011 individual estimated taxes is due. If your income or deductions have significantly changed, please call us to determine if any adjustment in estimates is appropriate.

### June 30, 2011

- This is the last day to report a financial interest in or signature or other authority over any foreign financial accounts with an aggregate value over \$10,000 by filing Form TD F 90-22.1. There are no extensions and substantial penalties will apply for failing to file.

### June-July 2011

- It's time to review 2011 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

### August 1, 2011

- This is the due date for self-employed individuals and employers to file 5500 series returns for 2010 calendar year benefit plans (including Keogh/HR-10 plans). Since the normal July 31 due date falls on a Sunday, this due date is extended to August 1, 2011.

### August 31, 2011

- This is the last day for taxpayers with undisclosed income for offshore accounts to become current under a special voluntary disclosure initiative offered by the IRS.

### September 15, 2011

- The third installment of 2011 individual estimated taxes is due.