MANAGEMENT
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MORE IN THIS ISSUE…

The gift tax exclusion: The gift that keeps giving

How to track your personal cash flow

IRS audits may be set to increase

UNPAID PAYROLL TAXES? WATCH OUT FOR THE TRUST FUND RECOVERY PENALTY

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Unpaid payroll taxes? Watch out for the trust fund recovery penalty

If your business fails to withhold income and payroll taxes from its employees' wages and remit those taxes to the federal government, the IRS has the authority to hold specific owners, officers, directors, employees and others personally liable for the unpaid amounts. This authority is derived from the trust fund recovery penalty (TFRP), one of the harshest penalties in the Internal Revenue Code.

UNDERSTANDING HOW IT APPLIES

The penalty applies only to employees' tax obligations, including withheld federal income taxes and the employee share of Social Security and Medicare taxes. They are considered trust funds because they're the property of the federal government, held in trust by the employer. The penalty doesn't apply to the employer share of payroll taxes. "Penalty" is a bit of a misnomer: Because the penalty amount is 100% of the unpaid taxes, it essentially serves as an alternative collection method for the IRS. And it's particularly dangerous because it can ensnare persons who ordinarily are protected against personal liability for the business's debts.

This penalty isn't new, but the COVID-19 pandemic has thrust it into the spotlight. This is because financial pressures have led some businesses to "borrow" from the government by delaying payroll tax payments. And the fact that employers were permitted to defer certain employee payroll taxes

Certified PEO offers peace of mind

Responsible persons generally can't avoid personal liability for unpaid payroll taxes simply by delegating responsibility for those taxes to someone else. Although that person also may be responsible, the IRS is free to go after either party, or both, in its effort to collect. One exception is a certified professional employer organization (CPEO). Many companies use professional employer organizations (PEOs) to handle payroll, payroll taxes and other employment-related duties. But delegating to a PEO doesn't relieve a company's responsible persons of their liability for unpaid payroll taxes.

Pursuant to federal legislation enacted in late 2014, however, companies can shift their payroll tax liabilities to a CPEO. In contrast to a regular PEO, a CPEO is treated as the employer of its customers' workers and is solely responsible for collecting and remitting their payroll taxes.

To find a CPEO — or to confirm that your current PEO is certified — visit IRS.gov and search for "certified professional employer organizations."

in late 2020, requiring them to collect and remit those taxes this year on top of their usual payroll tax obligations, doesn't help.

DETERMINING WHO IS LIABLE

The TFRP provides that:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

The IRS takes a broad view of who may be a "responsible person" under this provision, interpreting it to include anyone, within or outside the company, who possesses significant control or influence over the company's finances. Whether or not someone is a responsible person depends on all of the facts and circumstances, but factors that may support that conclusion include ownership interest, title, check-signing authority, control over bank accounts or payment of debts, hiring and firing authority, control over payroll, and power to make federal tax deposits. Responsible persons may include:

- Shareholders, partners or LLC members,
- Officers or other employees,
- Directors,
- Payroll service providers, including responsible persons within those providers,
- Professional employer organizations (PEOs), including responsible persons within those organizations, and
- Specific outside advisors.

Of several responsible persons within a company, each may be held liable for the full amount of the TFRP.

EVALUATING WHETHER IT'S WILLFUL

As noted above, to trigger penalties, the failure to pay trust fund taxes must be "willful." The IRS

interprets this term broadly to include not just intentional acts, but also a reckless disregard of obvious or known risks that taxes won't be paid. The courts have described various scenarios that reflect a reckless disregard, including:

1. Relying on statements of a person in control of finances, despite circumstances showing that this person was known to be unreliable,
2. Failing to investigate or correct mismanagement after receiving notice that taxes were not paid, and
3. Knowing that the company is in financial trouble but continuing to pay other creditors without making reasonable inquiry into the status of payroll taxes.

Thus, delegating the handling of payroll taxes — for example, to another owner, an officer or employee, a payroll service provider, or a PEO — isn't enough to avoid liability if there's reason to believe that those duties won't be fulfilled. (But see "Certified PEO offers peace of mind" on page 2.) The IRS won't impose a TFRP, however, on a responsible person who is unaware that payroll taxes haven't been paid, even if he or she was negligent.

PROTECTING YOURSELF

To avoid personal liability, potentially responsible persons should take steps to ensure that their companies are satisfying their payroll tax obligations. They also should ensure that their companies are filing timely payroll tax returns. The three-year limitations period within which the IRS may assess the TFRP against responsible persons doesn't begin to run until a return has been filed. •

The gift tax exclusion: The gift that keeps giving

Reducing the size of a taxable estate is a common estate planning goal. Among the various strategies for doing so is the annual gift tax exclusion. In fact, if you don't use your annual exclusion by the end of the year, you'll lose it — the exclusion can't be carried forward and used in future years. In addition, the current high exemption is likely temporary and is scheduled to drop in 2026, which would reduce how much you can pass estate-tax-free to heirs when you die — so 2021 might be a particularly good time to make annual exclusion gifts.

HOW IT WORKS

Using the annual gift tax exclusion, you can give to an unlimited number of family or friends cash or property valued up to a specified amount each year without owing any gift tax — so long as the gifts are considered to be "present interest" gifts. In general, a present interest gift is one in which the beneficiary has an unrestricted right to immediately use and enjoy the property. If you repeat the gifting strategy over several years, you'll see your taxable estate dwindle, while keeping the assets within the family.

The annual gift tax exclusion, which is stated as $10,000 in the tax code and is subject to inflation indexing, is currently $15,000 per recipient. In other words, you can give each recipient gifts of cash or property valued up to $15,000 each year with no gift tax consequences. The exclusion may be increased only in increments of $1,000, so it changes infrequently. The last time it was increased, from $14,000 to $15,000, was back in 2018.

Let's suppose you have three adult children and seven grandchildren. If you give each one of them $15,000 in 2021, for a total outlay of $150,000 (10 × $15,000), you'll have reduced your estate by that amount without paying federal gift tax. If you continue this strategy for five consecutive years, you will have handed out $750,000 (5 × $150,000) completely free of gift tax. You don't even have to file any gift tax returns!

What's more, if you're married, you and your spouse can give away a combined gift of up to $30,000 a year — via split gifts — without any gift tax. Assuming you follow the same pattern of gifting all 10 family members for five years, you will have whittled down your estate by $1.5 million ($30,000 × 10 × 5).

Of course, by giving away cash or property, you're relinquishing full control over those assets. Once they're out of your hands, they're technically gone forever. However, if this was your goal anyway, the annual gift tax exclusion can certainly provide the means with little fuss.

HOW TO GIVE ASSETS THAT APPRECIATE

The rules are a little trickier if you're gifting assets such as securities. Generally, the value of property for gift tax purposes is its fair market value. If you gift property that's appreciated in value, the recipient must use your basis (usually, the original cost) to compute the taxable gain if he or she subsequently sells the property. Nevertheless, the gain will be taxed to the recipient, who'll likely be in a lower tax bracket than you. Thus, gifting can result in income tax savings for the family as well.

In addition, be aware that gifts made directly to a financial institution to pay for tuition or to a health care provider for medical expenses on behalf of someone else don't count toward the gift tax exclusion, and, in fact, aren't even reportable gifts. For example, you can pay a student's tuition in excess of the annual exclusion amount of $15,000, and, unless you've made other gifts that may be reportable, you won't have to file a gift tax return.

Finally, you have one other gift tax break in your hip pocket: the lifetime gift tax exemption. This exemption applies to gifts of up to $10 million, indexed to $11.7 million in 2021 after you've exceeded the annual gift tax exclusion. But keep in mind that using any part of this exemption during your lifetime erodes the amount available to you at death.

ONE STRATEGY AMONG MANY

Using the $15,000 per recipient annual exclusion is a simple way of reducing your taxable estate. But don't forget the other more sophisticated estate planning techniques designed to maximize the benefits of the $11.7 million gift and estate tax exemption. Your tax advisor can assist you in choosing the year-end tax planning strategies best suited to your circumstances. •

How to track your personal cash flow

Monitoring cash flow is one of the most important tasks for any business. It's critical that companies know how much cash is coming into and going out of the business every month. The same is true for families. While families often calculate their household net worth, this calculation is just a snapshot of the family finances at a certain point in time. Net worth doesn't give an idea of income and spending, which tend to be better indicators of true financial health.

So, a better way to gauge financial health may be to perform a personal cash flow analysis. This will show how much money is coming into the household and how much is going out every month — as well as where the money is going.

NET POSITIVE

The first step is to create a personal cash flow statement. This is similar to a budget in which you record all of your monthly income and expenses. The goal should be net positive cash flow after you've met all of your financial obligations at the end of every month. Positive short-term cash flow is key to living within your means and building wealth.

Start by writing down all your sources of monthly income, beginning with your primary job or jobs. If

and car maintenance. For the purposes of your cash flow analysis, you could total your variable expenses for one year, divide this by 12 and add this amount to your cash flow statement as a fixed monthly expense.

BOTTOM LINE

With your personal cash flow statement in hand, you can now perform a cash flow analysis. Subtract total expenses from total income to arrive at your bottom line.

If your monthly income exceeds your monthly expenses, you have positive cash flow and are living within your means. With your excess monthly income, you can pay down debt (especially high-interest credit card debt), boost retirement savings, start or add to an emergency fund, or put the money toward a special purpose such as a vacation or home improvements.

If expenses exceed income, you should take steps to balance your household budget. This will require increasing your income, decreasing your expenses or both. For example, can you start a side consulting business or have one spouse return to work if just one of you is working?

On the expense side, start with discretionary expenses such as entertainment and eating out. Other possible cost-cutting steps include eliminating cable or satellite TV, downgrading cellular plans, streaming movies, and cutting back on retail shopping.

BUILD HOUSEHOLD WEALTH

Take the time now to perform a cash flow analysis, starting with a personal cash flow statement. Doing so could help build your family's wealth over the long term. •

you earn a salary and get paid at regular intervals, usually once or twice a month, this should be fairly straightforward. If you own a business or are self-employed and your income is variable, it can be a little harder. One strategy is to figure your average monthly income for the year and use this in your cash flow analysis.

Be sure to include any income you might derive from other sources. This might include Social Security, bonuses, sales commissions, alimony, child support, and a pension or annuity.

Next, move to the expense side of the ledger. Household expenses can be divided into two main categories: fixed and variable expenses. Fixed expenses remain fairly steady from month to month — these are expenses such as your mortgage, car notes, property taxes, insurance premiums and retirement plan contributions.

Variable expenses change from month to month. These typically include entertainment, eating out, utilities, groceries, gasoline, clothing, and home

IRS audits may be set to increase

The Biden administration's tax proposals include an additional $80 billion in funding for the IRS. Although the goal of this funding is to help the IRS combat tax avoidance among big corporations and the wealthiest Americans, some experts believe that audits of some small businesses will also increase.

This new funding for the IRS would assist the agency's enforcement efforts in several ways, such as 1) boosting enforcement staffing, including hiring and training agents dedicated to complex enforcement activities; 2) improving third-party reporting from financial institutions and others; and 3) modernizing the IRS's technology.

Some critics argue that the plan would result in a greater number of audits of specific small businesses, especially those owned by high-income-earners and those that deal primarily in cash.

Given the prospect of increased IRS enforcement activity in the future, now's a good time for businesses to get their affairs in order. Work with your accounting and tax advisors to be sure your books and records are complete and accurate. Verify that you have the documentation you need to substantiate every deduction or credit you claim on your tax return. Although every business should follow good recordkeeping practices, it's particularly important for those that exhibit "audit red flags" that may attract the IRS's attention. For example, watch for:

- High income reported on Schedule C — *Profit or Loss from Business (Sole Proprietorship)*,
- Frequent losses reported on Schedule C (which may lead the IRS to suspect that the activity is a hobby rather than a legitimate business),
- Home office deductions,
- Deductions that are exorbitant or disproportionate to your income,
- Low salaries for S corporation shareholders who work in the business (these shareholders — who are exempt from self-employment taxes — must receive reasonable compensation to ensure they pay their fair share of Social Security and Medicare taxes),
- Higher-than-average deductions for meal and travel expenses,
- Vehicle deductions based on 100% business use, and
- A high volume of cash transactions.

The existence of one or more of these red flags doesn't guarantee that your business will be audited — nor does it mean you're in danger of being hit with additional taxes or penalties if it is. But it does mean that you'll need to have thorough documentation to support your tax treatment of these items.

At the time of this writing, the future of President Biden's tax proposals — including increased funding for the IRS — is uncertain. But regardless of the chances that your business will be audited, it's always a good idea to ensure that your tax practices are beyond reproach. •

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