

# TAX NEWS

Winter 2011

TAX CLIENT NEWSLETTER

## CONGRESS IN BRIEF

Congress is almost in a stalemate waiting for the 2012 elections, but in the past couple of months, it has managed to pass a few tax bills with several important provisions. Congress has voted to repeal the requirement that government entities withhold 3% of payments made to private contractors for goods and services. This provision was scheduled to go into effect in 2013. The repeal bill also includes tax credits for hiring veterans which take effect immediately. Congress also passed a trade bill that increases health care coverage for trade-affected workers and also contains an increase in penalties on tax return preparers for failure to adequately evaluate their clients' claims for the earned income tax credit.

In addition, the bipartisan Congressional supercommittee failed to produce the \$1.2 trillion in deficit reduction by the Thanksgiving deadline. As a result, automatic spending cuts will take effect in 2013, and, unless Congress acts before the end of the year, many important tax provisions will expire at the end of 2011. More details on these developments appear in the Congressional Update feature beginning on page 3.

## IMPORTANT TAX FILING DEVELOPMENTS

### IRS TO ISSUE IDENTITY THEFT PINS TO TAXPAYER/VICTIMS IN DECEMBER, NUMBER MUST BE USED ON TAX FILINGS

The IRS sent letters to all known IRS identity theft victims in early December. These letters notified taxpayers that the IRS has placed an identity theft indicator on their account. The letter also advised the taxpayer that an additional letter will be forwarded toward the end of the month of December with a unique PIN that *must* be entered on the taxpayer's returns for 2011 for the taxpayer to file electronically. Absent this PIN, the taxpayer will be required to file a paper return, which could delay a refund. The IRS will then match the special PIN with the PIN to be entered on the e-filed returns to positively identify the taxpayer. If the PIN does not match or is not present on the e-filed return, the return will be rejected. The unique PIN will be "year" specific. These unique PINs will likely be issued for up to three

years *after* the IRS has identified and validated an identity theft victim.

### Important to Keep PIN Letters

If you receive one of these letters it is absolutely *essential* that you keep the letter and contact me immediately. If you lose the letter and do not know your special PIN, you cannot get it in any other way. The IRS will not issue duplicate letters. If you do not have the PIN, I cannot electronically file your return.

### ELECTRONIC FILING REQUIRED FOR MOST RETURNS IN 2012

New electronic filing requirements for tax return preparers go into effect in 2012. Starting in January 2012, any paid preparer that expects to file 11 or more Form 1040 returns must use IRS e-file. However, if you file these forms yourself, you may choose to file by paper, even if I prepare the return for you. If you do not want your return filed electronically, I can mail printed income tax returns to the IRS for you. However, I will need to obtain a hand-signed and dated statement from you stating that you do not want your return e-filed.

Filing tax returns electronically has benefits and drawbacks. The benefits are that the returns are processed quickly and you should get your refund in much less time. The drawback is that it is easier for the IRS to analyze and scrutinize an electronic tax return.

### TAXPAYERS MUST ATTACH CHECKLIST TO ALL 2012 RETURNS WITH EARNED INCOME CREDIT CLAIMS

The IRS has issued proposed regulations that require paid tax return preparers to file a due diligence checklist with any federal return claiming the Earned Income Credit (EIC), beginning in 2011. As a preparer, I have been required to complete this form and retain it in my client records. However, now it must be sent in with the tax return. To fill out the checklist, I am required to ask questions about a client's dependents, sources of support, living situation, and family relationships. Requiring that this checklist be submitted as part of the tax return raises its legal significance and subjects it to much greater scrutiny by the IRS. At this point, it also is unclear to what extent my clients will need to prove to me the accuracy of the information they are conveying. The IRS

regulations state that I must "make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete."

The significance of this change for you is that your tax return will be more complicated to complete and you can expect the IRS to more closely investigate your eligibility for the earned income credit.

### EIC by the Numbers

The earned income credit is targeted to low- and moderate-income workers and working families, and the tax benefit varies by income, family size and filing status. Unlike most deductions and credits, the EIC is refundable — taxpayers can get it even if they owe no tax. For 2011 tax returns, the maximum credit will be \$5,751.

### 2012 INFLATION ADJUSTMENTS INCREASE MANY TAX BENEFITS, SOCIAL SECURITY WAGE BASE ALSO UP

The IRS has announced inflation adjustments for 2012 which increase the personal exemption and standard deductions, along with numerous other tax benefits. The maximum amount of earnings subject to Social Security taxes also has been increased to \$110,000, up from \$106,800 in 2011. Social Security benefits will rise due to a 3.6 percent cost-of-living adjustment starting in January 2012. Yearly contribution limits for 401(k) and similar retirement plans are increased to \$17,000 from \$16,500.

Here is a run-down of the new numbers:

### Personal Exemptions, Standard Deduction and Brackets

- The personal and dependent exemption is \$3,800, up \$150 from 2011.
- The new standard deduction is \$11,900 for married couples filing a joint return, \$5,950 for singles and married individuals filing separately, and \$8,700 for heads of household. Several tax benefits are unchanged in 2012. For example, the additional standard deduction for blind people and senior citizens remains \$1,150 for married individuals and \$1,450 if the individual is unmarried and not a surviving spouse.
- Tax-bracket thresholds will be increased slightly for each filing status. For a married couple filing a joint return, for example,

the taxable-income threshold separating the 15-percent bracket from the 25-percent bracket is \$70,700, up from \$69,000 in 2011.

### Credits, deductions, and Medical Savings Plan Limits

- For tax year 2012, the maximum earned income credit (EIC) rises to \$5,891. The maximum income limit for the EIC rises to \$50,270.
- The foreign earned income deduction rises to \$95,100.
- The adjusted gross income threshold at which the lifetime learning credit begins to phase out is \$104,000 for joint filers and \$52,000 for singles and heads of household.
- For 2012, annual deductible amounts for Medical Savings Accounts (MSAs) will increase from the 2011 amounts as shown at the bottom of the page.

### Student Loan Interest Deduction

The \$2,500 maximum deduction for interest paid on student loans begins to phase out for married taxpayers filing joint returns with adjusted gross income of \$125,000 and phases out completely at \$155,000. For single taxpayers, the phase-out range is between \$60,000 and \$75,000.

### Nanny Taxes

The threshold amount for paying employment taxes on a domestic employee will rise from \$1,700 to \$1,800 per year. The dollar threshold applies separately to each domestic employee.

### Adoption Credit and Adoption Assistance Exclusion

The maximum credit allowed for adoption of a special needs child will be \$12,650 in 2012. The maximum amount of adoption assistance a taxpayer may exclude from income is set at the same amount, \$12,650.

### Estate and Gift

For an estate of any decedent dying during calendar year 2012, the exclusion from estate tax amount is \$5,120,000, up from \$5,000,000 for calendar year 2011. Also, if the executor chooses to use the special use valuation method for qualified real property, the aggregate decrease in the value of the property resulting from the choice cannot exceed \$1,040,000, up from \$1,020,000 for 2011.

The annual gift exclusion remains at \$13,000.

### Transportation Benefits

- The monthly limit on the value of excludable parking benefits for employees rises to \$240. However, the monthly limit on transportation in a commuter highway vehicle and on transit passes provided by an employer is reduced to \$125 for 2012.

### Expensing Limits for Depreciable Assets

The amount a business taxpayer can write off for tangible personal property in the first year the asset is placed in service will be reduced in 2012. The higher limits we have had for a few years are expiring. In 2011, \$500,000 could be expensed. In 2012, up to \$139,000 of eligible property costs can be deducted immediately. However, this amount must be reduced dollar for dollar if a taxpayer's aggregate purchases for the year exceed \$560,000. (See page 00 for an article on the election to expense depreciable assets.)

### Pension Plan Limitations for 2012

The IRS also announced cost of living adjustments to dollar limitations for pension plans and other retirement plans for tax year 2012. The contribution limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan is increased from \$16,500 to \$17,000.

- The catch-up contribution limit for those aged 50 and over remains unchanged at \$5,500.
- The deduction for taxpayers making contributions to a traditional IRA is phased out for singles and heads of household who are covered by a workplace retirement plan and have adjusted gross incomes between \$58,000 and \$68,000. For married couples filing jointly, in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, the income phase-out range is \$92,000 to \$112,000. For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between \$173,000 and \$183,000.
- The AGI phase-out range for taxpayers making contributions to a Roth IRA is \$173,000 to \$183,000 for married couples filing jointly. For singles and heads of household, the income phase-out range is \$110,000 to \$125,000. For a married individual filing a separate return who is covered by a retirement plan at work, the phase-out range remains \$0 to \$10,000.
- The adjusted gross income limit for the saver's credit for low- and moderate-income workers is \$57,500 for married couples filing jointly; \$43,125 for heads of household; and \$28,750 for married individuals filing separately and single taxpayers.

### Defined Benefit and Defined Contribution Plans

The 2012 limit on the annual benefit under a defined benefit plan is increased from \$195,000 to \$200,000. The limitation for defined contribution plans is increased to \$50,000.

### IRAs

The deductible amount for IRAs remains unchanged at \$5,000, but the income limits increase as follows: For taxpayers who are active participants in an employer plan filing a joint return or as a qualifying widow(er), the income limit is \$92,000. For all other taxpayers, the income limit is increased to \$58,000. The limit for a taxpayer who is *not* an active participant but whose spouse is an active participant is increased to \$173,000.

### Roth IRAs

The adjusted gross income limitation for determining the maximum Roth IRA contribution for married taxpayers filing a joint return or for a taxpayer filing as a qualifying widow(er) is increased to \$173,000. The limitation for all other taxpayers is increased to \$110,000.

## CONGRESSIONAL UPDATE

### CONGRESS REPEALS 3% WITHHOLDING FOR GOVERNMENT CONTRACTORS, PASSES VETERANS HIRING CREDITS

Congress has passed and sent to the President H.R. 674, a bill that repeals the 3% withholding on government contractors which was set to go into effect in 2013. President Obama has indicated he will sign the legislation. The measure also includes veterans hiring credits initially proposed by President Obama in his jobs bill. The Returning Heroes Credit would give employers up to \$2,400 for hiring post 9/11 veterans who have been unemployed for four weeks. If the veteran has been out of work for six months or more, the credit would be higher—\$5,600. Additionally, a \$4,800 Wounded Warriors tax credit would be available to employers who hire a disabled veteran who has been unemployed for four weeks. The credit would increase to \$9,600 if the veteran has been out of work for six months or more. The credits are allowed for veterans hired after the effective date of the Act, November 21, 2011.

To pay for the bill, a provision was included that allows a continuous 100% levy on payments to federal vendors for goods and services if the vendor owes back taxes.

### TRADE BILL RAISES HEALTH CREDIT COVERAGE FOR DISPLACED WORKERS

President Obama has signed into law several related trade bills which contain tax provisions. One bill increases the rate of the Health Coverage Tax Credit program that provides health insurance benefits to workers eligible for trade adjustment assistance and for retirees who were covered by pension plans taken over by Pension Benefit Guaranty Corporation who have lost their employer-sponsored coverage. (The Trade Adjustment Assistance Program is a federal program that aids U.S. workers who have lost their jobs as a result of foreign trade.) The legislation subsidizes 72.5

Medical Savings Accounts (MSAs)	Self-only coverage	Family coverage
Minimum annual deductible	\$2,100	\$4,200
Maximum annual deductible	\$3,150	\$6,300
Maximum annual out-of-pocket expenses	\$4,200	\$7,650

percent of the cost of the health care premium, provides workers with retroactive payments to help cover the up-front costs of obtaining health coverage, and provides coverage for the worker's spouse and dependents.

A related trade bill increases the penalty on tax preparers who do not exercise "due diligence" when determining a client's earned income tax credit. The penalty is increased from \$100 to \$500 for *each* failure, for tax returns that must be filed after 2011. The IRS also has issued new rules on the information that must be filed with a tax return to claim the earned income credit. See page 1 of this issue for a description of the new filing requirements.

### **SUPERCOMMITTEE'S FAILURE REQUIRES DEEP SPENDING CUTS, LEAVING POPULAR TAX PROVISIONS IN LIMBO**

The Congressional supercommittee formed to reduce the deficit after this Summer's debt-ceiling compromise has failed to reach its goal of producing a compromise measure producing \$1.2 trillion in deficit reduction. The supercommittee, formally known as the Joint Select Committee on Deficit Reduction, announced its stalemate on Monday, November 21<sup>st</sup>. The Supercommittee was not limited to spending cuts. It could have recommend tax increases or tax loophole closers as well.

After weeks of discussions with Republicans refusing to consider any tax increases at all, the Republicans made what they regarded as a major concession by offering nearly \$300 billion in new revenue. The Republicans even offered to reduce depreciation deductions for corporate jets, a symbolic gesture toward the other side. Supercommittee Democrats rejected that offer because the Republican plan also would have lowered the top individual tax rate to 28 percent and the corporate rate to 25 percent.

### **Democrats Urge Broader Tax Reform**

The Democratic members of the supercommittee offered instead a vague plan for broader tax reform, beginning with a \$350 billion tax increase from "miscellaneous revenue provisions." Another \$650 billion in revenue would come from more far-reaching tax reform provisions with lower corporate rates and a top individual rate of 35%. The Democrat's plan included \$1 trillion in spending cuts, but at not nearly the level the Republican members say is necessary to reduce the U.S. deficit.

### **Tax Limbo For Reduced Payroll Tax**

With the failure of the supercommittee to compromise on a deficit reduction plan, the fate of many tax provisions remains uncertain. For example, the 2% payroll tax holiday applicable for the last year will expire at the end of 2011. The extension of unemployment benefits will expire at the end of the year as well. (A list of tax provisions which expire in January 2012 appears below.) Also, the Bush tax cuts are currently set to expire on December 31, 2012. The

Bush tax cuts and 2011 expiring tax provisions will now have to be addressed in separate legislation. Congress may still bring forth some type of stop-gap legislation to address expiring tax provisions before the end of this year.

### **Washington Math**

With both sides of Congress pointing fingers, it is very difficult to understand what is and what it not a tax increase. The controversy hinges on whether or not the deficit reduction plans assume the Bush tax cuts continue or expire. It is projected that the Bush tax cuts, if extended for another 10 years, will cost \$3.7 trillion in federal revenues.

The sticking point is what each side considers a tax increase: The Republicans say any tax revenue above the permanent Bush tax cuts is a tax increase. On the other hand, the Democrats say any tax revenues that are above letting the Bush tax cuts expire for high-income taxpayers (over \$250,000) are the correct measure of a tax increase.

**Observation:** The tax legislative landscape is confusing. I want to assure you that I will keep abreast of any tax developments and will be ready to answer your questions and address your concerns about the status of important tax rules.

### **TAX PROVISIONS SET TO EXPIRE AT THE END OF 2011**

Below is a list of the major tax provisions set to expire at the end of 2011 unless Congress acts to extend them.

#### **Individual Provisions**

- Temporary 2% Payroll Tax Cut
- Increased Individual Alternative Minimum Tax (AMT) exemption and Nonrefundable Personal Tax Credits Allowed Against the AMT
- Deduction for State and Local Sales Taxes.

**Note:** The expiration of this provision will make a huge difference for taxpayers who live in states with no state income tax – and taxpayers who are planning to buy expensive items, such as appliances, motor homes, and boats.

- Tuition and Fees Deduction for Higher Education.
- Itemized Deduction for Mortgage Insurance Premiums.
- \$250 Deduction for Teacher Classroom Expenses
- Direct Charitable Contributions from an IRA

#### **Business Provisions**

- 100 Percent Bonus Depreciation
- Enhanced \$500,000 Expensing of Depreciable Property (not including real estate)
- Expensing of leasehold improvement property, qualified restaurant property, and qualified retail improvement property.
- Small Business Stock Exclusion
- Research and Development Tax Credit.

- Work Opportunity Tax Credit for Employers
- New Markets Tax Credit

#### **Energy Incentives**

• Nonbusiness Energy Credit for Energy-Efficient Building Improvements and Residential Energy Property, such furnaces, central air conditioners, water heaters, heat pumps and similar components.

- Electric-drive Vehicles and Plug-in Conversions
- Energy-Efficient Home Construction Credit
- Energy Efficient Appliance Credit

### **INTERNATIONAL TAX REFORM NECESSARY TO U.S. COMPETITIVENESS**

Stating that it could help create 1 million private sector jobs in the first year alone, House Ways and Means Committee Chairman Dave Camp (R-MI) has unveiled a far-reaching, international tax reform proposal. The plan would lower the U.S. corporate tax rate to 25%. The U.S. rate now is 35%, one of the highest in the industrialized world. In addition to rate cuts, the plan would transition the United States from a worldwide system of taxation to a territorial system — a move virtually every one of America's global competitors has already made.

#### **Worldwide v. Territorial Tax Systems**

The U.S. has a worldwide system of international taxation where all corporate income earned worldwide by a U.S. multinational company is subject to U.S. tax. The corporation is then given a foreign tax credit for taxes paid to other countries on income earned *outside* of the U.S. Under a territorial system, U.S. multinational corporations would only be taxed by the U.S. on income earned *within* the U.S. Most European countries and other major industrialized countries operate under a territorial system.

**Outlook:** While most Members of Congress are in favor of corporate tax reform, it does not appear that they will be able to agree on exactly how to do it any time soon, especially considering Congress' failure to develop a deficit reduction plan.

## **TAX PLANNING**

### **DEPRECIATION AND EXPENSING ELECTIONS IN 2011, 100% WRITE-OFFS POSSIBLE**

In an effort to stimulate the sluggish U.S. economy, Congress and the Administration over the last few years have put in place extremely generous options for writing off the cost of depreciable business property. These business tax incentives can provide you with significant, immediate tax savings if you placed assets in service in 2011 and you make the necessary elections. Three different types of cost recovery for your investments can come into play in tax year 2011: Section 179 expensing, bonus depreciation, and the regular modified

accelerated cost recovery (MACRS). All three types of cost recovery reduce your basis in the asset, which will increase your gain when the asset is sold. Note that your State may not allow bonus depreciation. After considering a number of factors discussed below, we will have to decide which combination of the three programs will be the most beneficial to you.

**Expensing:** Expensing is the immediate write-off of the cost of business property in the first year the property is placed in service. This is allowed under Section 179 of the Internal Revenue Code and is commonly referred to by this Code section. Only tangible, depreciable personal property qualifies, not real property (with a few exceptions). Off-the-shelf computer software also can be expensed in 2011. There are limits on how much you can expense each year. For 2011, the limits have been at an all-time high—\$500,000. The catch is that you must reduce this amount by the amount that your total purchases of eligible property exceed \$2 million for the year. For example, if you purchase a total of \$2,200,000 for the year, you can only expense \$300,000, which is the \$500,000 allowance reduced by the \$200,000 that you went over the purchase limit.

Another consideration is that your Section 179 expensing deductions cannot create a business loss. So, if you do not have enough income to absorb the deduction, you have to carry it over to future years when you may have the business income to cover it.

**Bonus Depreciation:** Also available in 2011 is an unprecedented benefit – 100% “bonus depreciation.” Bonus depreciation is allowed for MACRS-eligible property with a useful life of 20 years or less. Bonus depreciation is not subject to an allowance limit or a purchase limitation. It also is not limited by business income.

**MACRS:** The Modified Accelerated Cost Recovery System is the current system of depreciation used for personal, not real, property. (Most real property has to be depreciated under the straight-line method over 30+ years, with a level deduction amount each year.) The MACRS system allows a percentage write-off each year which starts out high and then declines over the life of the asset.

### Considerations

Because bonus depreciation does not have the same limitations as Section 179 expensing, this may be your best option for the most immediate deduction, especially if you do not have the business income to cover your Section 179 deduction. Section 179 expensing deductions cannot create a business loss, but bonus depreciation write-offs can. Therefore, you can use bonus depreciation to create a net operating loss that can be carried forward and offset income in future years.

Be aware, however, that if you take bonus depreciation, when you sell the asset, the entire gain will be taxed at ordinary income rates rather than capital gains rates under the “recapture” rules. You also must elect out of bonus depreciation or the IRS will assume you took it and reduce your basis in the asset.

There are some situations when you may not want to accelerate your depreciation deductions. If you are in a low tax bracket this year and expect your income to rise, you may want to delay accelerated write-offs until years when your income is higher. The deduction will be worth more to you then.

### Special Rules for Automobiles

Special rules and different limits apply to automobiles used in business. The write-offs for this type of asset are restricted, but still generous for tax year 2011, too. Different rules apply based on the weight of the vehicle. I will be glad to evaluate your business’ eligibility for a vehicle depreciation write-off if you have purchased business vehicles in 2011.

### WHAT YOU NEED TO KNOW ABOUT CLAIMING THE SMALL BUSINESS HEALTH CARE TAX CREDIT

If you are a small employer and pay at least half of the premiums for employee health insurance coverage for your workers you may be eligible for the small business health care tax credit. This credit can enable small businesses and small tax-exempt organizations to offer health insurance coverage for the first time. It also helps those already offering health insurance coverage to maintain the coverage they already have. The credit is specifically targeted to help small businesses and tax-exempt organizations that employ 25 or fewer workers with average incomes of \$50,000 or less.

Here is what you need to know so that you will not miss out on the credit:

- Businesses who were eligible but did not claim the credit on their 2010 return can still claim the credit. If you are in this category, you can file an amended 2010 tax return. If you think you were eligible for the credit in 2010 but did not take it, I will be glad to discuss how we can amend your return.
- Businesses that could not use the credit in 2010 may be eligible to claim it in future years. If you were not eligible in 2010, but you changed your health insurance plan structures and contributions in 2011, you may be eligible to claim the credit on 2011 returns or in years beyond. Small employers can claim the credit for 2010 through 2013 and for two additional years beginning in 2014.

For tax years 2010 to 2013, the maximum credit for eligible small business employers is 35 percent of premiums paid. For eligible tax-exempt employers the maximum credit is 25

percent of premiums paid. Beginning in 2014, the maximum tax credit will go up to 50 percent of premiums paid by eligible small business employers and 35 percent of premiums paid by eligible tax-exempt organizations.

## CLIENT ADVISORY

### TAXPAYERS’ E-MAILS NOT SUBJECT TO IRS SUMMONS

In a victory for taxpayers, the IRS Chief Counsel has decided that a revenue officer’s summons to an internet service provider (ISP) requesting a taxpayer’s e-mails was invalid and should be withdrawn. (A summons is a demand for information in a legal action.) The revenue officer was trying to collect more than a quarter million dollars from a taxpayer who received large refunds from credits claimed through a “shell” entity. The revenue officer was trying to identify the assets of the taxpayer behind the entity.

The summons requested all electronic communications of a particular customer that were electronically stored by the ISP for 180 days before the summons was issued. The IRS Chief Counsel found that this request was not allowed under the federal Stored Communications Act. The Stored Communications Act is a federal law that governs how a government agency can get account information of people who subscribe to computer networks. It contains privacy protections and generally requires that a criminal warrant be issued by a court for customer records.

### Your Right to E-Mail Privacy

Because the revenue officer was seeking the records in a civil tax case, rather than a criminal case, the IRS could *not* force the internet service provider to turn over the records. However, the IRS can force disclosure of other customer information, such as the name, address, length and type of service, and means of payment. This type of information must be turned over to the IRS, but the content of e-mails may not without a *criminal* warrant.

### Thank You for Your Business

As your tax professional, I assure you that I will be keeping a watchful eye on Congress and on IRS actions which may affect your business and your tax filings in the New Year. I will be happy to address any concerns and answer questions you have about any of the issues covered in this newsletter. Thank you for the opportunity and privilege of allowing me to serve as your tax professional.

Best regards,

“The nation should have a tax system that looks like someone designed it on purpose.”

—William Simon, a Secretary of Treasury of the U.S. for three years under Presidents Nixon and Ford.