

The Kiplinger Tax Letter

CIRCULATED BIWEEKLY TO BUSINESS CLIENTS SINCE 1925

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Dear Client:

Washington, Sept. 3, 2010

The latest [tax overhaul](#) debate is under way, now that President Obama's economic recovery board has issued its final report on options for tax reform.

But Congress won't take action this year. Lawmakers have too much remaining on their plate to tackle reform, especially since they're still stuck on what to do about extending the Bush tax cuts.

Still, taxwriters will eye many proposals from the board once they get serious about reform.

Atop the list: [Revamping family tax breaks.](#)

One option is to combine the personal exemption, standard deduction and the child credit into one credit. The earned income credit and the refundable extra child credit for low incomers would also be consolidated. The other choice would combine the earned income credit, the dependent exemption for kids and the child credit into a single credit. Because many of these tax breaks require complex calculations, Congress will likely opt for some form of simplification.

And restructuring education tax incentives. There's widespread agreement that the hodgepodge of the American opportunity credit, the lifetime learning credit and the tuition deduction is confusing. Melding them into one credit would help.

Defanging the alternative minimum tax, or possibly even repealing it. Lawmakers know the AMT is affecting far more taxpayers than it was intended to. Options include increasing exemptions and eliminating several tax preferences.

Easing the scope of the kiddie tax. Under current law, dependents with investment income over certain thresholds are taxed at their parents' rates. The leading options are to raise the threshold so the tax affects fewer dependents and to use the rate schedule for trusts to figure tax on excess investment income.

Simplifying the hodgepodge of savings plans. Two of the board's proposals have decent shots: Combining 401(k), 403(b) and 457 plans into one standard plan. And consolidating all health and education savings plans...flexible spending plans, health savings accounts, Archer MSAs, Coverdells, 529 plans...into a single plan.

Turning to business taxes: [Reducing the maximum corporate tax rate.](#) The board did not suggest a particular rate. But there is a consensus in Congress that the current 35% top rate makes it hard for U.S. companies to compete overseas.

Broadening the corporate tax base is the flip side of a rate cut. Tax reform won't result in a net tax cut for business, so many deductions will be wiped out. Among the more plausible options offered by the board are eliminating the deduction for domestic production and limiting the deduction of interest on corporate debt.

Discussions on bigger-ticket items such as [personal tax rates will come later.](#) The board wasn't asked to recommend major tax reform, such as the 1986 overhaul, which consolidated five tax rate brackets into two. That's why the report is silent about revising the tax brackets. Remember, to sell tax reform to the public in 1986, Congress funded tax cuts for individuals with a \$120-billion tax hike on business.

HIGHLIGHTS

Energy Tax credit for 2010

Benefits 401(k) plan forfeitures

Medicare Tax free \$250 payment

Capital Gains Demutualization

Payroll Taxes No coupon deposits

Losses Five-year carryback easings

ENERGY

Making energy saving improvements to your home this year? Take note: The improvements must be installed by Dec. 31 to qualify for a tax credit.

Homeowners can claim a credit for 30% of the cost of energy saving improvements made to a primary residence. They include skylights, outside doors, windows, pigmented or special asphalt roofs plus high efficiency furnaces, water heaters and central air conditioners. The maximum credit available for 2010 is \$1,500, but the ceiling is reduced dollar for dollar by any credit that you claimed last year.

BENEFITS

Firms can't use forfeitures to help satisfy 401(k) nondiscrimination rules,

IRS says. In the past, the Revenue Service sometimes allowed employers to allocate 401(k) forfeitures as employer contributions to lower paid employees in cases where high paid deferred a much higher percentage of pay than low paid. That lets the employer cure the discrimination by putting in less of its own funds to accounts for low paid and avoid having to return excess deferrals to high paid. IRS now won't OK that and will fix its voluntary error correction program to say so.

Time is running out for existing firms to set up SIMPLE-IRAs for 2010.

The deadline for this year is Oct. 1. Otherwise, payins cannot be made for 2010. Companies can use Form 5304-SIMPLE or 5305-SIMPLE to set up plans. SIMPLEs are plans for small businesses...those that have 100 or fewer employees. Employers must match employee payins up to 3% of pay...or put in 2% of pay for all. Employees can contribute up to \$11,500...\$14,000 if they were born before 1961. The Oct. 1 date doesn't apply to businesses that come into existence after Sept. 30.

Oct. 1 is also the deadline to establish a SIMPLE-401(k) plan. Payin limits are the same as for SIMPLE-IRAs. Providers have model plans that firms can adopt.

A homeowners' association owes tax on income from beachfront parking, the Tax Court says. The tax-exempt association operated a residential community with its own police force and recreation staff. Eight miles away, the association owned oceanfront property with a parking lot and beach club. Only its members could park there during peak summer hours, and only part of the club was open to the public. Since the facilities were not primarily for the public, the income that they generated isn't exempt from tax ([Ocean Pines Association, 135 TC No. 13](#)).

MEDICARE

A reminder for seniors in the Medicare Part D prescription drug program:

The \$250 they get this year for entering the "doughnut hole" is tax free.

Seniors in the Part D program start paying 100% of their drug costs once the total exceeds \$2,830. Coinsurance doesn't resume until their out-of-pocket expenses top \$4,550. When someone hits the \$2,830 threshold, plans will notify Medicare, triggering a \$250 check. The supplemental payment is just for this year. Next year, those in the doughnut hole will get a 50% discount on the cost of brand-name drugs.

PREPARERS

As the Revenue Service begins to gear up for registering preparers...

Unenrolled return preparers will come under IRS disciplinary procedures

for the first time. Currently, all lawyers, CPAs, enrolled retirement plan agents and enrolled agents are subject under IRS rules to standards of ethical conduct. Those charged with misconduct have a right to a hearing. Violators lose their right to practice before the IRS. Now similar rules will apply to unenrolled preparers. Those who act unethically can be barred from doing returns, possibly permanently.

Unenrolled preparers also will have to meet continuing education rules to remain qualified to do returns. They will have to complete 15 hours a year... at least two hours on tax related ethics, three hours on federal tax law updates and 10 hours on federal tax law topics. This will take effect no earlier than 2011. The private sector is already developing programs so preparers can meet this rule.



**CAPITAL
GAINS**

Refund claims for sales of stock in demutualized insurers are still on hold for the most part. Although an Appeals Court rejected the IRS' position that the stock received had no tax basis, the Service still hasn't decided what to do with the many protective refund claims that taxpayers have filed, though tax pros tell us that a small number of claims have been OK'd. Despite the loss in court, the Revenue Service is stubbornly sticking with its zero-basis position for now.

Recent sellers of stock in these firms can safely claim a basis in the shares. Tax experts we've talked to say to use the stock's value on the date of distribution as the basis. The Court's ruling is grounds to avoid an IRS penalty. Some advisers say the stock's basis equals all premiums paid on the policy, less any borrowings. But many tax pros aren't comfortable stretching the Court's decision that far.

**BUSINESS
TAXES**

Be careful transferring S company debt to a firm you are incorporating: The transfer can trigger tax, as this case shows. The owners of an S firm advanced money to it. The firm's losses exceeded the owners' basis in its stock. They deducted the excess loss and had to reduce their income tax basis in the loans. To consolidate their holdings, they later decided to transfer the S company's stock and the advances made to it, along with their other enterprises, to a new corporation in what they thought was a tax free transaction. But they had to recognize income because the advances were deemed to be repaid on the transfer date, and their basis in the advances was lower because they deducted excess losses ([Russell, 8th Cir.](#)).

**PAYROLL
TAXES**

Businesses lack standing to sue competitors over misclassified workers, a district court rules in a suit by a pest control firm against a competitor. The firm claimed that the competitor obtained an unfair competitive advantage by intentionally misclassifying workers as independent contractors. But the court won't adjudicate claims that competitors aren't paying their fair share of taxes. That's for IRS to investigate ([EcoSure Pest Control v. Eclipse Marketing, D.C., Utah](#)).

Note that firms have a defense against IRS charges of misclassification:

They can invoke a 1978 law that limits IRS' ability to reclassify workers.

Companies must be able to show they have always treated similarly situated workers as contractors and filed 1099s on them. They also must have had a reasonable basis for classifying them as contractors, such as relying on a court case or an IRS ruling, on long-standing industry practice or on the result of a prior employment tax exam.

The Social Security tax break for hiring the unemployed is giving IRS fits.

Its computers are cranking out erroneous penalty notices to employers.

Employers don't have to pay their 6.2% share of Social Security tax on the wages of folks hired after Feb. 3, 2010 who worked less than 40 hours in the past 60 days. The problem affects firms that paid wages to eligible employees from March 19 through March 31, the end of the first quarter. The exemption for those wages was taken on the second quarter 941. However, firms could trim their tax deposits anytime in the quarter by the amount of the exemption. IRS computers hiccupped in some cases and didn't pick up that the deposit shortfall was due to the exemption. The Service expects to get its computers up to speed quickly on the new law.

IRS will eliminate use of federal tax deposit coupons after 2010.

Thus, firms will have to wire deposits of all taxes to IRS... payroll taxes, corporate income taxes and estimates, excise taxes and the like. Currently, employers can use paper coupons if their annual deposits don't exceed \$200,000.

Only very small firms will be exempted from depositing electronically... employers with \$2,500 or less in quarterly employment taxes that pay their liability when filing their returns. All other coupon users must switch to making deposits by wire using Treasury's Electronic Federal Tax Payment System. For information on enrolling for electronic deposits, go to www.eftps.gov or call 800-555-4477.



LOSSES

Filers who failed to claim a five-year loss carryback get a second chance, the IRS says. If they timely filed their 2009 return, they get six months after the unextended due date to elect a five-year carryback for net operating losses they incurred for 2009. So for calendar year filers, the deadline is Oct. 15, 2010. Newly released IRS guidance spells out special rules for taxpayers with fiscal years, interactions with elections by small firms for 2008 loss carrybacks and the AMT. See kiplinger.com/letterlinks/nolcarrybacks for the complete details. Remember, too, that losses from investments in Ponzi schemes also qualify for five-year carrybacks. Revised instructions for Forms 1045 and 1139 now cover the new rules as well.

But there's some bad news for companies that [claim loss carrybacks](#):

The Service will offset any pending liabilities against the expected refund, according to newly finalized regulations. This includes unresolved bills for taxes that IRS agents have asserted for intervening tax years and any proofs of claims the agency has filed in bankruptcy court. That can wipe out the refund entirely. IRS will do this for carrybacks of capital losses, net operating losses and tax credits.

EXEMPT GROUPS

A deadline is approaching for small nonprofits that didn't file Form 990-N. They have until Oct. 15 to e-file for 2009 or face the loss of their exemption. Many small charities with average annual revenues of \$25,000 or less didn't realize that they'd lose their exemption if they didn't e-file the 990-N for three straight years. 2009 tax returns for calendar year organizations were originally due by May 17.

Midsize groups also have until Oct. 15 to file. Those with gross receipts of more than \$25,000 but less than \$500,000 will pay a small penalty for filing late.

A ministry without regular religious services doesn't qualify as a church, an Appeals Court says. The group disseminated its message via radio broadcasts and the Internet, conducting traditional religious services only sporadically. Because the organization didn't bring its members together regularly for worship, it wasn't a church for tax purposes ([Found. of Human Understanding, Fed. Cir.](#)). Thus, the group is required to file an annual tax return with IRS, and the Service can audit it without following the strict guidelines on examinations of churches. But even though the group lacks church status, donations to it remain deductible.

ENFORCEMENT

IRS is doing a poor job policing [claims for excluding income earned abroad](#), Treasury inspectors say. Even though the Service has opened five projects to sniff out people who are erroneously taking the foreign earned income exclusion, many violators still fall through the cracks. For 2010, U.S. citizens can exclude up to \$91,500 of earnings abroad if they are a bona fide resident of another country for the entire year or they were outside of the U.S. for at least 330 complete days in a 12-month span. IRS will audit the potential violators whom inspectors uncovered.

But the agency is doing fine paying [Build America Bond subsidies](#), according to Treasury inspectors. Municipalities issue these taxable bonds, which bear a higher rate of interest than tax exempts, and get a federal subsidy for 35% of the interest cost. The net effect is to reduce their overall borrowing costs. Since the subsidy payment is made directly from the Treasury, there was concern that scammers could file bogus claims and receive a huge payout. But the Service has tight controls in place to make sure that the bond issuers are legitimate.

Yours very truly,

The Kiplinger Editors

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