

TAX NEWS



www.gsaccounting.com 303-798-8897

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TAX CLIENT NEWSLETTER

OPPORTUNITY FOR 2010 TAX PLANNING WITH ROTH IRA

You as a taxpayer have a unique opportunity this year to do long-term retirement planning under very favorable conditions. For 2010 only, it is possible to roll over funds from a traditional IRA into a Roth IRA without penalty and to postpone taxation of the rollover until 2011 and 2012. Also, for the first time, there is no income limitation for IRA to Roth rollovers. Prior to 2010, only those persons with adjusted gross income of \$100,000 or less could convert to a Roth.

Roth IRAs are different from traditional IRAs because they are more liquid—you can pull money more easily out of a Roth before retirement age without penalty, after you have had the Roth for more than 5 years. Also, earnings on a Roth may never be taxed at all if you do not withdraw the earnings portion until after age 59 $\frac{1}{2}$. With Roths, you have no minimum distribution rules, so you do not have to withdraw funds at age 70 $\frac{1}{2}$ if you do not want to.

Another major difference is that Roth IRAs are funded with after-tax money. You get no deduction for contributions to a Roth. So when you convert a traditional IRA, which has never been taxed, into a Roth IRA, you must pay the income tax on the portion of the account

that was funded with pre-tax dollars.

Special 2010 Income Splitting Rule

The traditional IRA rules impose a 10 percent penalty on any unqualified withdrawal before age 59 $\frac{1}{2}$. The special 2010 rule allows you to move funds from your traditional IRA into a Roth IRA without paying the 10% penalty. Even better, you do not have to pay the regular income tax on the rollover in 2010. You can elect to pay $\frac{1}{2}$ in 2011 and $\frac{1}{2}$ in 2012, spreading the income tax hit over two years. You also can make the rollover and then change your mind and undo the rollover anytime up to the 2010 filing date, including extensions of time to file. Therefore, you could wait until as late as October 15, 2011 to make the final decision.

Strategies

You must consider where you will get the money to pay the extra tax if you decide to rollover your IRA into a Roth. Also, you should elect the two-year income split if a one-year rollover would push you into a higher tax bracket. If you already are in a high bracket, you may want to take the entire rollover amount into income in 2010 since it is possible that tax rates may increase for higher income individuals in 2011 when the Bush tax cuts expire.

If you expect to be in a lower tax bracket in 2010 because of a job loss or other reduction in income, you may want to take all of the rollover into income in 2010. Again, you must have a source of funds to pay the income taxes. Finally, if you have other losses, such as net operating losses from a business, it may be time to make the switch to a Roth. These losses can help offset the increased income from a Roth conversion.

Act Fast

Time is running out to make these decisions. Please contact me and I will evaluate your situation to help you decide if making the special 2010 Roth IRA conversion is beneficial for you. Below is a list of what can and cannot be rolled over into a Roth IRA.

What Can and Cannot Be Rolled Over Into a Roth IRA

It is important to know what assets can and cannot be rolled over into a Roth IRA. Here's a run down:

The following items CAN be rolled over into a Roth IRA:

- Funds held in another Roth IRA.
- Funds held in a traditional IRA.
- A Simplified Employee Plan (SEP) or Simple IRA (two years after establishment).
- A rollover distribution from an employer retirement plan.

- An eligible rollover distribution from a plan where the taxpayer is a beneficiary.

The following items CANNOT be rolled over into a Roth IRA:

- Required minimum distributions (RMDs) from any plan, including inherited IRAs.
- Hardship distributions.
- Yearly annuity distributions paid over a taxpayer's life expectancy or over 10 years or more.
- Deemed distributions resulting from a default on an employer plan loan.
- Dividends on employer securities.
- Corrective distributions of excess contributions made to a plan.

Special Rule for Inherited IRAs

If a taxpayer inherits an IRA from his or her spouse, the taxpayer can elect to treat it as the taxpayer's own plan and can roll it over into a Roth IRA. If a taxpayer inherits an IRA from anyone besides a spouse, it may not be rolled over into an inherited Roth IRA.

EXTENSION OF POPULAR TAX BREAKS CLOSE TO PASSAGE

The House and Senate are close to resolving their differences on the so-called "Extenders" bills passed by each side over the last few months. The extenders bill contains a one-year extension of popular tax breaks such as the tuition deduction, the research credit, and the new markets credit. Reacting to the Gulf oil leak, Congress has just added to the bill an increase in the excise tax on oil to fund clean-up efforts. The House passed H.R. 4213 in December 2009, while the Senate passed its amended version of the measure in March 2010.

Both Houses are working on a combined version, trying to resolve the conflicts in how to pay for the tax breaks contained in the bills. The new bill with the same number, H.R. 4213, has now taken on the title of the "American Jobs and Closing Tax Loopholes Act of 2010."

Under Congressional rules, the tax breaks in the bill have to be paid for with revenue increases (the "pay-go" rule.) The House wants to raise tax revenues by targeting the foreign operations of U.S. corporations. The House bill also contains a provision to increase taxes on hedge fund and other investment fund managers on appreciation of investments (so-called "carried interests"). Under the bill, these interests would be taxed at higher ordinary income rates rather than the lower capital gains rate of 15%. The Senate previously opposed this provision but negotiations are headed toward a compromise. A group of Senators wants to exempt venture capitalists from the carried interest provision.

S Corporation Shareholders Payroll Tax Increase

Senate negotiators added a provision imposing additional payroll taxes on S Corporation income. The provision would apply payroll taxes to all the service-related income of shareholders of S corporations primarily engaged in service businesses. The provision is targeted at service professionals, such as lawyers and doctors, who route their self-employment income through S Corporations. It would apply to S Corporations whose service business is based on the reputation and skill of 3 or fewer individuals or an S Corporation that is a partner in a professional business.

The S Corporation Association of America has opposed the idea as harmful to small businesses, the backbone of the U.S. economy. In fact, the S Corporation is the most common business form for small businesses. If the bill passes, it will take away what is known as the S Corporation payroll advantage, which allows S Corporation owner-employees to draw a set salary subject to social security and Medicare tax, while taking the remaining profits out of the business subject only to income taxes. The bill also states that service professionals cannot use an LLC or LLP to avoid payroll taxes.

Yearly Extensions Now the Norm

Congress, on a regular basis, extends these tax breaks one year at a time so each year there is a scramble to pass an extension bill. This year, the provisions already expired as of the end of 2009, so now Congress is faced with extending them retroactively to the beginning of 2010. Even if the extension bill is passed within the next month, as is expected, Congress will be faced with the same problem next year. This bill only extends most of the provisions until the end of 2010, when they will expire again. The entire exercise will then have to be repeated next year.

Expiring Tax Provisions to Be Extended

- Tax deduction of \$250 per year for teachers who buy their own classroom supplies.
- The deduction for college education expenses. This provision also would disallow the deduction for higher income families who would receive a higher tax benefit from taking one of the education credits.

- The additional standard deduction for State and local property taxes.
- The deduction for state sales tax for taxpayers in states that do not have an income tax;
- The research and development tax credit for businesses;
- The new markets tax credit for businesses;
- 5-year writeoff for most farm equipment;
- Faster depreciation deductions for new construction, and improvements to restaurants and retail stores;
- A tax cut for small businesses that continue to pay employees who have been called to active duty;
- Tax incentives for use of biodiesel fuel, hybrids, and other renewable energy;
- Tax credit for energy-efficient new homes and energy-efficient windows.
- Increased charitable deductions for contributions of food inventory, book inventories, computer equipment, and conservation property;
- Tax-free distributions from IRAs used for charitable purposes;
- Tax incentives for business investment in low-income areas.
- Bonus depreciation and small business expensing for new property purchased by businesses in Federally-declared disaster areas;
- Allowing businesses to carryback to previous tax years losses that are attributable to a Federally-declared disaster;

Revenue Raisers

- Increased payroll taxes on service professionals who route their self-employment income through an S corporation.

- Excise tax increase on oil companies from 8 cents to 34 cents per barrel to increase the funding for the Oil Spill Liability Trust Fund.
- Close foreign "loopholes" including limits on the foreign tax credit given for taxes paid by U.S. companies to other countries.
- Taxing "carried interests" of investment fund managers as ordinary income instead of capital gains.
- Increased taxes on corporate reorganizations, including capital gains taxation of some types of spin-offs of corporate subsidiaries and taxation of dividends received in certain types of business reorganizations.

CELL PHONE TAX RELIEF MOVES THROUGH CONGRESS

Just before the April 15th filing deadline, the House of Representatives passed a bill that would remove the tax on the personal use of employer-provided cell phones. The measure, H.R. 4994, the Taxpayer Assistance Act of 2010, had overwhelming bipartisan support, passing by a vote of 399-9. The bill would relax the burdensome recordkeeping requirements for businesses that provide cell phones to their employees. Under current law, personal use of business phones is taxed to employees. Also, employers can only deduct the phones if they can prove the exact amount of business use with extensive records. The bill would remove the recordkeeping requirements, making it easier to get the deduction for business cell phone use.

Offers in Compromise, Partial Payment Suspension

The bill also contains a number of other taxpayer relief proposals, including an elimination of the partial payments that are required when you submit an offer to compromise your tax liability. Under current law, taxpayers must send in a partial payment with their request for an offer in compromise (OIC). The partial payment can be as much as 20% of the total tax liability. Since the partial payment has been required, the number of compromise agreements with the IRS has fallen. Eliminating the up-front payment will make it easier for struggling taxpayers to enter into payment plans with the IRS.

Interest on Tax Refunds

The bill also would require the IRS to pay interest on refunds on income tax returns which are filed electronically if the refund is not paid promptly. The IRS has to send the refund within the later of 30 days of the return due date or the date the return is filed. Another new rule would require the IRS to notify taxpayers when it suspects that their identities, or their dependents' identities, have been stolen.

Outlook

The cell phone change has been proposed before, but has not made it through the Senate. In the past, the cell phone fix has been combined with other tax provisions which the Senate objected to. Since this current bill is considered noncontroversial, and is backed by the Obama Administration, this time it may pass. With the widespread use of cell phones by businesses, the passage of this tax relief would be a significant help to small businesses in difficult times.

Write Your Congressman: You may want to write your Congressman to encourage the passage of this important taxpayer relief legislation. To find out who represents you in the House and Senate and for a link to their e-mail addresses, go to the website www.contactingthecongress.org and click on your state.

EMPLOYERS GET 2010 PAYROLL TAX HOLIDAY FOR NEW EMPLOYEES

Despite Congress's stalemate on many legislative agenda items, both sides of the aisle put aside their differences and quickly passed a jobs bill in mid-March. H.R. 2847, the Hiring Incentives to Restore Employment Act (the "HIRE Act") was signed into law by the President on March 18, 2010. The bill gives employers a payroll tax holiday during 2010 for hiring unemployed workers. Specifically, the HIRE Act relieves employers from having to pay the employer's share of social security taxes on wages paid to new employees between March 19, 2010 and December 31, 2010. The social security tax rate for employers is 6.2% on wages up to \$106,800 for 2010. (The new law does not cover the 1.45% Medicare tax.) A special rule allows a portion of payroll taxes already paid by employers in the first quarter of 2010 to be applied as a credit against the employers' second quarter tax.

Qualified Hires

Employers can only claim the credit for qualified workers. The Act defines "qualified workers" as individuals who meet the following criteria:

- They begin work after February 3, 2010 and before January 1, 2011.

- The new law requires employers to get a statement from each eligible new worker certifying this information: they were unemployed during the 60 days before beginning work or had worked fewer than 40 hours for anyone during the 60 days before being hired. (**Note:** The IRS has a new form to use for the employee affidavit, which I will provide to you if you want to claim this exemption. You do not have to file this form with your taxes, but you need to keep it on file with other payroll and income tax records.)

- They are not employed to replace another employee unless the previous employee left the job or got fired for cause.

- They are not related to the employer.

Strict Eligibility Requirements:

The Congressional Committee that wrote the bill emphasized in its report that the payroll credit will not be allowed if an employer fires an employee to take the credit on someone else they hire. What this means for you as an employer is that the IRS will be keeping close tabs on your hiring and firing practices if you decide to take advantage of the credit.

Employer Must Elect Payroll Credit or Work Opportunity Credit

Under the Act, an employer may not receive the Work Opportunity credit and the payroll credit at the same time. (The Work Opportunity credit allows a credit for employers who hire members of certain targeted groups.) As an employer, you will have to elect which one to take, but you can make this election for each new employee.

Self-Employed, Household Employers Do Not Qualify

The payroll tax holiday is not available for self-employed workers who must pay self-employment taxes, which represent both the employer and employee portion of social security and Medicare taxes. It also is not available for hiring household employees, such as maids or babysitters.

Railroad Retirement Tax

The 2010 HIRE Act includes a railroad retirement tax holiday for employers which is similar to the Social Security tax holiday.

Credit for Retained Workers

The new Act also gives employers an additional credit for employees who stay on the job for a year. The "retention credit" increases an employer's general business credit by \$1000 for each worker the employer keeps on the payroll for at least 52 weeks. A "retained worker" also must receive wages during the last 26 weeks that are at least 80 percent of the wages the employer paid the worker during the first 26 weeks. While the general business credit usually can be carried back and carried forward, the employee retention credit may not be carried back to earlier tax years.

Higher Deduction for Business Property

The 2010 HIRE Act increases for one year the amount a taxpayer may deduct for investments in business property. Under the bill, taxpayers may take an immediate deduction instead of depreciation for up to \$250,000 of the cost of business property. For taxable years beginning in 2010, these limits were going to be reduced to \$125,000, however, the HIRE Act continues the higher limits.

HEALTH CARE TAX PROVISIONS

The 2010 Health Care Act passed by Congress in March is an amazingly complicated piece of legislation. It contains many tax provisions, both in the form of incentives and disincentives for individuals, businesses and insurance companies designed to increase health insurance coverage for U.S. workers. Most parts of the bill are phased in over time or do not take effect at all for several years.

Health Coverage Mandate

It is important to understand the overreaching feature of the law: individuals are required to obtain health insurance coverage for themselves and their dependents after 2013. The law exempts the following persons from this requirement:

- individuals who cannot afford coverage (according to a poverty calculation),
- taxpayers with income below the income tax return filing threshold,
- members of Indian tribes,
- individuals who have short coverage gaps, and
- hardship cases. It also mandates that businesses with more than 50 workers will have to offer health coverage or pay a \$2,000-per-worker penalty if any of their employees have to seek government-subsidized coverage on their own.

To offset the effects of these requirements, the bill offers tax credits for individuals and for businesses to acquire private health insurance. As your tax professional, I have been studying the legislation to determine which provisions will have the most immediate and far-reaching effect on you and my other clients.

As part of my initial assessment, here is a description of some of the key elements of the new Act and how such elements may affect you or your business.

I. Tax Credit for Small Businesses Who Offer Health Insurance Coverage

A new tax credit is available to small businesses that offer health insurance coverage to their employees. The credit is available to employers that pay at least half the cost of single coverage. The maximum credit is 35 percent of premiums paid in 2010 or 25 percent of premiums paid by employers that are tax-exempt organizations. In 2014, the credit increases to 50 percent of premiums paid by small businesses and 35 percent of premiums paid by tax-exempt organizations. If your business qualifies for the credit, you can claim it starting with your 2010 income tax return which will be filed in 2011.

The credit is targeted to small businesses and tax-exempt organizations that primarily employ low and moderate income workers. To qualify, a business must have 25 or fewer full-time employees whose wages average \$50,000 or less per employee per year. The employer also must provide at least one-half of the employee's health insurance coverage amount.

Note: Because the eligibility rules are based in part on the number of full time equivalent employees rather than the actual number of employees, businesses that use part-time help may qualify even if they employ more than 25 workers. The maximum credit goes to smaller employers -- those with 10 or fewer full time equivalents -- paying annual average wages of \$25,000 or less.

The amount of the credit is reduced for employers with more than 10 full-time equivalents and average wages of more than \$25,000 and is **completely phased out** for employers that have more than 25 full-time equivalents or pay average wages of more than \$50,000 per year.

Example: For the 2010 tax year, an employer has the equivalent of 9 full-time employees with average annual wages of \$23,000 per worker. The employer pays \$72,000 in health care premiums for those employees (which must not exceed the average premium for the small group market in the employer's state). This employer's credit for 2010 would equal \$25,200 or 35% x \$72,000 in premiums.

Ineligible Employees

Self-employed persons, including partners and sole proprietors, 2% shareholders of an S corporation, and 5% owners of the employer's company are not treated as employees for purposes of the credit. Unfortunately, sole proprietorships—unincorporated businesses owned by one person or a married couple, cannot take the credit for the owner and the owner's family members who work in the business, although some commentators have taken the position that a spouse-employee who otherwise qualifies would be eligible for the credit. I believe the IRS will have to put out more guidance on this issue, as it is unclear from the legislative language and the IRS news releases.

Coordination with Health Insurance Deduction

Employers now are eligible for a deduction for health insurance premiums paid for their employees. Under the new law, the employer will be able to continue to deduct health insurance expenses which exceed the expenses for which the credit was claimed.

Criticism of its Complexity

A number of Republicans in Congress and several small business groups, such as the National Federation of Independent Business, have criticized the credit as being too complicated. The full time equivalency rules and the average wage calculations are making it difficult for businesses to determine whether they qualify. The credit also drops off sharply once a company gets above 10 workers and \$25,000 in average annual wages, so slightly larger business actually may receive a very limited credit. Finally, the credit is not refundable. It is limited to an employer's federal income tax liability. Therefore, if a small business is losing money due to the economy, it might not be able to use the credit even if the business otherwise qualifies. Congress may have to make some adjustments in the credit to answer these concerns. In the meantime, the IRS has undertaken a media campaign to acquaint small businesses with the existence of this credit, as explained below.

Your Eligibility for the Credit

The IRS has mailed postcards to more than four million small businesses and tax-exempt organizations to make them aware of the new health care tax credit, so you may hear from the tax collector on this issue.

In addition, I am studying the IRS and Congressional information on the credit, and I will be prepared to evaluate your situation if you incur health insurance costs for your employees, and you believe you are within the employee and wage limits.

II. Tax Credit for Individuals to Buy Health Insurance

The 2010 Health Care Act provides a new refundable tax credit to qualifying taxpayers who buy their own health insurance through one of the new Health Care Exchanges to be put in place after 2013. This new credit is called the "premium assistance credit." The credit will be refundable—you can get it even if you have no tax liability—and will be payable in advance directly to the health insurance provider.

The problem with this credit is that most taxpayers cannot qualify for it unless they have relatively low income. To qualify, a taxpayer must have household income of at least 100% but not more than 400% of the federal poverty line and must not be eligible for Medicaid, employer-sponsored insurance, or other acceptable coverage. The current federal poverty line for a family of four is \$22,050 (slightly higher for Alaska and Hawaii).

Amount of the Credit

The credit will be based on a sliding scale for individuals and families with household incomes between 100% and 400% of the Federal Poverty Line. The Secretary of Health and Human Services will determine the credit amount based on the percentage of a taxpayer's income needed to pay health insurance premiums.

As the availability of the credit gets closer, the government will be releasing more information to assist taxpayers and their representatives in calculating the available credit.

III. Health Benefits Coverage for Adult Children

If you have adult children who need to participate in a group health insurance plan, you now may be able to cover them under your employer's plan. Health insurance coverage for an employee's children under 27 years of age is tax-free to the employee, effective March 30, 2010. The Health Care Act requires group health plans and health insurance issuers that now provide dependent coverage of children to continue to make coverage available for an adult child up until age 26.

If you participate in an employer cafeteria plan, your employer can allow you to immediately make pre-tax salary contributions to provide coverage for children under age 27. (Cafeteria plans allow employees to choose from a menu of tax-free fringe benefit options.) **Note:** There is no requirement for a health insurer to provide coverage for anyone, including dependents, but if the employer offers a plan for dependent children, the coverage must continue until the child turns 26.

Employees who have children who will not have reached age 27 by the end of the year are eligible for a tax exclusion of the amount the employer pays for the adult child's coverage. This exclusion is available from March 30, 2010 forward, if the child is already covered under the plan or is added to the plan at any time during 2010. Eligible children

include a son, daughter, stepchild, adopted child or foster child. Also, self-employed persons may take a deduction for the health insurance costs of their adult children up to age 27.

IV. Excise Tax on High-Value Health Plans

This provision is not a tax on individuals, but is a tax on health insurers who provide high-cost health plans (called "Cadillac plans" in the media). There is so much press on this issue, that I have included a basic description. The tax will be 40% of the cost of a health plan which exceeds \$27,500 for a family and \$10,200 for an individual. It takes effect in 2018.

V. Increased Businesses Reporting Provisions

To help pay for the Health Care Act, a non-health-related tax reporting provision was included in the final legislation requiring businesses to report payments of \$600 or more to other businesses for property or services. With the ink barely dry on the new Act, a House Republican joined by the National Federation of Independent Business (NFIB) is calling for repeal of business-to-business reporting provision. The provision, which is scheduled to take effect in 2012, is estimated to raise \$17.1 billion. Given the large revenue number associated with this provision, it is unlikely that the opponents of the reporting requirement will have much success in the short term in getting it repealed. However, this change could have a very broad-reaching effect on small businesses across the country. Under the provision, any business that pays another business more than \$600 a year in gross proceeds for goods or services must file a 1099 Form with

the IRS for the payment. Reacting to recent criticism, the IRS Commissioner, Douglas Schulman, has assured businesses that they will not have to report credit or debit card payments because these transactions already will be reported to the IRS under new rules for credit card processors. Still, businesses will have to report all other payments over \$600 made to another business.

Outlook

As more companies become aware of the business-to-business reporting provision, the opposition may grow and force Congress to retreat by raising the threshold or otherwise exempting smaller companies. The paperwork burden for small businesses IRS will relax this rule for smaller companies before it takes effect in 2012.

VI. Increased Medicare Tax on Individuals and Investment Income

Another revenue raiser in the Health Care Act is an increased Medicare tax on higher income individuals of .09% and a Medicare tax of 3.8% on the net investment income of higher-income taxpayers. The Act increases the employee portion of the Medicare Hospital Insurance Tax by an additional .09% on wages received over the threshold amount of \$250,000 for a joint return or surviving spouse, \$125,000 for a married individual filing a separate return, and \$200,000 for all other taxpayers. This additional tax also applies to the Medicare portion of self-employment taxes.

The Medicare tax on investment income is a significant change from current law. Under current law, the Medicare tax is only imposed on wage or compensation income.

For the first time under this bill, the Medicare tax will be imposed on investment income—which is income from interest, dividends, annuities, royalties, rents, and capital gains. The tax begins in 2013 and is imposed on net investment income if a taxpayer's income exceeds the threshold amount of \$250,000 in adjusted gross income for a joint return or surviving spouse, \$125,000 for a married individual filing a separate return, and \$200,000 for all other taxpayers.

NEW PROCEDURES FOR TAXPAYERS' CHANGE OF ADDRESS

The IRS recently has updated its rules on how taxpayers must change their address in IRS records. The new procedures are effective June 1, 2010. The IRS uses the taxpayer's address on the most recently filed tax return for all notices, correspondence and refunds, which are required to go to the taxpayer's "last known address." **Note:** The designation of a taxpayer's "last known address" is important because IRS correspondence to a taxpayer's "last known address" is legally effective even if the taxpayer never receives it.

For this reason, it is important that the IRS have your most up-to-date address on file. The IRS will automatically update your address if you provide an official change of address to the U.S. Postal Service. Otherwise, any change of address with the IRS must be in a very specific form. If your address changes, please notify me promptly, especially if you expect any communications from the IRS. I will promptly make the necessary changes in your address of record with the IRS.

STORM VICTIMS IN MANY STATES QUALIFY FOR IRS DISASTER RELIEF

The IRS can barely keep up with all of the areas being designated federal disaster areas due to recent storms, floods, and other natural disasters. Taxpayers in the following states have recently been given tax relief by the IRS: Alabama, Connecticut, Kentucky, Massachusetts, Mississippi, North Dakota, New Jersey, Oklahoma, Rhode Island, Tennessee, and West Virginia. The relief comes in the form of relaxed filing and payment deadlines for taxpayers who live in disaster areas or who operate a business in a disaster zone. The IRS's computer systems automatically identify taxpayers located in the covered disaster area and apply automatic filing and payment relief. If you live in or have a business in an area located outside of the immediate disaster area, you may still be eligible for tax relief. I will be glad to contact the IRS on your behalf to see if you qualify.

PAYROLL AUDIT PROGRAM LAUNCHED BY IRS

The IRS has begun an extensive payroll audit program targeting fringe benefits, worker classification and other payroll tax issues. The audits are to begin in June 2010 and will cover 2008 payroll returns. The IRS suspects that \$15 billion in unpaid taxes is due to employment and payroll related issues. Beginning in March, the IRS sent out notices to 2,000 companies notifying them of the audits. Next year, 2,000 more payroll companies will be chosen for audits and another 2,000 in year three. The bulk of these audits will be of small businesses and self-employed taxpayers.

Those taxpayers selected for audit will be audited for all four quarters of 2008.

The IRS expects to complete the audits within 6-8 months although some may take longer. The IRS says the audits were selected at random, and it did not target any particular industry. The primary focus of the audits will be on determining if some 30 types of fringe benefits are being handled properly. The second main focus will be on determining whether employers are properly classifying their workers as employees vs. independent contractors. The IRS also will be looking at the tip reporting of service employees such as restaurant workers. Finally, the IRS will be scrutinizing the compensation of company officers and managers.

Observation: The results of the payroll audits will affect every business because the IRS will use the information it uncovers in these audits to develop payroll audit strategies for all businesses.

TWO COURT CASES EXPOSE INCOME REPORTING MYTHS

Two recent court cases show how taxpayers can get caught up in filing and income myths if they ignore tax rules or they do not seek advice on their income tax liability.

Keep Adequate Records and Save Receipts for Ebay Auctions

In the first case, Orellana v. Commissioner, an IRS Revenue Agent was trading on Ebay, with approximately 1200 transactions over a two-year period. She did not include any income or expenses from this activity on her Federal tax filing. The IRS determined that she had unreported income in excess of \$32,000.

The taxpayer argued that many of the items sold were her own personal property that she paid considerably more for than the amount she received when the items were sold. She explained that she liked designer clothes for which she would pay over \$350 but might get only \$50 when sold. However, she never kept her original purchase receipts. The Court ruled in the IRS's favor, noting that the burden was on the taxpayer to produce the receipts and prove that the original cost of the items exceeded the amount of income from the sales. The Court had little sympathy for the taxpayer's arguments, given that she was an IRS Officer. The lesson in this case is that the taxpayer did not keep adequate records; consequently, she lost the case.

Held Check Included in Income

In the second case, Morgan v. Commissioner, the taxpayer held a check he received for work performed as a subcontractor for a consulting company. He received it in December 2006 but did not cash it until 2007 and did not report the \$16,989 on his 2006 income tax return. The IRS issued a notice of deficiency. The taxpayer argued that he had an agreement with the owner of the company that paid him that he would not cash the check until 2007. However, the company reported the full amount to the IRS on a Form 1099-MISC in 2006. It has long been settled that when a taxpayer is using a cash basis for accounting, a check received is considered income upon receipt because it is considered the equivalent of cash. The taxpayer did not present any evidence that there had been an agreement not to cash the check other than his own testimony.

Therefore, the holding of the check did not shift the income into 2007. It should have been reported in 2006, which the check was received. The Court found for the IRS.

SPECIAL RULES FOR FARM INCOME AND DEDUCTIONS

If you are in the farming business, there are a number of special tax provisions which apply to you. Here is a list of farm tax issues which I can help you with.

1. **Crop Insurance Proceeds.** Crop insurance proceeds are income and must be reported on a farmer's return. Farmers receive these payments as a result of crop damage.
2. **Sales Caused by Weather-Related Conditions.** If a farmer sells more livestock and poultry than he normally would in a year because of weather-related conditions, the farmer may be able to elect to postpone reporting the gain until the next year.
3. **Farm Income Averaging.** Farmers can average their current year's farm income by allocating it over the three prior years.
4. **Deductible Farm Expenses.** The ordinary and necessary costs of operating a farm for profit are deductible business expenses. The expenses must be of the types that are common and accepted in the farming business.
5. **Employees and Hired Help.** Farmers who employ farm workers can deduct their wages. This includes full-time employees as well as part-time workers.

6. Items Purchased for Resale.

Farmers may be able to deduct the cost of livestock and other items purchased for resale in the year of sale. This cost includes freight charges for transporting the livestock to the farm.

7. **Net Operating Losses.** Farmers may generate a net operating loss that is usable in other tax years if their deductible expenses from operating a farm are more than their income for the year. These net operating losses may be carried over to other years and deducted. If the loss is carried back, the farmer may be entitled to a refund of tax paid in past years.

8. **Repayment of loans.** Farmers can deduct the interest on loans used for their farming business.

9. **Fuel and Road Use.** Farmers are eligible for a special credit or refund of federal excise taxes on fuel used on a farm for farming purposes. The IRS carefully scrutinizes the use of the fuel credit because of problems with ineligible taxpayers trying to claim it. Therefore, it is important that you keep records of your fuel use so you can prove the fuel was used for the farming business.

FILING PENALTIES REMINDER

If you do not file on time, do not pay on time, or pay too little, you could face a confusing array of penalties. Here's a list of the most common penalties taxpayers may face for not complying with tax filing requirements. You can avoid these penalties by working with me to file your taxes in a timely and complete manner.

PENALTIES

1. If you do not pay your tax by the due date of your tax return, you could face a failure-to-pay penalty.
2. The failure-to-file penalty is generally more than the failure-to-pay penalty. So if you cannot pay all the taxes you owe, it is better to simply file your tax return and then explore other payment options.
3. The penalty for filing late is usually 5 percent of the unpaid taxes for each month or part of a month that a return is late. This penalty will not exceed 25 percent of your unpaid taxes.
4. If your return is filed more than 60 days after the due date or the extended due date, the **minimum penalty** is the smaller of \$135 or 100 percent of the unpaid tax.
5. You will have to pay a failure-to-pay penalty of $\frac{1}{2}$ of 1 percent of your unpaid taxes for each month or part of a month after the due date that the taxes are not paid. This penalty can be as much as 25 percent of your unpaid taxes.
6. If you filed an extension and you paid at least 90 percent of your actual tax liability by the due date, you will not be faced with a failure-to-pay penalty if the remaining balance is paid by the extended due date.
7. If both the failure-to-file penalty and the failure-to-pay penalty apply in any month, the 5 percent failure-to-file penalty is reduced by the failure-to-pay penalty. However, if you file your return more than 60 days after the due date or the extended due date, the **minimum penalty** is the smaller of \$135 or 100% of the unpaid tax.

8. You will not have to pay a failure-to-file or failure-to-pay penalty if you can show that you failed to file or pay on time because of **reasonable cause** and not because of willful neglect. Reasonable cause includes such things as getting incorrect information from the IRS or having a death or serious illness in your family. You also may qualify for payment extensions due to **financial hardship**.

NEW MORTGAGE DEBT FORGIVENESS RULES

Under a special rule enacted by Congress in 2007, you may be able to exclude income resulting from the forgiveness of a mortgage debt during tax years 2007 through 2012. Normally, if your mortgage company forgives any amount of your debt, the amount forgiven would result in taxable income to you. However, up until 2012, taxpayers can exclude up to \$2 million of debt forgiven on their principal residence. The limit is \$1 million for a married person filing a separate return.

The rule applies both to debt reduced through mortgage restructuring, as well as debt forgiven in a foreclosure. To qualify, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and the loan has to be secured by the residence. Refinanced debt used for the purpose of substantially improving the taxpayer's principal residence also qualifies for the exclusion. Refinanced debt used for other purposes, such as to pay off credit cards, does not qualify for the exclusion.

When a debt is forgiven, lenders send taxpayers a year-end statement, Form 1099-C, Cancellation of Debt, showing the amount of debt forgiven and the fair market value of any property foreclosed. If you have lost your home or sold your home for less than its value and you receive one of these Forms, please contact me immediately so I can help you take advantage of this special taxpayer relief provision.

IRS BOOSTS OVERSIGHT OF TAX RETURN PREPARERS

You may have heard recently that the IRS has undertaken a major initiative to regulate all tax return preparers. Not only is the IRS conducting field visits to tax return businesses, but they also are sending out agents posing as taxpayers. The undercover visits were designed to catch "unscrupulous preparers" from filing inaccurate returns.

The IRS also is requiring that all tax preparers register with the IRS in a central database and put their registration number on all tax returns or claims for refunds that they prepare. Tax preparers who prepare returns for a fee must sign the tax return and must put their number on the return. One problem is that the registration requirement will not catch preparers who do not sign the returns. Only taxpayers can stop preparers from preparing returns and then giving them to taxpayers to file without the preparer's signature.

What This Means for You

As your tax professional, I want to assure you that I support the efforts to improve the competency of the profession. I already sign all returns, and I have an IRS registration number. As part of a professional organization, the National Society of Tax Professionals, I abide by a rigorous Code of Ethics, and I regularly take professional continuing education courses to keep up with all tax developments so I can serve you to the best of my ability.

Thank You for Your Business

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. I will be happy to address any concerns and answer questions you have about any of the issues covered in this newsletter.

I hope your summer is filled with fun and excitement.

Best regards,

