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2011

INCOME TAX DEVELOPMENTS

UPDATED NOVEMBER 10, 2011

2011 NEW DEVELOPMENTS LETTER

INTRODUCTION

Over the past 18 months, Congress has been passing tax legislation at a frantic pace. The primary "tax" themes underlying this legislation are Congressional attempts to provide temporary tax relief for both *businesses* and *individuals* and to spur a struggling economy by encouraging businesses to make *capital investments*. Examples of these tax relief provisions for ***Individuals*** *include:* extending all existing income tax rates for two years (through 2012); providing temporary estate and gift tax relief through 2012; extending a long list of tax breaks that would have otherwise expired; a *"2011 only"* Social Security tax cut of two percentage points; and an increased refundable adoption credit. ***Businesses*** also received their share of tax relief and incentives, *including:* a temporary increase from 50% to 100% for the §168(k) first-year bonus depreciation deduction; a temporary increase and expansion of the §179 deduction for business equipment, etc.; a 100% gain exclusion for "qualified small business stock;" and, relaxation of the S corporation built-in gains tax rules. **In addition,** the IRS and the Courts have been busy issuing rulings and cases that impact both businesses and individuals.

Keeping up with these rapidly changing tax provisions is extremely challenging. To help you with that task, we are sending this letter that provides a summary of the key legislative, administrative, and judicial tax developments that we believe will have the greatest impact on our clients.

> **Caution!** We highlight only *selected* tax developments. If you have heard about other tax developments not discussed in this letter, and you need more information, please call our office for details.
>
> **Planning Alert!** This letter also contains planning ideas. However, you cannot properly evaluate a particular planning strategy without calculating your overall tax liability (**including** the *alternative minimum tax*) with and without the strategy. You should also consider any state income tax consequences of a particular planning strategy. We recommend you call our firm before implementing any tax planning technique discussed in this letter, or if you need more information.

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DEVELOPMENTS IMPACTING PRIMARILY INDIVIDUALS

RECENT TAX LEGISLATION

Since March of 2010, Congress has enacted five tax bills which include the: ***HIRE Act*** (signed March 18, 2010), ***Health Care Act*** (signed March 30, 2010); ***Jobs Act of 2010*** (signed September 27, 2010); ***Tax Relief Act of 2010*** (signed December 17, 2010); and ***Comprehensive 1099 Taxpayer Protection Act*** (signed April 14, 2011). Collectively, this legislation provides a host of tax relief for both "individuals" and "businesses." However, many of these tax breaks are temporary and are scheduled to ***expire*** after ***2011,*** or ***2012.*** In this segment, we are highlighting the most significant tax relief for "individual" taxpayers, provided by the above tax bills, emphasizing the provisions that are expiring after 2011 or after 2012.

Existing Income Tax Rates Scheduled To Continue Through 2012. Over the past several months, President Obama has proposed several tax increases on higher-income taxpayers as part of his deficit reduction proposals. Due to the political uncertainty of these proposals, it is impossible to predict with any certainty what the tax rates may be after 2012. However, the existing individual income tax rates for all income levels are currently scheduled to remain in place ***through 2012.*** Consequently, the current 10% through 35% tax brackets for ordinary income, and the maximum 15% tax rate for long-term capital gains and qualified dividends (zero percent if the dividends or capital gains would otherwise fall in the 10% or 15% tax brackets) **continue through 2012.** **Caution!** Starting ***in 2013,*** absent Congressional action, the top individual income tax rates will generally increase to: **1)** 39.6% for ordinary income; **2)** 39.6% for qualified dividends; and **3)** 20% for long-term capital gains.

> **Planning Alert!** Starting ***in 2013,*** the *Health Care Act* imposes a new Medicare Surtax of 3.8% on the *investment income* (e.g., interest, dividends, capital gains) of higher-income individuals, and a Medicare Surtax of .9% on the *earned income* (e.g., W-2 income, self-employment income) of higher-income individuals.

- **No Personal Exemption Or Itemized Deduction Phase-Out Through 2012.** For the past two decades, higher-income individuals have been subject to phase-out provisions that reduced their *personal exemptions* and *itemized deductions* as their income exceeded certain amounts. These phase-outs are **eliminated** for **2010, 2011,** and **2012.**

  > **Planning Alert!** Starting ***in 2013,*** these personal exemption and itemized deductions phase-out rules will automatically re-appear, potentially causing the highest "effective" income tax rate for many higher-income individuals to be above the scheduled rate of 39.6% on ordinary income.

- **Marriage Penalty Relief Extended.** Several tax provisions were enacted back in 2001 to reduce the so-called "marriage penalty" (i.e., provisions in the tax law causing married individuals filing jointly to pay more tax than if they were single filing separate returns). These relief provisions were originally scheduled to expire after 2010. However, these *marriage penalty relief* provisions (e.g., an enhanced standard deduction and larger 10% and 15% brackets for married taxpayers filing jointly) were extended ***through 2012.*** Absent future Congressional action, this marriage penalty relief will expire **after 2012.**

"Individual" Tax Breaks Scheduled To Expire. A host of other current tax breaks for individual taxpayers are scheduled to expire unless Congress takes action to extend these provisions. The expiration date for some of the more popular tax breaks are as follows:

- ***Selected*** **"Individual" Tax Breaks Expiring After 2011: 1)** school teachers' deduction (up to $250) for certain school supplies; **2)** election to deduct state and local sales tax; **3)** deduction (up to $4,000) for qualified higher education expenses; **4)** expanded deduction and carryover limits for charitable contributions of "conservation easements"; **5)** deduction for home mortgage "insurance premiums"; **6)** "District of Columbia" first-time homebuyer's credit; **7)** tax-free transfers from IRAs to charities for those at least age 70½; **8)** 2% OASDI tax holiday; **9)** "refundable" adoption credit; and **10)** credit for energy-efficient improvements to your principal residence.

  Planning Alert! The maximum credit was $1,500 cumulative for 2009 and 2010, but dropped to a maximum life-time credit of $500 for installations during 2011.

- **Alternative Minimum Tax "Patch" Expires After 2011.** For the past several years, Congress has enacted a series of temporary increases in the alternative minimum tax (AMT) exemption amounts to ensure that most lower and middle income taxpayers were not subject to the AMT. The current increased AMT exemption amounts ***expire after 2011.*** Also, the non-refundable personal income tax credits will not offset the AMT ***after 2011.***

- ***Selected*** **"Individual" Tax Breaks Expiring After 2012: 1)** enhanced rules for Coverdell education savings accounts; **2)** enhanced student loan interest deduction; **3)** enhanced earned income tax credit; **4)** expanded and enhanced $1,000 child credit; **5)** expanded child and dependent care credit; **6)** expanded and enhanced American Opportunity Tax credit (formerly the "Hope" credit); **7)** expanded rules for tax-free treatment of scholarships under the NHSC Scholarship Program and the Armed Forces Scholarship Program; **and 8)** tax-free employer-provided educational assistance up to $5,250 per year.

  Planning Alert! Although Congress has traditionally extended a majority of expiring tax breaks in the past, there is no guarantee that it will do so in the future.

Estate And Gift Tax Relief Through 2012. Over the years, the estate tax has generally been imposed only on estates exceeding certain dollar amounts ("exclusion amounts"). In 2001, Congress increased the estate tax *exclusion amount* in stages and, by 2009, the estate tax applied only to taxable estates in excess of $3.5 million. The 2001 Act also repealed the estate tax for *"2010 only."* The *Tax Relief Act* reinstated the estate tax ***retroactive to January 1, 2010.*** For ***2010 through 2012,*** the Act increased the estate tax exclusion amount to $5 million ($5,120,000 for 2012). This legislation also reduced the tax rate on the amount of the estate in excess of $5 million to 35% (down from 55%).

> **Caution!** For individuals dying ***after 2012,*** the *exclusion amount* is scheduled to revert to ***$1 million,*** and the top rate is scheduled to go back up to ***55%.***

- **Election To "Opt Out" Of The Estate Tax For *2010 Only*.** For ***individuals dying in 2010,*** the new law allows an executor the option to use the rules in effect prior to the reinstatement of the estate tax (i.e., the **"no estate tax"** rules), or the ***new* rules** (i.e., **a "$5 million exclusion amount"**). Although this option to use the *"no estate tax"* rules for ***2010 only,*** could save *"estate"* taxes for larger estates (e.g., those over $5 million), it could have a negative *"income"* tax impact on the beneficiaries who receive appreciated property from the estate. This is because an individual who inherits an asset from an estate that elects out of the estate tax, *generally* acquires a basis for income tax purposes equal to the *lesser of* the decedent's basis or the *value* of the asset on the date of the decedent's death (commonly referred to as a ***"modified carryover basis"***). However, under the *modified carryover basis* rule, there is a limited amount of basis increase for certain appreciated properties (e.g., generally up to a $1.3 million increase with an additional $3 million for assets passing to the surviving spouse). **By contrast,** if the executor does not elect out of the estate tax for 2010, heirs of the estate will generally acquire an income tax basis equal to the asset's value on the decedent's date of death (even if this value exceeds the decedent's tax basis). In other words, there is no $1.3 million or $3 million limit on the basis increase to the heirs, if the executor does not elect out of the estate tax. Thus, if an estate with appreciated assets makes the *"no estate tax"* election for 2010, beneficiaries who later sell appreciated property they inherited from the estate might have a lower basis in the property and, therefore, a larger gain on the sale.

  > **Tax Tip.** For most estates of decedents **dying in 2010** that are valued at **$5 million or less,** using the *"new rules"* (i.e., $5 million exclusion amount) will probably be preferable to the "no estate tax" election since: **1)** there will be no estate tax, **2)** no Federal estate tax return is required to be filed *for 2010*, and **3)** the heirs of the estate will generally have a basis in appreciated assets received from the estate equal to the fair market value of the assets at the date of the decedent's death. Estates choosing to use the "new rules" (i.e., the $5,000,000 exclusion) **do not have** to make an **"election."** The new estate tax rules **apply automatically** unless the executor affirmatively elects out of the estate tax for 2010 by timely filing a Form 8939.

Planning Alert! Most 2010 estates valued at more than $5 million will probably decide to make the "no estate tax" election in order to avoid having to pay any estate tax. However, for some estates in excess of $5 million with highly-appreciated assets, it may be preferable not to make the *"no estate tax"* election and pay some estate tax (i.e., 35% rate on estate's value exceeding $5 million). This may be the case where the estate tax is small compared to the income tax savings resulting from the additional "step up" in basis of the appreciated assets received by the heirs.

Caution! For estates of individuals who died in 2010 that exceed $5 million, determining whether to make the *"no estate tax"* election may involve complex calculations. Please call our office as soon as possible if you need assistance in making this decision. The deadline for making this election is ***January 17, 2012*** (as discussed in more detail in the next segment).

- **Elections And Due Dates.** For estates of ***decedents dying in 2010,*** the IRS has recently announced the due dates **1)** for making the ***"no estate tax"*** election (which also requires the use of the *modified carryover basis* rules), and **2)** for filing an estate tax return (if required) where the election is not made. The ***"no estate tax"*** election is made on ***Form 8939,*** and is due no later than ***January 17, 2012.*** If the estate makes this election, it will ***not*** be required to file a federal estate tax return (i.e., Form 706), because the election exempts the estate from any federal estate tax. If the estate does not wish to "elect out" of the estate tax for 2010, no election of any sort is required. Instead, the estate will "automatically" be subject to the retroactive estate tax rules and will *generally* be required to file a federal estate return (Form 706) *only if* the estate has a value ***exceeding $5 million.*** If a Form 706 is required to be filed, the filing deadlines are as follows: **1)** if the decedent died ***after 2009*** and ***before December 17, 2010,*** the due date was ***September 19, 2011*** (unless the estate timely requested an automatic 6-month extension allowing it to file and pay taxes by ***March 19, 2012***); and **2)** if the decedent died ***after December 16, 2010*** and ***before 2011,*** the due date is 9 months after the date of death (unless the estate timely requested an automatic 6-month extension for filing Form 706 and paying taxes).

- **Unused $5 Million Exclusion Amount Of First Spouse To Die Available To Surviving Spouse.** Historically, *each* spouse's estate has been entitled to a full estate tax *exclusion amount* (e.g., $3.5 million for 2009 and $5 million for 2010 through 2012). However, technical estate tax planning structures and strategies (e.g. credit shelter trusts) were often necessary to ensure that the estate tax *exclusion amount* of the first spouse to die was not partially or completely wasted. For **individuals dying in 2011 or 2012,** the personal representative of a deceased spouse's estate may **"elect"** for any of the $5 million exclusion amount not used by the estate of the first spouse to die to be available to the surviving spouse. Thus, under this new "portability" feature, a surviving spouse could actually end up with an exclusion amount of up to $10 million (i.e., where the first spouse to die had no assets).

Tax Tip. Unless this *portability* feature is extended by Congress, it will ***only*** be available to be used by a surviving spouse's estate where the surviving spouse passes away ***before 2013,*** or for gifts made by the surviving spouse before 2013.

Planning Pointer! Traditional estate planning, including the use of credit shelter trusts, should not be neglected! In addition to potential estate tax savings, use of a will and traditional estate planning techniques are often necessary to accomplish a decedent's wishes. In addition, credit shelter trusts continue to be an important estate planning tool: **1)** because the portability provision is currently scheduled to apply only for individuals dying in 2011 and 2012, **2)** to keep post-death appreciation of assets in the deceased spouse's estate from increasing the size of the surviving spouse's estate, **and 3)** to accomplish non-tax goals and desires of the decedent.

Planning Alert! The unused exclusion amount of the first spouse to die may be used to reduce the taxable estate or taxable gifts of the surviving spouse ***only if*** the deceased spouse's estate timely files an estate tax return using Form 706 (even if the estate tax return is not otherwise required).

- **Filing Form 706.** For decedents who pass away in ***2011 or 2012,*** the estate is generally not *required* to file an estate tax return (Form 706) unless the value of the estate exceeds $5,000,000 ($5,120,000 for 2012). However, if a spouse dies in 2011 or 2012, the personal representative must complete and *timely* file an estate tax return (even if the value of the estate is not more than $5 million) in order for the deceased spouse's unused *$5 million exclusion amount* to be available to the surviving spouse. An estate tax return is due 9 months after the date of death (unless the personal representative timely requests a 6-month extension). Consequently, for many spouses who pass away in **2011 or 2012** and who do not have a large enough taxable estate to fully utilize the $5 million exclusion amount, it may be advisable to *timely* file a Form 706 in order to preserve the unused exclusion amount for the surviving spouse. In most cases, it would be advisable for the personal representative to obtain an automatic 6-month extension for filing the Form 706, providing extra time to evaluate whether filing a Form 706 would be warranted.

  Caution! Even if the surviving spouse does not expect to use the unused exclusion amount of the deceased spouse for gifts before 2013 and is expected to live beyond 2012, Congress may extend this provision. Therefore, executors of estates of individuals dying in 2011 or 2012 should strongly consider filing a Form 706 to make the election where there is a surviving spouse. For example, an unused exclusion amount of $1,000,000 could possibly save the surviving spouse $350,000.

  - **Gift Tax.** For ***2011*** and ***2012,*** there is a single, unified, lifetime "estate" and "gift" tax *exclusion amount* of $5,000,000 ($5,120,000 for 2012). The gift tax rate for 2011 and 2012 on amounts in excess of the exclusion amount is 35%. This exclusion amount may be used to reduce otherwise taxable gifts during life and any unused amount may be used to reduce estate tax at death.

Planning Alert! After ***2012,*** the *exclusion amount* is currently scheduled to revert to $1 million, and the top gift tax rate is scheduled to increase to 55%.

Tax Tip. Any unused $5 million exclusion amount that passes from a spouse dying in 2011 or 2012 to the surviving spouse (as discussed above), may be used by the surviving spouse to reduce other wise taxable gifts made before 2013. Any amount not used to offset pre-2013 gifts, may be used in the surviving spouse's estate if the surviving spouse dies before 2013.

Two Percent Social Security Tax Holiday For "2011 Only." For **2011 only,** there is *a **2%*** reduction in Social Security taxes for both employees and self-employed individuals. Therefore, **if you are an employee,** your take-home pay for 2011 is generally being increased by 2% of each dollar of compensation that you earn. However, since Social Security taxes apply only to the first $106,800 of compensation in 2011, your maximum savings will generally be $2,136 (i.e., $106,800 x 2%). Likewise, if you are self-employed, your Social Security taxes are reduced by 2% of your self-employment income for 2011 (up to $106,800). Therefore, if your self-employment income is $106,800 or more, your self-employment taxes will be reduced by $2,136.

Tax Tip. This temporary Social Security tax reduction will not impact your future Social Security benefits.

Adoption Credit Increased And Made Refundable For 2010 And 2011. For tax years beginning in 2010 and 2011, two significant changes were made to the adoption credit: **1)** the maximum adoption tax credit was **increased to $13,360 (for 2011) per child,** and **2)** the credit became *"refundable"* (this generally means that, to the extent the credit exceeds your income taxes before the credit, the IRS will send you a check for the excess). **For 2011,** the adoption credit is phased-out as your modified adjusted gross income increases from **$185,210 to $225,210** (whether you're married filing a joint return, or single).

Tax Tip. Generally, for *"domestic"* adoptions, you are allowed the adoption credit in the tax year *following the year* the qualifying adoption expense is "paid." However, the credit is allowed for adoption expenses paid in the same tax year that the adoption is finalized. Therefore, qualified expenses for a "domestic" adoption paid **during 2011** will generally result in a credit **in 2012** (when the credit is no longer refundable). However, if you can *finalize* the adoption on or before **December 31, 2011,** your **2011 expenses** will qualify for the credit **in 2011** and the credit will be refundable if you have insufficient tax to utilize the credit.

Tax Alert! For 2012, the adoption credit is scheduled to be **reduced to $12,650** and **will not be refundable.**

Foreign Adoptions. Expenses incurred in attempting to adopt a child who is not a citizen or resident of the United States, do not qualify for the adoption credit unless and until the adoption is actually *finalized*. Consequently, if you are currently pursuing the adoption of a foreign child, you will be entitled to the adoption credit for 2011 ***only if*** you finalize the adoption *by* the ***end of 2011.***

Tax-Free Medical Benefits Extended To Children Under Age 27. Effective March 30, 2010, an employer-provided health plan may provide tax-free reimbursements to an employee's child **who is under age 27** *at the end of the tax year*. This exclusion applies even if the employee cannot claim the child as a dependent for tax purposes. Previously, an employer could only reimburse "tax free" the medical expenses of
an employee, the employee's spouse and the employee's "dependents."

In addition, if you are self-employed, you may take an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions") for health insurance premiums that you pay for your child who is **under age 27** at the **end of the year,** even if the child is not your "dependent" for tax purposes.

RECENT NON-LEGISLATIVE TAX DEVELOPMENTS (COURT CASES & RULINGS)

In 2011, the IRS and the Courts have been busy issuing rulings and decisions that will affect many taxpayers. The following highlights *some of the more important* developments impacting individual taxpayers:

IRS Says Employee-Use Of Employer-Provided Cell Phone Can Be Tax-Free Fringe Benefit If Provided Primarily For Noncompensatory Business Reasons.

If your employer provides you with a cell phone or similar communication device (e.g., PDA, Blackberry), the IRS has recently announced that this will be deemed a *tax-free* fringe benefit so long as the phone is provided "*primarily for non-compensatory business reasons*." This generally means that if you are provided the phone because your employer needs to be able to contact you at all times for work-related matters, your employer needs you to be available to speak with clients while you are away from the office, or you need to speak with clients in other time zones at times outside your normal work day, your phone will not be treated as taxable compensation to you. The IRS also announced that your employer may reimburse you for work-related use of your personally-owned cell phone, provided your employer requires you to use your personal phone for business purposes and the reimbursement is only for reasonable cell phone coverage.

> **Planning Alert!** The IRS warns that your employer-provided phone (or your employer's reimbursements for your personally-owned phone) will be taxable if the arrangement is a substitute for compensation or there is no substantial business reason for you to have the cell phone. **For example,** if an employer provides you the phone primarily to promote goodwill among employees, or as a perk to attract employees, IRS says that this will constitute taxable compensation.

Tax Court Says A Consultant May Not Deduct Contributions To SEP If Determined To Be A "Common Law" Employee.

Generally, if you are a sole proprietor or independent contractor, you can establish a qualified retirement plan (e.g., 401(k), SIMPLE Plan, SEP) and make deductible contributions. By contrast, if you are an "employee" and do not have another business, generally you may participate in your employer's retirement plan, but you are not allowed to establish a separate 401(k) plan, SIMPLE Plan, or SEP for yourself. In a recent Tax Court case, an outside consultant was providing services primarily to one client that classified him as an "independent contractor" for tax reporting purposes. Consistent with that treatment, the consultant established a SEP to which he made deductible contributions. After an IRS audit, the IRS asserted that the consultant was really a "common law" employee of the client. The Court ultimately agreed with the IRS, and disallowed any deduction for the consultant's contributions to his SEP, and also imposed an "excess contribution" excise tax on the contributions.

Planning Alert! Determining whether a worker is an independent contractor or common law employee for tax purposes is a gray area, and is generally a case-by-case determination. The IRS has recently advised its field agents to pay special attention to the "independent contractor" classification of professional "consultants" particularly former executives who are now providing similar services to their former employer as an independent contractor.

Caution! If you are receiving income as an "independent contractor," we should carefully analyze your classification before you establish a retirement plan for your business. This case illustrates that setting up a plan could be costly if you are later determined to be an employee and not an independent contractor.

District Court Decision Emphasizes Importance Of Reviewing Spousal Rights Under 401(k) Plans.

Many employer-sponsored retirement plans (e.g., a 401(k) plan) provide that if a participant dies, his or her plan balance must go to the surviving spouse unless the surviving spouse expressly waives survivorship rights to the plan account. In a recent case, a participant in a 401(k) plan named his three adult children as the beneficiaries of his 401(k) account after his first wife's death. He later remarried and died 6 weeks after the wedding. Even though his children were expressly named as beneficiaries, the Court concluded that his 401(k) balance must go to his second spouse because she *had not waived* her spousal rights to the survivor benefit.

Planning Alert! The participant could have avoided this problem by having his new spouse waive her spousal rights in the plan after he remarried, if she were willing to do so.

IRS Says That Self-Employed Individuals May Be Entitled To An "Above-The-Line" Deduction For Medicare Premiums.

Generally, if you are self-employed, a partner in a partnership, or a more than 2% shareholder of an S corporation, you may qualify for an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions") for health insurance premiums you pay for yourself, your spouse, your dependents or your children who have not reached age 27 by the end of the tax year (even if a child is not your dependent). Until recently, there had been some confusion as to whether Medicare premiums paid by a self-employed individual, a partner in a partnership, or a more than 2% shareholder of an S corporation, qualified for this treatment. The IRS has now confirmed that if you otherwise qualify for an *above-the-line* deduction for health insurance premiums, you may be able to deduct your Medicare premiums.

Tax Tip. The IRS also says that if you are self-employed and failed to take this deduction for Medicare premiums in prior years for which the statute of limitations is still open (generally, three years back), we may be able to amend those returns and take the deduction. **Please contact us if you think this applies to you and we will assist in determining if you may amend prior year returns and take the deduction.**

Planning Alert! If you are a partner in a partnership or a more than 2% shareholder in an S corporation and you are paying your 2011 health insurance premiums directly (including Medicare premiums), the IRS says that you should have the partnership or S corporation reimburse you for those premiums ***before the end of 2011*** to qualify for the *above-the-line* deduction. If you are in this situation, please call our office and we will help you structure the reimbursement of the premiums to maximize your deduction.

Note! If you own more than 2% of the stock of an "S" corporation, please see the section of this letter below concerning the tax treatment of health insurance premiums for S corporation shareholders for additional information.

IRS Provides "Passive Loss" Relief For Real Estate Professionals Who Own Rental Real Estate.

Generally, any losses from renting real estate, where the average period rented is more than seven days, are deemed for tax purposes to be "passive" losses. Passive activity losses (PALs) are generally suspended, and are not allowed unless and until you have qualifying "passive" income to offset the losses (dividends, interest, wages, and income from business activities in which you materially participate, ***are not*** considered "passive income" for this purpose). However, if you are a "qualified real estate professional" (*QREP*) and **meet certain "material participation" tests,** you will be able to deduct losses from your rental real estate activities even if you do not have passive income (e.g., the losses could offset your W-2 compensation, interest, dividend income, and income from businesses in which you materially participate). Generally to be a *QREP*, (assuming that you meet certain "material participation" tests) you must: **1)** spend more than 750 hours for the year working in qualifying real estate activities in which you materially participate, AND **2)** spend over 50% of your work time for the year working in qualifying real estate activities in which you materially participate. As a *QREP*, you are also allowed to make a "tax" election to treat all of your rental real estate activities as a "single" rental real estate activity.

Planning Alert! If you have multiple rental properties, this election frequently makes it easier for you to qualify as a *QREP* and also to meet the required "material participation" tests, allowing your rental real estate losses to offset your non-passive income. This "aggregation" election is generally made by filing a statement with your original income tax return for the tax year you want to treat all of your real estate rental properties as a single activity. However, under new IRS guidance, you may now be able to make this election for prior tax years on an amended return if you meet certain conditions.

Tax Tip. Making this election for prior tax years may insulate rental real estate deductions that you have taken in prior years from future IRS attack. These rules can be complicated, please call our office for additional information if you think this election might benefit you.

IRS Announces That It Will No Longer Apply Rigid 2-Year Limitation On Requests For "Equitable" Innocent Spouse Relief.

Married couples filing a joint return are *jointly and severally* liable for any taxes, interest and penalties arising from their joint returns. There are three provisions in the law that potentially allow an *"innocent"* spouse to avoid this liability. One of those provisions will allow relief if a spouse can demonstrate that it would be "inequitable" to hold that spouse responsible for the tax liability, interest, and penalties arising from the joint return. However, an IRS regulation states that in order to qualify for this "equitable" relief, the spouse must submit an "equitable innocent spouse relief" request to the IRS no later than two years from the first collection activity against the spouse. The IRS has recently announced that it will **no longer apply this rigid 2-year filing deadline** for equitable innocent spouse relief.

Planning Alert! If you have previously requested equitable innocent spouse relief and relief was denied because you did not apply for relief within the previously required 2-year period, please call us, you may be able to reapply for relief under this new provision.

Caution! The other innocent spouse relief provisions (other than the "equitable relief" provision) continue to require a request for relief within two years from the first IRS contact concerning the liability. Therefore, please call us if you have been contacted by the IRS concerning payment of taxes on a joint return and you wish to request innocent spouse relief. We can help you file for relief.

New Reporting Requirements For Owners Of Certain "Foreign" Investments Or Accounts.

Any U.S. person having interests in (or signature authority over) foreign financial accounts that in the aggregate exceed $10,000 at any time during the calendar year is required to file a foreign bank account report, Form TD F 90-22.1 (FBAR), disclosing those accounts to the Department of Treasury. The FBAR is due ***by June 30*** of the following year. Civil penalties for non-willful failure to file the FBAR can range up to $10,000 per violation. The criminal penalties for willful failure to file a FBAR include a monetary penalty of up to $500,000 and a prison term of up to 10 years. Under the FBAR reporting rules, a "financial account" generally includes a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a foreign financial institution. A financial account also includes a commodity futures or options account, an insurance or annuity policy with a cash value, and shares in a mutual fund or similar pooled fund. Generally, a "foreign financial account" is a financial account located outside of the United States. For example,

under the FBAR reporting rules, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

> **Tax Tip.** The IRS recently clarified that owners and beneficiaries of IRAs or qualified retirement plans are not required to report a foreign financial account held in the IRA or qualified plan. In addition, IRS says that financial accounts maintained with a financial institution located on a U.S. military installation is not required to be reported.

The FBAR reporting rules have been in effect for years. However, recent legislation imposes a new reporting requirement on ***individuals*** who, for any tax year ***beginning after March 18, 2010,*** hold interests in "specified foreign financial assets" (SFFAs) exceeding certain threshold amounts. For example, IRS says reporting is required for individuals filing a joint return where the aggregate SFFAs are greater than $100,000 at the end of the year or greater than $200,000 at any time during the year. SFFAs include foreign financial accounts. However, according to the IRS, SFFAs also include other foreign financial assets held for investment including stock in foreign corporations; interests in foreign partnerships; notes, bonds and debentures, issued by foreign persons; interests in foreign trusts or estates; and many other types of foreign investment assets. SFFAs are required to be reported on ***Form 8938.*** Form 8938 is filed along with an individual's income tax return for the applicable year. The penalty for failing to timely file Form 8938 generally ranges from $10,000 to $50,000.

> **Planning Alert!** For the vast majority of individuals subject to this new reporting requirement, the 2011 tax year will be the first year that the Form 8938 will be required to be filed. However, as we complete this letter, the IRS has not yet released its final Form 8938, or its regulations providing guidance on how these new reporting rules will work. Consequently, the IRS has announced that individuals ***are not required*** to file *Form 8938* ***until the form is finalized*** and released to the public. Once it is finalized, Form 8938 will have to be filed with the individual's next income tax return (and will have to include the required information for any previous "suspended" year).

> **Caution!** FBAR reporting is still required for persons with aggregate financial accounts (or signature authority over such accounts) in excess of $10,000. The Form 8938 reporting requirements are in addition to the FBAR reporting requirements.

> **Tax Tip.** If you need to file, or are uncertain whether or not you need to file a *FBAR* form or a Form 8938, we will be glad to assist you.

DEVELOPMENTS IMPACTING PRIMARILY BUSINESSES

RECENT TAX LEGISLATION

The following highlights significant tax relief provisions of the five most recently-enacted tax bills that impact businesses. However, most of these tax breaks are temporary and are scheduled to *expire* after ***2011,*** or ***2012.*** Therefore, we are emphasizing the provisions that are available ***through 2011,*** or ***through 2012.***

First-Year §168(k) Bonus Depreciation Temporarily Increased From 50% To 100%. For *qualifying* "new" business property placed-in-service from **2008 through September 8, 2010,** businesses were allowed a 50% first-year §168(k) bonus depreciation deduction. Recent legislation increased this deduction to 100% for new "qualifying business property" ***acquired*** and ***placed-in-service*** after **September 8, 2010 and through December 31, 2011** (through December 31, 2012 for certain long-production-period property and qualifying noncommercial aircraft). In other words, for §168(k) property acquired and placed-in-service within this period, the *entire cost* of the property can be fully deducted. For qualifying §168(k) property placed-in-service ***during 2012,*** the §168(k) bonus depreciation deduction reverts back to **50%,** and generally ***expires*** altogether for property placed-in-service ***after 2012.***

> **Tax Tip.** *Qualifying business property* that is "acquired" *after* September 8, 2010 and generally before 2012 pursuant to a binding contract entered into *before* September 9, 2010 will still qualify for the 100% §168(k) bonus depreciation, provided that the binding contract was entered into after 2007 and the property is placed-in-service by ***December 31, 2011.***

> **Planning Alert!** Fiscal year taxpayers must generally acquire and place-in-service qualifying assets by December 31, 2011 to qualify for the 100% §168(k) deduction. In other words, the deadline is generally December 31, 2011 for both fiscal year and calendar year taxpayers.

- **Qualifying 50%/100% §168(k) Bonus Depreciation Property.** Property qualifies for the §168(k) bonus depreciation deduction if it is purchased *new* and it has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, qualified motor fuels facilities and "qualified leasehold improvements").

> **Planning Alert!** These are only examples of qualifying property. If you have a question about property that we did not mention, call us and we will help you determine if it qualifies.

- **Re-Conditioning Used Property.** Although §168(k) bonus depreciation property must generally be "new," capital expenditures incurred to re-condition or re-build used property may qualify. ***Example.*** Tim purchases a *used* machine for use in his business during 2011 for $50,000. Also during 2011, Tim incurs $20,000 to recondition the machine. The $50,000 cost of the used machine does not qualify for the §168(k) bonus depreciation deduction. However, the $20,000 expenditure to recondition the machine would qualify for the 100% deduction.

- **Qualified Leasehold Improvement Property.** Even though improvements to a commercial building do not *generally* qualify for the §168(k) bonus depreciation deduction, "qualified leasehold improvement property" (QLHIP) does qualify. Furthermore, QLHIP qualifies for the 100% deduction if it is "acquired and placed-in-service" after **September 8, 2010** and **before 2012.** *QLIP* is generally any capital improvement to an interior portion of a building that is used for nonresidential commercial purposes, provided that **1)** the improvement is made under or pursuant to a lease either by the lessee, sublessee or lessor of that interior building portion; **2)** the interior building portion is to be occupied exclusively by the lessee or sublessee; **and 3)** the improvement is placed-in-service **more than 3 years** after the date the building was first placed-in-service.

  Planning Alert! *QLIP* **does not include** any improvement attributable to: the enlargement of the building; any elevator or escalator; any structural component benefitting a common area; or the internal structural framework of the building.

  Caution! Leasehold improvements made to property leased between certain *related persons* **will not qualify.**

- **Newly-Constructed Buildings And Cost Segregation Studies.** Depreciable components of newly-constructed or newly-renovated buildings that are properly classified as depreciable *personal* property under a ***cost segregation study*** with a depreciable life of 20 years or less, qualify for the 100% §168(k) bonus depreciation if "acquired and placed-in-service" **after September 8, 2010 and before 2012.** In certain situations, these nonstructural components of the building might qualify for the 100% bonus depreciation even if the construction or renovation of the building itself began ***before*** *September 9, 2010*, provided you make a timely election to apply the 100% §168(k) rules separately to the components.

- **100% §168(k) Bonus Depreciation Property Generally Must Be "Placed-In-Service" By December 31, 2011.** If you plan on making substantial acquisitions of machinery, equipment, business vehicles, or other property qualifying for the 100% §168(k) bonus depreciation, you must place the property in service on or before the ***end of 2011*** (before the end of 2012 for certain long-production-period property and qualifying noncommercial aircraft). Generally, "placed-in-service" means the property is ready and available for use. To be safe, qualifying property should be ***set up and tested*** on or before the ***last day of 2011.***

Planning Alert! The §168(k) bonus depreciation reverts **to 50%** for qualifying property **placed-in-service in 2012** (except for certain long-production-period property and qualifying noncommercial aircraft).

§168(k) Bonus Depreciation For Passenger Automobiles, Trucks, And SUVs. The maximum annual depreciation deduction (including the §179 deduction, discussed below) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in **calendar year 2011,** the maximum first-year depreciation deduction is generally capped at $3,060 ($3,260 for trucks and vans not weighing over 6,000 lbs). However, Congress previously increased the first-year depreciation cap for vehicles qualifying for the §168(k) bonus depreciation deduction by $8,000 for 2008 and 2009. Recent legislation again **extended this $8,000 increase through 2012 for new vehicles otherwise qualifying for the §168(k) bonus depreciation deduction. For example,** let's say you are self employed and you are planning to purchase a *new* vehicle weighing 6,000 lbs or less that will be used 100% in your business. If you buy a new car and place it in service during 2011, your first-year depreciation deduction will be $11,060 ($11,260 if you bought a truck or van).

Tax Tip. Trucks, vans, and SUVs **with loaded vehicle weights over 6,000 lbs** are generally exempt from the passenger auto annual depreciation caps discussed above. Therefore, if you buy a new "heavy" truck, van, or SUV and use it 100% in your business during 2011, you could deduct the "entire cost" **for 2011 using §168(k).**

§179 Deduction Increased From $250,000 To $500,000 For 2010 And 2011. For the last several years, Congress has increased the maximum §179 up-front deduction for the cost of qualifying new or used depreciable business property (e.g., business equipment, computers, etc.). For **property placed-in-service in tax years beginning in 2010 and 2011,** the §179 cap was increased from **$250,000** to **$500,000,** and the beginning of the deduction phase-out threshold was also increased from **$800,000** to **$2,000,000.** In addition, for **2010 and 2011 purchases,** a taxpayer may elect for up to $250,000 of "qualified real property" (discussed in the next segment) to be §179 property. Prior to this change, real property generally did not qualify for the §179 deduction.

Taxpayers Can "Elect" To Treat Up To $250,000 Of *"Qualified Real Property"* As §179 Property *For 2010 And 2011*. Traditionally, the up-front §179 deduction was only allowed for depreciable, tangible, "personal" property, such as equipment, computers, vehicles, etc. However, taxpayers may "elect" to treat up to $250,000 of qualified "real" property as §179 property, provided the property is **placed-in-service in tax years beginning in 2010 or 2011.** "Qualified Real Property" includes property within any of the following three categories: **1) Qualified Leasehold Improvement Property** (generally capital improvements to the interior portion of certain leased buildings that are used for nonresidential commercial purposes); **2) Qualified Retail Improvement**

Property (generally capital improvements made to certain buildings which are open to the general public for the sale of tangible personal property); and **3) Qualified Restaurant Property** (generally capital expenditures for the improvement, purchase, or construction of a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals). If you elect to take a $250,000 §179 deduction for *qualified real property,* the $500,000 overall §179 deduction limitation is reduced to $250,000 ($500,000 - $250,000). In other words, the $250,000 §179 limitation for "qualified real property" is a part of the overall $500,000 §179 limitation and not in addition to the $500,000 limitation.

> **Planning Alert!** If you are currently acquiring or making capital improvements to "qualified real property," and you want to take the §179 write-off **for your tax year beginning in 2011,** you must place the building (or capital improvements) in service by the ***end of your 2011*** tax year. A certificate of occupancy will generally constitute placing the building or improvement in service.

Pros And Cons Of §179 Deduction Versus §168(k) Bonus Depreciation Deduction. For qualifying property purchased and placed-in-service ***in 2011,*** in many cases both the §179 deduction and the 100% §168(k) bonus depreciation deduction will be available for the same property. For example, both provisions would apply to new depreciable, tangible, "personal" property (e.g., new business equipment, computers, vehicles, etc.). Where both the §179 and the §168(k) deduction is available, generally the 100% §168(k) bonus depreciation deduction would be preferable to the §179 deduction because the §179 deduction is not allowed in excess of your business income, while the 100% §168(k) bonus depreciation has no such limit and can generate an overall tax loss (i.e., "net operating loss"). You can use a *net operating loss* to offset income in the preceding 2 years (allowing you to recoup taxes paid in those previous years) as well as up to 20 future years. However, the §179 deduction may be preferable where: **1)** your business is purchasing "used" business property (§168(k) bonus depreciation only applies to "new" property); **2)** your business is purchasing ***"qualified restaurant property"*** or ***"qualified retail property"*** which qualifies for the §179 deduction but does not qualify for the §168(k) bonus depreciation deduction; **3)** your business is located in a state that allows some or all of the §179 deduction for state income tax purposes, while the state does not allow any or as much §168(k) bonus depreciation; or **4)** your business is subject to the uniform capitalization (UNICAP) rules (the §179 deduction is not required to be capitalized into the cost of inventory while the §168(k) bonus depreciation deduction is not exempt from the UNICAP rules).

> **Planning Alert!** These rules are complex. If your business is considering significant asset purchases, please call us so we can help you develop a strategy to utilize these rules to maximize your tax savings.

Selected "Business" Tax Breaks Scheduled To Expire. A host of current tax breaks for businesses ***not previously discussed in this letter*** are scheduled to expire unless Congress takes action to extend these provisions. The expiration dates for some of the more popular tax breaks are as follows:

- ***Selected*** **"Business" Tax Breaks Expiring After 2011: 1)** 15-year (instead of 39-year) depreciation period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property; **2)** 7-year depreciation period for certain motor sports racetrack property; **3)** research and development credit; **4)** employer differential wage credit for payments to military personnel; **5)** various tax incentives for investing in the District of Columbia; **6)** favorable S corporation charitable contribution provisions; **7)** 100% exclusion of the gain from the sale of certain small business stock (discussed in more detail below); **8)** tax benefits for certain qualified energy-efficient expenditures; **9)** enhanced charitable contribution rules for qualifying business entities contributing computer equipment, book, and food inventory; **10)** work opportunity tax credit for qualified employees; and **11)** temporary reduction in the waiting period for an S corporation to avoid the built-in gains tax (discussed in more detail below).

- ***Selected*** **"Business" Tax Breaks Expiring After 2012: 1)** election for C corps to exchange bonus depreciation for refundable AMT credits; **2)** up to $5,250 tax free employer-provided education assistance; **3)** credit for employer-provided child-care facilities; and **4)** the 15% "accumulated earnings" tax rate and "personal holding company" tax rate (both rates increase to 39.6% after 2012).

"Qualified Small Business Stock" Exclusion *Temporarily* Increased To 100%. If you sell "qualified small business stock" (QSBS) **acquired after September 27, 2010 and before January 1, 2012,** you may be able to exclude the **entire gain** from taxable income if you hold the stock for more than 5 years (the gain will also be exempt from the alternative minimum tax). QSBS is generally stock of a non-publicly traded domestic "C" corporation engaged in a qualifying business, purchased directly from the corporation, and **held for more than 5 years;** where the issuing corporation meets certain active business requirements and has assets at the time the stock is issued of $50 million or less. Businesses engaged in a professional service, banking, insurance, financing, leasing, investing, hotel, motel, restaurant, mining, or farming activity generally *do not* qualify.

> **Planning Alert!** If you are considering investing in a small business, we will gladly help you evaluate whether structuring your investment as QSBS will work to your overall tax advantage. However, you must act promptly to take advantage of this narrow window of opportunity to qualify for the 100% exclusion. Only stock acquired **from September 28, 2010 through December 31, 2011** qualifies for the 100% exclusion (after you satisfy the 5-year holding requirement). Also, to qualify, you must purchase the stock directly from the corporation that is issuing the stock or from an underwriter of the stock (stock purchased from other third parties does not qualify).

S Corp 10-Year Built-In Gain "Waiting" Period Temporarily Shortened To 5 Years. If a regular "C" corporation elects "S" corporation status (a "Converted S corporation"), the election itself generally does not trigger income. However, the Converted S corporation must generally pay a 35% corporate "built-in gains tax" on gain from the sale of any built-in gain asset (up to the amount of appreciation in that asset on the effective date of the S election), if the asset is sold during the first 10 years following the S election. A *built-in gain* asset is generally any asset with a market value greater than the asset's basis on the effective date of the S election. The Jobs Act *has temporarily* reduced the 10-year waiting period *to 5 years* **for S corp tax years beginning in 2011.** That is, the Jobs Act provides that there will be no 35% built-in gains tax on the net recognized built-in gain of an S corporation for any taxable year **beginning in 2011,** if the 5th year in the waiting period (i.e., "recognition period") preceded such taxable year.

Planning Alert! For sales of "built-in gain" assets that occur in tax years beginning ***after 2011*****,** the waiting period to avoid the *built-in gains tax* is scheduled to revert to 10 years.

Caution! We have just summarized these extremely complicated rules in this letter. If your S corporation plans to sell a built-in gain asset, please call us. We will gladly help you determine if the S corporation qualifies under this special 5-year rule.

Congress Repeals Recently-Enacted 1099 Reporting Rules. New rules enacted in 2010 expanded the 1099 reporting rules to include payments aggregating $600 or more made to "corporations" (previously, payments to corporate payees, other than attorneys and certain health care providers, were exempt from the 1099 reporting rules). These changes also expanded the 1099 reporting requirements to include payments of $600 or more for "property" (previously, the 1099 reporting rules generally applied to payments for "services"). Both of these changes were effective for payments made after 2011. In addition, effective for payments made after 2010, Congress imposed 1099 reporting requirements on taxpayers receiving real estate rental income, whether or not the taxpayers were in the rental real estate "trade or business." The *Comprehensive 1099 Taxpayer Protection Act of 2011* has now retroactively repealed all three of these provisions as if they had never been enacted.

Practice Alert! If you are considered to be in the *"trade or business"* of renting real estate (traditionally a *facts & circumstances* determination), you may still be required to file a Form 1099 for payments of $600 or more to service providers (e.g., payments to a plumber or painter). Also, the 1099 reporting requirements continue to apply to payments made to corporations for ***attorneys' fees,*** and to corporations providing ***medical or health care services*****.**

<u>IRS Expands Interim Relief From Reporting Cost Of Employer-Provided Health Insurance On W-2s.</u> Beginning with 2011 W-2s, employers were generally required to report the cost of employer-provided health insurance coverage on Forms W-2. In 2010, the IRS announced that this reporting would be "optional" for ***all employers*** for the ***2011 Forms W-2*** (generally given to employees in January, 2012). The IRS recently extended this interim relief by making the reporting of the health insurance cost *"voluntary"* for "2012 Forms W-2" for employers that file less than 250 W-2s for the 2011 calendar. Therefore, if your business ***files less than 250 W-2s for compensation paid to employees in 2011,*** it will ***not be required*** to report the health insurance cost on the ***2012 W-2s*** (generally filed in January 2013).

> **<u>Practice Alert!</u>** Reporting the health insurance cost on the W-2 is for information purposes only, it does not cause the premiums to be taxable to the employee.

RECENT NON-LEGISLATIVE TAX DEVELOPMENTS (COURT CASES & RULINGS)

The following are highlights from some of the more important recent IRS rulings and Court cases that impact businesses:

Health Insurance Premiums For S Corporation Shareholders - Including Medicare Premiums.

Generally, if you own S corporation stock and the S corporation pays for your health insurance premiums, IRS says you can take an *"above-the-line"* deduction (i.e., unrestricted by the 7½% subtraction as an itemized medical expense deduction) for the premiums on your personal tax return if the S corporation timely reports the cost of the premiums paid on your W-2 as wages. However, if the medical insurance policy is your personal policy, the IRS says that your S corporation must pay the premiums directly, or reimburse you for the premiums ***before the end of the year*** ***and*** timely report the payment (or reimbursement) on your W-2 as wages for you to take an *"above-the-line"* deduction on your personal return.

> **Planning Alert!** Make sure your S corporation complies with these rules (including reimbursing any premiums you paid during 2011 by 12/31/11 and including any premiums the S corporation paid for you or reimbursed you on your 2011 W-2) so you will not be limited to a deduction only for the premiums in excess of 7½% of your AGI.
>
> **Tax Tip.** The above rules apply to premiums paid or reimbursed for you, your spouse, your dependents, and any of your children **under age 27 at the end of the year** (even if the child does not qualify as your dependent). In addition, the IRS has clarified that Medicare premiums qualify as medical insurance premiums. Therefore, the above rules also apply if the S corporation reimburses or pays **your Medicare premiums.**

Court Concludes That CPA's Formally-Approved Salary From His S Corporation Was Unreasonably Low.

For 2011, an employer must pay FICA taxes of 7.65% on an employee's wages up to $106,800 and FICA taxes of 1.45% on wages in excess of $106,800. In addition, for 2011, an employer must withhold FICA taxes from an employee's wages of 5.65% on wages up to $106,800 (normally 7.65%, but reduced to 5.65% for 2011 only) and 1.45% of wages in excess of $106, 800. If you are a stockholder/employee of an S corporation, this FICA tax applies to the salary (i.e., wages) you take from your S corporation. Other income that passes through to you or is distributed to you as a distribution on your stock is generally not subject to FICA taxes or to self-employment taxes.

Planning Alert! If the IRS determines that you have taken an unreasonably "low" salary from your S corporation, the Service will generally argue that other amounts you have received from your S corporation (e.g., distributions) are disguised "compensation" and should be subject to FICA taxes. Determining "reasonable salaries" for S corporation stockholder/employees is a hot audit issue, and the IRS has a winning record on taking taxpayers to Court on this issue. The IRS has been particularly successful where S corporation owners pay themselves no salary even though they provided significant services to the corporation. However, in a recent case, the IRS took a CPA to Court who had paid himself $24,000 of salary from his S corporation, while receiving additional cash "distributions" from the S corporation of approximately $200,000. The Court concluded that his salary (subject to payroll taxes) should be $91,000 rather than $24,000. Therefore, the Court treated $67,000 of the $200,000 of distributions from the S corporation as additional wages.

Caution! Determining a "reasonable" salary for an S corporation shareholder is a case-by-case determination, and there are no "rules of thumb" for determining whether the compensation is "reasonable." However, this case makes it clear that salaries to S corporation shareholders should be supported by independent data (e.g., comparable industry compensation studies), and be properly documented and approved by the corporation.

Planning Alert! Keeping salaries low and minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages."

Tax Court Concludes That Pass-Through Income To Law Firm Partners Operating As A Limited Liability Partnership (LLP) Was Subject To Social Security And Medicare Taxes.

Partners of businesses operating as partnerships are generally subject to Social Security and Medicare taxes (SECA tax) on their business income from the partnership. For example, the pass-through business income from a "general partnership" to a general partner is subject to SECA tax. By contrast, business income from a "limited partnership" to a *limited partner* is generally exempt from SECA tax except to the extent of any "guaranteed payments" made to the limited partner. However, it has never been entirely clear whether and to what extent pass-through business income to the owner of a Limited Liability Company (LLC) or Limited Liability Partnership (LLP) is subject to SECA tax.

Planning Alert! In a recent case, the Tax Court held that owners of a law firm operating as a "limited liability partnership" (LLP) should be treated as "general" (not "limited") partners and, therefore, should be subject to SECA tax on all pass-through business income from the LLP (whether or not distributed). The Court concluded that an owner of an LLP qualifies for the "limited partner" exception to SECA taxes *only if* the LLP owner is a ***"mere investor"*** who does not ***"actively participate"*** in the business operations of the LLP. Since the lawyers in this case

were not mere investors and actively participated in the firm's law practice, the Court imposed SECA tax on their business income from the partnership. Although this case dealt with an LLP and not a "limited liability company" (LLC), the IRS could easily try to extend the rationale of this decision to LLC owners.

IRS Warns Employers Using Outside Payroll Firms They Have Obligation To Make Sure Employment Taxes Are Paid.

It has become an increasingly common practice for businesses to outsource their payroll to outside third parties, commonly referred to as Payroll Service Providers (PSPs), Professional Employer Organizations (PEOs), or "Employee Leasing Companies." The IRS has recently announced that the outside firm may be held liable for failure to pay over payroll taxes.

Planning Alert! The IRS also said that the mere use of an outside payroll firm does not eliminate the "common law employer's" obligation for the payment of the payroll taxes even if the failure to pay is entirely due to the payroll service provider's negligence or fraud.

Caution! For businesses using outside payroll firms, the IRS has offered the following advice: **1)** It strongly suggests that the address of record with the IRS not be changed to that of the payroll service provider. If there are any issues with an account, the IRS will contact the employer. Changing the address may significantly limit the employer's ability to be timely informed of tax matters involving its business. **2)** The IRS advises employers to make sure that the payroll service provider is using the "Electronic Federal Tax Payment System" (*EFTPS*). *EFTPS* maintains a business's payment history for 16 months and can be viewed and monitored by the employer on-line. A red flag should go up the first time a payroll service provider misses a payment or makes a late payment.

Tax Tip. The IRS cautions that there have been instances of individuals and companies acting under the guise of payroll service providers who have stolen funds intended for payment of employment taxes. IRS says that employers who believe that a bill or notice received is a result of a problem with their payroll service provider should contact the IRS as soon as possible by calling the number on the bill, or writing to the IRS office that sent the bill.

Recently-Updated Automatic Accounting Method Change Procedures.

Generally, if your business needs to change its tax accounting method, it must submit a request for approval to the IRS, pay a user fee, and wait until the IRS approves the change in writing.

Tax Tip. In 2011, the IRS issued its most recent set of procedures for businesses to obtain "automatic" IRS approval for many common accounting method changes by submitting an accounting method change request with a timely filed tax return (including extensions) for the year of the change. There is ***no user fee*** if a taxpayer qualifies to use these "automatic accounting method change" procedures. In addition, if the request is properly completed, the request is "deemed" granted unless you hear from the IRS. In some cases, the request may even be filed with an amended return. **Example.** Let's assume your business purchased or constructed a commercial building several years ago, and you have been depreciating the entire cost of the building over 39 years using the straight-line depreciation method. You now discover, **after conducting a "cost segregation study"** that 25% of the original cost of the building constitutes "nonstructural components," depreciable over 5 to 7 years using an accelerated depreciation method. Based upon these facts, your company could deduct the additional depreciation it should have taken for all prior years (utilizing the shorter lives) by using this recently-updated automatic accounting change procedure. By attaching a properly completed accounting method change form to the current year's tax return and timely sending a copy to the IRS National Office, your business may deduct, in the current year, all the depreciation it failed to deduct in prior years.

Note! This automatic accounting method change procedure applies to many other accounting method changes listed within the procedure.

Planning Alert! Please do not attempt any accounting method change without contacting us first. The approval procedure does not apply to all accounting method changes and depends upon the proper completion and filing of Form 3115, and compliance with specific guidelines.

The IRS Announces That More Small Tax-Exempt Organizations May File A Simplified Annual Information Return.

For tax years beginning on or ***after January 1, 2010,*** tax-exempt organizations with ***annual gross receipts of $50,000*** or less can file ***Form 990***-N ("Electronic Notification e-Postcard"). The threshold previously was $25,000 in annual gross receipts.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information. **Note:** The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

Circular 230 Disclaimer: Any tax advice contained in the body of this material was not intended or written to be used, and cannot be used, by the recipient for the purpose of **1)** avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions, or **2)** promoting, marketing, or recommending to another party any transaction or matter addressed herein.