# The Kiplinger Tax Letter

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Dear Client: Washington, April 4, 2008

**HIGHLIGHTS**

- **Enforcement** Foreign taxpayers
- **Benefit Plans** Win for employers
- **IRAs** Flexibility for nonspousal heirs
- **Payroll Taxes** 2009 wage base
- **Joint Ventures** Nominal owners
- **Filing Season** Final reminders

Congress is eyeing estate tax reform.

But action isn't likely until 2009, in our opinion. Presently, the estate tax is scheduled to be eliminated after 2009, but only for one year. It returns to life in 2011 with a paltry $1 million exemption. Lawmakers realize that this makes little sense, but election-year politics will keep taxwriters from developing a solution until next year.

Two ideas are getting a lot of play this year as lawmakers debate estate tax fixes.

One would be a major rewrite of the way estates are taxed:

An inheritance tax levied on bequests in lieu of taxing the estate of the individual who died. One plan being reviewed would tax heirs once the total they have inherited in their lifetimes tops $1.9 million. Heirs would owe income tax plus a 15% surtax. To ease the tax hit, taxpayers could elect to pay the tax ratably over a five year period. This system is projected to bring in as much revenue as the estate tax.

On the plus side, large estates could escape tax completely. No inheritance tax would be due on an $11 million estate split evenly among three children and their spouses. That is significantly higher than the current $2 million exclusion for estates not left to spouses.

But there are some potential problems with an inheritance tax. States with estate taxes would be out of step with the feds. All bequests would have to be reported to IRS so it could track usage of the exemption. Charities would be concerned that there would be less incentive to donate by will. And transitioning over to the new tax system would be tricky.

These are enough to make an inheritance tax a long shot for 2009.

The second idea would tweak the existing estate tax system... one of many such changes to be discussed as a reform bill takes shape:

Simplifying estate tax planning for surviving spouses. Nowadays, if one spouse dies without fully using up his or her $2 million exemption, that amount is wasted. This can happen when the first spouse to die doesn't own enough assets in his or her name or when many or all assets go to the survivor. Estate planners use trusts to avoid the second problem.

The leading plan makes exemptions portable. When one spouse dies, the unused amount would pass to the surviving spouse and be available for use when the survivor dies. This would eliminate the need for spouses to have to establish trusts in their wills solely to save estate taxes. However, an estate tax return would have to be filed for a deceased spouse to tell IRS the amount of the exemption passing to the surviving spouse.

This is likely to pass next year as part of estate tax reform, especially since all of the presidential candidates favor the concept.

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ENFORCEMENT

How much do foreign taxpayers contribute to the U.S. tax gap? IRS plans to find out by doing the first-ever random audits of these folks in 2008. Agents will look at 2006 returns of foreigners with U.S. source income. The audits are part of a larger ongoing project that uses random exams to help IRS fine-tune its audit selection formulas.

IRS has private-activity bond issuers in its crosshairs. The Revenue Service suspects that many issuers of these tax-exempt bonds violate rules that bar using more than 2% of proceeds for issuance costs. So next year IRS will contact issuers to get more issuance-cost data, and will launch full-blown examinations if this effort bears fruit.

State and local agencies are getting more scrutiny from the IRS on employment tax issues, including worker classification and fringes. The Service will audit nearly 100 housing authorities this fiscal year and send letters to about 200 fire districts to get a better idea of where violations are prevalent. Audits of other agencies are next.

And IRS is targeting so-called sick leave banks offered by states and municipalities. The Service says that if employees have the option to cash in excess sick leave, they are taxed on the value of that leave, even if they don't exercise the option. The IRS suspects many employers don't enforce this, so it will audit eight Northeast leave banks in 2008. Exams will go nationwide in 2009 if these audits turn up many problems.

The feds are digging in their heels on worker verification rules, despite a court decision a few months ago striking down the regulations. They're aimed at firms that file many W-2s with Social Security numbers that don't match names in government records. Business groups expected the rules would be revised to give firms more time to fix discrepancies before having to fire workers. But the feds, while making other changes the court ordered, decided to stick with the original 90-day time frame.

However, it will be at least 2009 before the rules go into effect. Because the regulations weren't eased, firms will challenge them in court.

BENEFIT PLANS

A big win for employers that provide retiree medical coverage: The Supreme Court won't review a key Appeals Court decision backing proposed Equal Employment Opportunity Comm. rules. They let firms cut health benefits for retirees who become covered by Medicare at age 65. Now that employers know they can safely trim benefits just for that group, they'll be more inclined to maintain health plans for early retirees.

COUPLES

IRS clarifies a new filing option for married business partners: Owners of limited liability companies can't use it. Joint filers who are the sole owners of unincorporated businesses can elect not to file as a partnership, thus avoiding a complicated partnership return and K-1s. Starting with 2007 returns, each spouse can instead report their share of income and expenses on separate Schedule Cs. But IRS says to qualify, the spouses must own and operate the business as co-owners, not as an LLC.

TAX PRACTICE

Tax pros can charge contingent fees for whistleblower claims, IRS says. In these cases, folks with information on tax cheating by another taxpayer tell IRS about it and seek a reward equal to a portion of any extra tax recovered. Now, tax attorneys who are hired to dog IRS for the reward can base their fee on a percentage of whatever IRS pays.

IRAs

IRS shows some flexibility on IRA payouts to nonspousal heirs. Lifetime payouts not started promptly can be made up later on to avoid triggering the five-year payout rule, the IRS says privately. A 30-year-old woman who had inherited two IRAs from her deceased father planned to take payouts over her life expectancy but failed to begin them within 12 months after his death. To correct this mistake, the woman made up the missed payouts and paid a 50% penalty. IRS says she avoids having to clean out the IRAs over five years. For her, the steep penalty is worth it to keep the much longer lifetime payout schedule of 52 years.

Planning to donate your IRA payout to charity this year? You'll have to wait a few months if you want to be sure the gift is tax free. By the end of the year Congress will renew the provision that allowed folks who reach 70½ to donate up to $100,000 a year tax free from regular IRAs or Roths. Although this had been a popular tax break for seniors trying to cut their tax bills, Congress allowed it to expire at the end of 2007. Lawmakers will revive it retroactive to Jan. 1, 2008.

PAYROLL TAXES

The 2009 Social Security wage base is expected to be $106,500, according to the Social Security trustees. That is up $4,500 over this year but $300 less than projected by the president's budget. Tax rates will stay the same...6.2% for FICA and 1.45% for Medicare.

Employers are not liable for doing IRS' bidding on withholding, a court says. The case involved an employee who claimed he was exempt from withholding. The Service challenged his claim and sent a letter telling his employer to withhold as if he were single with no exemptions. He sued his employer, but the court nixed his claim because the firm was merely following the IRS' orders (Giles v. Volvo Trucks, D.C., Pa.).

An exempt group's chairman owes a penalty on undeposited taxes, a court says. The nonprofit hospital's chairman had been informed by the executive director that withheld payroll taxes were being used to pay creditors. Instead of requiring documentation that the payments were made, he accepted verbal assurances and looked the other way. So, the court says IRS can nail him with a penalty (Verret, D.C., Texas).
There is an exception for volunteer directors of exempt groups. They escape payroll tax penalties if they serve in an honorary capacity, don't participate in daily operations and didn't know of the delinquency.

EXEMPT GROUPS

The public can get copies of a charity's 990-T form from IRS. But the procedure isn't obvious. Form 4506-A doesn't have a box to check to request 990-Ts, so you must write in "Form 990-T" on line 7. IRS eventually will add a 990-T check box on the form. The Service will send out copies of 990-T forms that were filed after Aug. 17, 2006.

JOINT VENTURES

A nominal owner of a business can't be taxed on the profits, the Tax Court says. A man put a bar in his name as a favor for a friend with a record who thought he couldn't get a liquor license. The man owned the building housing the bar, and his friend paid him rent. The rent wasn't based on the bar's profits. IRS said that since the man was listed as the bar's owner, the payments were subject to SECA tax. But the Tax Court disagreed...the man had no involvement with the bar, and it ruled his friend was the real owner (Monk, TC Memo. 2008-64). The Court noted that the bar's name was tattooed on the friend's chest.

FILING SEASON

Some final reminders for your 2007 return as April 15 approaches: Your 2007 IRA contribution is due April 15, even if an extension has been requested. Payins by mail are OK if postmarked before the 16th.

Coverdell education savings account payins are due by the 15th.

Securities traders have until the 15th to elect special tax status for 2008 if they haven't done so before. With a section 475(f) election, traders can fully deduct trading losses and ignore the wash-sale rule.

Keogh payins can be made by the extended due date of the return. But you must have set up the plan before 2008 to take a 2007 deduction.

Consider a SEP-IRA if you didn't open up a Keogh plan in time. You have until the extended due date of your tax return to set one up. Self-employeds will not lose any tax benefits by establishing a SEP-IRA because the contribution limits for a SEP and a Keogh plan are the same.

There are two options if you need an extension: File Form 4868 by the due date and send a check with it for extra tax you think you owe. If your estimate is unreasonably low, the Service can void the extension. The extension defers the due date of your income tax return to Oct. 15.

Or charge an extension-related tax payment on your credit card through an IRS-approved processor. That gives you until Oct. 15 to file.

Fine-tune your estimated tax payments and withholding for 2008 to avoid an underpayment penalty if you owe a lot for 2007 or you expect to owe a lot more tax in 2008. You must make adjustments on estimated tax right away, but for withheld taxes you also have the option of waiting until year end to increase withholding. That's because withheld taxes are treated as if paid evenly during the year. You needn't pay ALL tax that you might owe for 2008. You can avoid a penalty by prepaying 90% of your 2008 tax or 100% of your 2007 tax liability...110% if your AGI topped $150,000. Then you beat the penalty no matter how much tax is due.

Armed forces members get help qualifying for the tax rebate. Nontaxable combat pay counts toward the $3,000 in qualifying income needed to be eligible for the rebate, the Service says. Military members who otherwise would not have enough taxable income to file a tax return should file Form 1040A and report their nontaxable combat pay on Line 40b.

Consider e-filing your 2007 return so your rebate isn't delayed. Rebates will start going out on May 2, but only to taxpayers whose returns are processed by April 15. As the mid-April filing crunch approaches, IRS takes up to two weeks to process paper returns. But e-filed returns take only a few days to process, so electronic filers have until April 10 or so to file to ensure that they will make the first wave of rebates.

Filers who owe tax can still have their rebates deposited by wire, according to Internal Revenue. Even though they are not getting refunds, they should fill out the direct deposit information on their returns. Then, the Service can wire their upcoming rebates to their bank accounts.

Yours very truly,

The Kiplinger Editors

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