

The Kiplinger Tax Letter

CIRCULATED BIWEEKLY TO BUSINESS CLIENTS SINCE 1925

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Dear Client:

Washington, March 2, 2012

Tax reform plans are popping up all over, like crocuses rising in the spring. President Obama has released the framework of his long-awaited plan to revamp the corporate tax system, and Mitt Romney is proposing a major tax code overhaul for individuals. Although both proposals are short on some key details, they are the starting point for an election year debate over how to reform the current convoluted tax system.

Obama's plan creates winners and losers.
He'd cut the top rate on corporations to 28%.
And he'll keep some popular tax breaks:

The R&D credit would be made permanent. The 9% domestic production deduction would be raised to 10.7% for manufacturers, and even higher for advanced processes. Factoring in this break, the top tax rate on manufacturers would effectively be 25%. Small companies would be able to expense up to \$1 million a year in asset purchases, and the \$5-million ceiling on using the cash method of accounting would be doubled.

But he'd pare many tax breaks: Firms not involved in manufacturing would lose the domestic production deduction. Use of the LIFO inventory method and the lower-of-cost-or-market method would be nixed. The deductibility of interest on corporate debt would be restricted, although the proposal doesn't offer the details. Multinationals would have to pay a minimum tax on earnings of foreign subsidiaries. And though not explicitly stated in the proposal, it seems that depreciation schedules for many assets would be lengthened. That would affect not only depreciation claimed by corporations, but also write-offs of partnerships, S companies and proprietorships.

Romney's proposal covers tax reform for individuals and businesses.
He backs an across-the-board 20% cut in marginal rates for individuals.
Capital gains and dividends would keep their 15% maximum tax rate,
but filers with incomes below \$200,000 wouldn't pay any tax on gains and dividends.
The estate tax and the alternative minimum tax would both be repealed.

Romney takes a different tack than Obama on corporate reform. His plan would cut the top rate to 25% and switch to a territorial tax system, so only income that's earned within U.S. borders would be taxed here. He'd also nix the minimum tax on corporations and make the R&D tax credit permanent. Unfortunately, his proposal doesn't say specifically which tax breaks he would eliminate to offset these easings.

He would impose broad spending cuts to cover lost revenues from reform, such as turning Medicaid into a federal grant program to the states, raising the age of retirement for Social Security and modifying Medicare for those not near retirement.

Election year politics will stymie any efforts this year on reform, of course.

But you can bet the coming changes will affect individuals and businesses.

If tax reform is limited to corporations, the top rate on them would end up far below that for individuals, negatively affecting proprietors, partners and owners of S firms. So a full overhaul of the tax system is in the cards. That will be a multiyear process.

HIGHLIGHTS

[Estate Taxes](#) Break on portability

[IRAs](#) Name your beneficiary carefully

[Business Taxes](#) Use of vehicles

[Payroll Taxes](#) S corporations

[Filing Season](#) IRS slipups

[Enforcement](#) Corporations eyed

ESTATE TAXES

IRS is giving estates [more time to elect portability](#) of any unused exclusion between spouses. Last fall, IRS announced that estates had to file Form 706 to elect to make the unused exclusion portable, even for those with under \$5 million in assets. The late announcement didn't give executors of estates of people who died in early 2011, especially smaller estates, much time to prepare and file the 706. So the Service now says it will grant estates of those who died in the first half of 2011 a retroactive extension of the filing deadline. They'll have 15 months from date of death to request the extra time...which will be automatically granted...and file Form 706.

BENEFIT PLANS

Don't worry if your W-2 shows the value of your health insurance coverage paid for by your employer. Starting with W-2s for tax year 2012, employers that file 250 or more W-2s must report on the form the value of health coverage they provide. This amount isn't taxable to workers. It's for informational purposes only so employees will have a better appreciation of the amount that their employers spent. Some businesses have jumped the gun and included the figure on W-2s for 2011. Smaller employers will have to report these amounts on W-2 forms for tax year 2013.

IRAs

Making your estate the IRA beneficiary affects timing of payouts to heirs. A woman who owned an IRA named her estate the beneficiary of the account. After her death, her four kids inherited the IRA and transferred their 25% interests into four separate IRAs. The Revenue Service privately ruled that the segregated IRAs are treated as inherited IRAs and the trustee-to-trustee transfers are not taxable. But the children must take minimum payouts based on their mother's life expectancy because she named her estate as the beneficiary of the IRA instead of her children. Had she designated the kids as beneficiaries, they could have based the distributions on their own life expectancies, which would have produced lower annual withdrawals.

If you switched an IRA to a Roth in 2010 and deferred tax on the income...
Remember that one half of that amount is taxable this year. Check line 20a of Form 8606 for 2010 to see how much income from the conversion is taxed in 2011. You report this amount directly on line 15b of this year's 1040, not on Form 8606. When you file your income tax return for 2012, you will report the remaining 50%.

INTEREST RATES

IRS interest rates [will remain the same](#) for the second quarter of 2012. On overdue taxes, IRS will charge 3%. The rate will be 5% on corporations that owe over \$100,000. On refunds, the Service will pay 3% to individuals and 2% to corporations. For corporate refunds over \$10,000, the rate on the excess is 0.5%.

The Service will not pay interest on 2011 tax refunds made by May 30 for returns that are filed on time. There's a 45-day waiting period on late returns, too. However, in both cases IRS can lop as much as 30 days of interest off the check.

BUSINESS TAXES

An unreliable logbook can cost a deduction for the business use of a car. A couple who used their vehicles in their sole proprietorships found this out the hard way. Their logbooks were riddled with mistakes, questionable entries and other irregularities...so much so that the Tax Court was unable to rely on them. As a result, the Court upheld IRS' disallowance of all mileage expenses for the vehicles, even though they were used partially for business ([Moore, TC Summ. Op. 2012-16](#)).

IRS provides more guidance on energy tax breaks for commercial buildings. Improvements that cut a building's energy usage by 50% or more can be expensed, but not more than \$1.80 a square foot of floor space. A smaller write-off of up to 60¢ per square foot is allowed if the reduction in energy and power costs is less than 50%. IRS has provided an alternative way for firms to qualify for the partial deduction, depending on energy savings percentages for heating, cooling and hot water systems, interior lighting and the building envelope. [Notice 2012-22](#) has the complete details.



PAYROLL TAXES

IRS continues to go after S corporations that pay low salaries to owners.

Many owners of S companies take low salaries so the bulk of the profits are passed through to their own returns free of Social Security and Medicare taxes. IRS and the courts balk at this practice. In a recent case, a CPA set up an S company to serve as a partner in an accounting firm. He took a \$24,000 salary from the S firm in a year when its share of the partnership's profits was \$203,000. An Appeals Court agreed with IRS that the pay was unreasonably low, relying on an expert's testimony that the CPA's services were worth \$91,000. The Court held that \$67,000 of the profits are properly reclassified as salary and subject to payroll taxes ([Watson, 8th Cir.](#)).

Determining what is a reasonable salary is the key. In this case, the reason the CPA's services were valued at less than half of his share of the partnership's profits was that employees who weren't partners also performed significant services. This easing is not available in cases where only the S firm owner is providing services.

Authority to write checks won't always make you liable for back payroll taxes, as this case shows. A high-paid employee signed more than 1,700 checks for a firm, including paychecks. During this time, unbeknownst to him, the company fell behind on depositing withheld taxes from employees. IRS came after him for the unpaid tax, claiming he was responsible for the shortfall. At trial, he said one of the higher-ups made the decisions on which creditors to pay, and since he wasn't a company officer, he had no idea that the payroll taxes weren't being deposited. The jury believed him and a district court absolved him of the 100% trust fund penalty ([Tarpoff, D.C., Ill.](#)).

Form 941 now reflects the extended payroll tax cut for 2012. Last month, Congress made sure that the two-percentage-point reduction in an employee's share of Social Security tax would remain in effect the full year instead of expiring after Feb. The new version of the 941 with the 4.2% rate on employees is now available from IRS.

Wages paid to a parent to care for an adult disabled child aren't hit with FICA, the IRS privately rules. This is so even if the parent is considered to be an employee of the child. Normally in that case, both the household employer and the employee are subject to FICA tax if the wages exceed a threshold amount...\$1,800 for 2012. Although the wages paid may be free of FICA tax, they aren't exempt from income tax.

LOSSES

A loss carryforward won't trim a self-employment tax bill, the Tax Court says.

While the net-operating-loss carryover will reduce a taxpayer's *income* tax bill, it can't be used to lower the filer's SECA tax liability ([DeCrescenzo, TC Memo. 2012-51](#)).

TAX PATENTS

A ban on tax strategy patents doesn't affect any issued before Sept. 16, 2011.

But those grandfathered patents aren't necessarily valid, as this case shows. A firm that got a patent for an investment tool designed to enable real estate owners to more easily do like-kind exchanges via tenancies in common sued another company that used the technique. But an Appeals Court ruled that the patent was invalid because it consisted mainly of mental processes and abstract intellectual concepts, which are not patentable ([Fort Properties v. American Master Lease, Fed. Cir.](#)).

ENERGY

Buyers of solar heating systems cannot have their cake and eat it, too.

A tax free subsidy from a utility trims the allowable energy credit, IRS says in a private ruling. Purchasers aren't allowed to base the 30% solar energy credit on the portion of the cost that's subsidized by a utility's energy conservation grant.

The rule is different for recipients of energy subsidies from governments. Since subsidies paid by a federal, state or local conservation program are taxable, the full cost is taken into account when figuring the credit. The only exception to this rule is if a government's program is designed to assist lower-incomers. If so, the subsidy is tax free welfare and does not count when calculating the credit.

FILING SEASON

The current filing season isn't going so smoothly for the Revenue Service.

Refunds of early filers were delayed because of a glitch in the IRS' software. The agency put in new procedures to sniff out refund fraud, especially identity theft. But these fraud filters held up many valid refunds. Now, the Service is having trouble with its popular Web-based refund status tool. Many taxpayers are complaining that their refunds are coming much later than the date first indicated by the tool. In addition, there have been sporadic glitches and system failures affecting e-filing.

ENFORCE- MENT

Corporations will see two rounds of random audits soon, an IRS official says.

About 2,500 small corporations...those with assets of less than \$250,000... will be eyed as part of the Service's national research audit program, starting in April. Tax returns from 2010 will be reviewed. A set of audits also is on tap for corporations with assets of more than \$10 million and up to \$100 million, beginning in April. IRS will check a sampling of their returns for a five-year period, starting with returns for 2010. It will use the results of these exams to update its return selection formulas.

Contract manufacturers are getting special audit scrutiny from the IRS.

The Service is checking claims for the domestic production deduction...the write-off for 9% of income derived from U.S. manufacturing activities. Contract manufacturers are ineligible for the deduction unless they take title to the goods that they fabricate before delivering them to another manufacturer. The Revenue Service wants to be sure that the producer and the party receiving the goods aren't both taking the write-off. Go to www.kiplinger.com/letterlinks/manufacturing to see the guidance to field agents.

Filing a false return can lead to deportation, the Supreme Court says.

A resident alien pleaded guilty to making false statements on his income tax return. And his wife copped a guilty plea for assisting in preparing the return. The tax loss to the government from their conduct exceeded \$10,000. As a result, their crimes were serious enough to be treated as a deportable offense ([Kawashima v. Holder](#)).

A change for couples who want someone to represent them in tax matters:

They now are required to file separate power-of-attorney forms with the IRS.

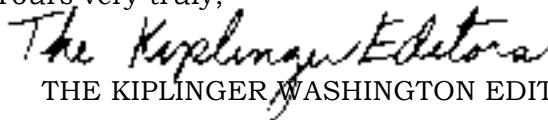
The old rule, under which a married couple could designate their tax representative on a single [Form 2848](#), was scrapped as of March 1. Any joint designations filed by couples before that date remain valid, so they don't have to refile separate 2848s.

More government scrutiny of volunteer tax return preparers is likely

in light of a recent incident involving a false return prepared at a volunteer site. A volunteer told a taxpayer he did not need to report cash income that he received, and the quality reviewer concurred because people in the locality were hit hard by the bad economy and needed the extra money. Unfortunately for the preparers, the taxpayer turned out to be a Treasury inspector who was checking the accuracy of returns prepared there. As a result, that site was closed, along with another one where the preparers also volunteered. Look for more undercover visits to occur.

Expect IRS to give returns done by volunteers extra audit scrutiny as well.

Yours very truly,



THE KIPLINGER WASHINGTON EDITORS

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