

The Kiplinger Tax Letter

CIRCULATED BIWEEKLY TO BUSINESS CLIENTS SINCE 1925

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Dear Client:

Washington, March 5, 2010

Despite lawmakers' push for tax cuts now... They will be forced to raise taxes before long to rein in the federal budget deficit, which is projected to exceed \$600 billion each year for the next 10 years. If deficits are left unchecked, the total federal debt could climb to \$15 trillion by the end of this decade. That gap won't be plugged just by reducing spending. The debate will start in earnest next year, after Obama's deficit commission reports this Dec. Its recommendations will provide political cover for some of the tough choices that must be made.

HIGHLIGHTS

Benefit Plans COBRA subsidy
Damages False imprisonment
IRAs Converting to a Roth this year
Payroll Taxes Severance pay case
Enforcement Audits of universities
In Congress Rangel's abdication

If the Democrats maintain their majorities in the House and Senate... Upper incomers will eventually pay more income and capital gains taxes. Obama will use the deficit as a main argument for raising the top tax rate to 39.6% on singles with taxable income above \$196,000. On marrieds...over \$231,000. And he'll push for a top capital gains rate of 20% for this group, up from 15% now. Obama will also revive his idea for limiting itemized deductions for high incomers by capping, at 28%, the rate at which itemizations reduce a filer's tax liability.

Other alternatives that Democrats support: A payroll tax increase. One option would be to raise the Medicare tax from 1.45% to 1.8% or even higher. Another would be to make high-incomers pay Medicare tax on unearned income. A surtax on incomes can't be ruled out because it's a big revenue raiser: A 5.4% surtax the House OK'd in 2009 would have pulled in more than \$500 billion over 10 years and would have hit filers at the same levels as Obama's tax rate plan. Republicans, meanwhile, would consider adopting a consumption tax. The huge revenue that could be raised by a value-added tax or national sales tax will look very attractive to deficit cutters. The trick would be where to set the rate. Lawmakers will want it low to garner votes, but they'll be pressured to exempt food and the like. To offset those exemptions, the rate would have to be 3% or more.

There are also some major revenue raisers that both sides can agree on: Higher self-employment taxes on owners of S corporations. Shareholders in personal service S firms would have to pay self-employment tax on the share of the firm's income that comes from the owner's services. This would keep folks from skirting the payroll tax by taking profits through dividends instead of salary. Tighter rules on worker classification so IRS would have more authority to crack down on firms treating workers as contractors who are really employees. And beefed up information reporting in a number of areas...for payments made to corporations and landlords, and for filers who hold accounts overseas.

Which tax increases have the best chance of being approved by Congress? A lot will depend on which party is in power after the November elections. Most of these big-ticket items are very controversial, but lawmakers will be stuck: They'll have to pick at least one of them to make a substantial dent in the deficit.

QUALIFIED PLANS

A tax dodge involving life insurance transfers by qualified plans is nixed. A plan funded by an IRA rollover used the proceeds to buy life insurance on the lives of the couple that owned the company sponsoring the plan. The policy had an account value of \$1.37 million and a surrender charge of \$1.06 million, so the cash value was \$310,000. The husband bought the policy from the plan for the cash value, but the Tax Court says the policy is worth the account value. Thus, he owes income tax on the \$1.06-million discount (Matthies, 134 TC No. 6).

BENEFIT PLANS

Ex-workers who were denied the COBRA coverage subsidy, take note: The Labor Dept. has a new form for appealing a former employer's decision to deny the subsidy, which is 65% of the premium for continued health coverage for up to 15 months. The new form takes into account changes made by Congress last year, including extending the subsidy to workers let go through Feb. 28, 2010. The Labor Dept. is required to act on appeals within 15 days after they are filed.

403(b) plan sponsors get help from the Labor Dept. to satisfy new rules that require them to send audited financial statements along with the Form 5500s for the 2009 plan year. Earlier, Labor had said data on pre-2009 annuity contracts needn't be listed on 5500s for 2009. This relief is now expanded to future years. Plus, reporting isn't required for 2009 if the last 2008 payment on an old contract was deposited in 2009. Since this is the first year for attaching audited financials, the DOL will send letters to 16,000 403(b) sponsors to remind them of the rule.

An IRS program for OKing 403(b) prototype plans is likely to start in April. Once the Service gives the nod, vendors will be able to market them to employers. The process for blessing individually-designed 403(b) plans will be announced later.

A deadline looms for sponsors of some preapproved plans. April 30, 2010 is the last day to file applications to get IRS' OK that a firm's plan satisfies mandates that were enacted by Congress in recent years. The deadline only applies to 401(k)s and other types of defined contribution plans, not to defined benefit pension plans.

Tying a bonus to profits derived from a well won't give payees a tax break. The bonus recipients can't claim depletion to reduce their taxable income, the IRS says in a private ruling. Depletion is allowed only to the owners of interests in the minerals in the ground. In this case, the company retained title to the well.

DAMAGES

A damage award for false imprisonment is taxable, an Appeals Court says. The buyer of a used car stopped payment on a check used to purchase it after the car died on her way home from the dealership. The bank mistakenly noted that the check was returned for insufficient funds and the dealership filed charges. She was arrested in front of her family, strip-searched at the jail and released on bail after eight hours in jail. The charges were dropped after the bank admitted it erred. She sued the bank and got \$49,000. Despite her ordeal, the award is income to her because she had no physical injuries from her confinement (Stadnyk, 6th Cir.).

IRAs

If you plan to convert more than one of your IRAs to a Roth this year... You will have to choose the same tax treatment for all your conversions. An individual converting in 2010 can elect to defer the tax and report half the income from the conversion on the 2011 tax return and the rest of it on the 2012 return. Or a person can report 100% on the 2010 return. But you can't defer the tax on one Roth conversion and pay the tax up front on another of your conversions. In effect, that would let you spread the tax over three years...2010, 2011 and 2012. Couples who each do a Roth conversion have a different rule: One spouse can elect to defer the tax bill, while the other one can choose to pay the tax up front.

PAYROLL TAXES

Stunning news on payroll taxes for companies that are downsizing: Severance pay for laid-off employees isn't subject to Social Security taxes, a district court says in a case involving a bankrupt retailer that closed all its stores and let its staff go. The court noted that the tax code specifically requires employers to treat severance paid to laid off workers as if it is wages for withholding purposes. This indicates that severance is not otherwise treated as wages, and thus is exempt from FICA tax. The court also nixed IRS' position that severance avoids FICA tax only if it is tied to receipt of unemployment benefits (Quality Stores, D.C., Mich.).

IRS almost certainly will appeal. In 2008, it won an Appeals Court case on this issue. But the district court here expressly repudiated that Court's analysis.

Companies should consider filing protective refund claims for FICA tax paid on severance pay, citing this new decision. This is particularly true for businesses that had layoffs in 2006, because the statute of limitations for 2006 expires April 15, a little over a month away. IRS will stash the protective claims until after the appeal is decided. Firms can submit claims on Form 843 now and perfect the claims later. Employees can file for their half of the FICA tax, or employers can claim both halves. If claiming both, employers must first refund the workers' share or get their consent to file a claim for their portion. In the latter situation, the employer agrees to refund the employees' share of FICA directly to them if the refund claim proves successful.

To help with filing protective claims, we are having an audio conference on April 1. Register by visiting www.krm.com/kiplinger or calling 800-775-7654.

IRS gives hospitals half a loaf on FICA refunds for medical residents' pay: It is granting refunds on existing claims for periods before April 1, 2005, the effective date for stricter regulations that severely limited the FICA tax exception for students employed by a school. The new rules impose FICA tax on the wages of students, such as medical residents, who work at least 40 hours per week. The Service will continue to deny refund claims for periods after March 2005.

Bad news for a company that pays a nanny to look after the owner's kids: The nanny is the company's employee, the Service says in a private ruling. The domestic worker tended the kids in the owner's home, readying them for school and also feeding and changing an infant. The firm paid the nanny an hourly wage, and she didn't work for anyone else. Since the company gave her a 1099-MISC form, it qualifies for reduced penalties: 9.18% of pay for the employer and employee share of FICA and 1.5% of pay for failing to withhold income taxes. The reason the Service issued the ruling? The nanny filed Form SS-8 asking IRS to determine her status.

Relying on a tax adviser's incorrect advice avoids payroll tax penalties. The sole owner of an S company wanted to avoid making semiweekly tax deposits, so he decided to pay himself his full salary at year-end, taking periodic advances to tide him over until then. His CPA erroneously said no payroll taxes were due on the advances because the owner was obligated to repay them. The Tax Court waived the late payment and deposit penalties, since the owner wasn't a tax expert and his accountant gave him bum advice (Ken Ryan, Inc., TC Summ. Op. 2010-18).

ESTIMATED TAXES

Small firm owners may be eligible for estimated tax penalty relief for 2009. If your 2008 AGI was under \$500,000 and over 50% of your gross income was from a firm with fewer than 500 employees, you avoid an underpayment penalty as long as you based your estimates on 90% of tax liability for either 2008 or 2009. The IRS says your business can be a corporation, partnership, LLC or proprietorship. To use this easing, check box F in Part II of Form 2210. Remember that for 2010, the usual estimated tax rules apply again. You must prepay 100% of your tax bill for 2009, or 110% of it if your 2009 adjusted gross income was more than \$150,000.

BUSINESS TAXES

A builder's payments for a breach of warranty don't get special tax relief.
Losses due to these expenses cannot be carried back for up to 10 years, the Service says in a private ruling. That break is limited to product liability losses. Here, the company incurred costs to correct workmanship defects in homes it built, such as damage caused by poorly installed windows, leaky pipes or ground settling. In the Revenue Service's view, the 10-year carryback is available only for losses that are attributable to safety defects, such as personal injuries or property damage caused by an unsafe product. Deficiencies in the construction process don't qualify.

ENFORCEMENT

400 colleges and universities will be seeing IRS auditors this year.
Unrelated business income will be a major focus of the examinations. A survey of schools a couple of years ago caused IRS to suspect that many colleges aren't paying taxes on income from activities unrelated to their tax-exempt purpose, such as gym memberships and stadium advertising. Executive pay will be eyed, too.

Municipalities issuing Build America Bonds are getting more scrutiny.
These taxable municipals debuted last year and come with a 35% federal subsidy that can go either to the issuers to reduce their borrowing costs or to investors as a tax credit for 35% of the interest. All issuers that received the subsidy directly will soon get a four-page questionnaire from IRS. It asks about their procedures for making sure that their bonds remain in compliance with tax rules and qualify for the subsidy. IRS hopes to nip bogus or excessive subsidy claims in the bud.

The Service is teaming up with the Securities and Exchange Comm.
to monitor and regulate the municipal bond market. Any hanky-panky uncovered in IRS' review of Build America Bond issuers will be shared with market regulators.

Treasury clears up confusion on disclosing foreign financial accounts.
Non-U.S. citizens are exempt from the reporting rule, which now applies to U.S. citizens or residents with any overseas accounts totaling more than \$10,000. The agency scrapped an earlier attempt to broaden the definition of who must report on financial accounts held overseas to include anyone doing business in the U.S.

And the IRS offers one last respite on the disclosure requirement for folks
who have signature authority over, but no financial interest in, a foreign account: They have an additional year, to June 30, 2011, to start reporting. The disclosures are made on Treasury Form 90-22.1. Employees of banks and brokerage houses who have signature authority over client accounts are exempted from filing reports.

There is also good news for pension plans: The new rules exempt accounts that invest in offshore hedge funds...an investment vehicle often used by pensions.

IRS gives small firms one more reprieve from stiff tax shelter penalties.
The moratorium continues through May 31. Congress will soon pass a bill capping penalties at 75% of tax benefits derived from a transaction that IRS deems to be a shelter. In the meantime, IRS examiners will hold off on collecting penalties if they discover shelter investments while doing audits of small business owners.

IN CONGRESS

Rep. Rangel's abdication at Ways & Means won't have much effect on taxes.
Speaker Pelosi has been calling the shots on big tax issues in recent years, and will keep doing so. Past chairmen of Ways & Means used to wield a lot of power. But Rangel's influence began to wane long ago on account of his ethics problems.

Yours very truly,

The Kiplinger Editors
THE KIPLINGER WASHINGTON EDITORS

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