

TAX NEWS

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TAX CLIENT NEWSLETTER

CONGRESSIONAL UPDATE

DEBT CEILING DEAL REACHED, TAX CHANGES MAY RESULT

Congress and the President reached an agreement on the debt ceiling increase in August, just one day before the U.S. was scheduled to run out of borrowing power. Under the new law, the debt ceiling was raised by \$900 billion immediately and will be raised again by either \$1.5 trillion or \$1.2 trillion later, depending on the next round of spending reductions. This increase should tide over the U.S. Treasury until 2013, after the next elections. Spending will be cut by at least \$2.4 trillion over 10 years. There are no tax increases in the first phase of the agreement, but tax changes could come into the mix in the next phase of the deficit reduction plan.

Deficit Reduction 'Supercommittee' Named

The debt-ceiling bill created a bipartisan Congressional committee, commonly known as the "Supercommittee," to produce \$1.5 trillion in deficit reduction. The Supercommittee is not limited to spending cuts. It can recommend tax increases or tax loophole closers as well. The 12-member Supercommittee is slated to make its recommendations by Thanksgiving. The recommendations will then be subject to an up or down vote in Congress by December 23rd with no amendments allowed.

The members of the Supercommittee include three House and three Senate members appointed by Republicans and three House members and three Senators appointed by Democrats. A majority of the 12 members must support the package for it to pass. Therefore, with six Democrats and six Republicans, only one member would have to defect from each party to obtain that majority.

The Supercommittee did not send something to Congress, so automatic spending cuts will take effect. The cuts will be split 50/50 between domestic and defense spending. However, Social Security, Medicare and low-income

assistance programs are exempt from the automatic cuts. This means that the Defense Department could face steep cuts because defense spending is such a large part of the non-entitlement budget.

The Tax Angle

Right now, the Bush tax cuts are set to expire at the end of 2012. One thing is clear. Under the new debt-ceiling plan, tax changes are still on the table. If the bipartisan Supercommittee does not include tax reform in its deficit reduction proposals or if Congress does not approve the Supercommittee's plan, the battle on extension of the Bush tax cuts moves to election season 2012.

WHAT IS THE DEBT CEILING?

The debt ceiling is a cap set by Congress on the amount of money the federal government can legally borrow. The federal government borrows money primarily by issuing Treasury bonds. The limit applies to debt owed to those who buy Treasury bonds including individual investors, foreign governments and pension funds. It also applies to intragovernmental debt—that owed to federal government trust funds such as Social Security and Medicare.

TRADE BILL HAS HEALTH TAX CREDIT FOR WORKERS WHO LOSE EMPLOYER COVERAGE

The House and the Senate have been working on legislation on trade adjustment assistance that contains a tax provision designed to help workers and retirees who lose employer-provided health insurance coverage. The bill, H.R. 2832, increases the health coverage tax credit under the U.S. Trade Adjustment Assistance (TAA) Program. The TAA Program is a federal program that provides aid to U.S. workers who have lost their jobs as a result of foreign trade.

The Health Coverage Tax Credit program provides health insurance benefits to TAA-eligible workers and retirees covered by pension

plans taken over by Pension Benefit Guaranty Corporation who have lost their employer-sponsored coverage. The amendment subsidizes 72.5 percent of the cost of the health care premium, gives workers retroactive payments to help cover the up-front costs of health coverage, and gives coverage to the worker's spouse and dependents.

The Senate's version of the bill is different from the House version, so the measure must go back to the House for another vote before it becomes law. The outlook on this legislation is good, as the two sides are close to final agreement.

IRS UPDATE

NEW IRS VOLUNTARY WORKER CLASSIFICATION PROGRAM OFFERS PAST PAYROLL TAX RELIEF

The IRS has launched a new program that allows employers an amnesty of sorts if they agree to reclassify their workers as employees rather than independent contractors. If you want to participate in the program, you would be required to make a minimal payment covering past payroll taxes before the IRS audits you.

Specifically, under the new Voluntary Classification Settlement Program (VCSP), you as an employer can make a payment of just over one percent of the wages paid to reclassified workers for the past year. You also must agree to treat the covered workers as employees instead of independent contractors going forward.

According to the IRS literature, the program is available to many businesses, tax-exempt organizations and government entities that currently "erroneously treat their workers or a class or group of workers as nonemployees or independent contractors, and now want to treat these workers as employees to avoid an audit and IRS reclassification."

Here are the eligibility rules:

- You must have consistently treated the workers in the past as nonemployees.

- You must have filed all required Forms 1099 for the workers for the previous three years.
- You must currently *not* be under audit by the IRS, the Department of Labor or a state agency concerning the classification of these workers

No interest or penalties will be due, and you will *not* be audited on payroll taxes related to these workers for prior years. If you are interested in applying for this program, please contact me.

EMPLOYER-PROVIDED CELL PHONES TAX-FREE UNDER NEW RULES

New IRS rules greatly ease the burden on employers who provide their employees with cell phones by lifting the detailed recordkeeping requirements. Now, if an employer provides an employee with a cell phone primarily for business reasons, the business *and* personal use of the cell phone is tax-free to the employee. For this rule to apply, there must be substantial business reasons, other than for compensation, morale or goodwill, for giving the employee a cell phone. This tax treatment is retroactive to the beginning of 2010.

Cell-Phone Reimbursements

A similar rule applies when an employer reimburses an employee for cell phone expenses. If an employer requires employees to use their personal cell phones for business purposes, reimbursements of employees' expenses are not taxable. However, the employer can only reimburse the employee for reasonable expenses, not for excessive or unnecessary cell phone expenses.

Examples of Business Reasons for Phone

Here are some examples demonstrating acceptable business reasons for reimbursing an employee for a cell phone:

- The employer's need to contact the employee at all times for work-related emergencies.
- The employer's requirement that the employee be available to speak with clients at times when the employee is away from the office or outside of the employee's normal work schedule (such as when clients are in different time zones).
- The employee must communicate with clients outside of business hours and the employee's basic coverage plan charges a flat-rate per month for a certain number of minutes for domestic calls. The employer can reimburse the employee for the monthly basic plan expense.

Examples of Excess, Taxable Reimbursements

The IRS gives the following examples of reimbursement arrangements that may exceed the employer's needs and, therefore, should be examined:

- Reimbursement for international or satellite cell phone coverage to a service technician whose business clients and other business contacts are all in the local geographic area where the technician works.
- A pattern of reimbursements that deviates significantly from a normal course of cell phone use in the employer's business. For example, if an employee received reimbursements for cell phone use of \$100/quarter in quarters 1 through 3, but receives a reimbursement of \$500 in quarter 4.

PROOF OF DOCUMENT DELIVERY TO IRS

The IRS has changed what it will consider proof of delivery for documents that taxpayers send in under a filing deadline. The new rules allow proof of delivery for not only registered or certified U.S. mail, but also when taxpayers use a private delivery service, such as FedEx or UPS. The problem is that not all services offered by private delivery companies qualify. Therefore, if you have a document that needs to get to the IRS by a certain deadline, you must make sure you use a service that offers adequate proof that your document got there. I will be glad to assist you with any required mailings or answer questions you may have on how to do it yourself. Remember, if you are late filing required documents with the IRS, you will be subject to interest and possibly penalties.

TAX RELIEF FOR DISASTER VICTIMS

The U.S. has had its share of natural disasters this year, including flooding, wildfires, and the ravaging effects of Hurricane Irene. The IRS provides relief to individuals and business taxpayers affected by these disasters in the form of extended filing and payment deadlines. The states eligible for relief and the deadlines that apply are constantly changing. If you believe you may qualify, I will be glad to determine your eligibility and take the necessary steps to ensure you benefit from this program.

IRS EXTENDS 2010 ESTATE FILING DEADLINES

The IRS has extended the filing deadlines for large estates of people who died in 2010. These estates will now have until early next year to file required returns and pay any

estate taxes due. In addition, the IRS is providing penalty relief to beneficiaries of these estates on their 2010 federal income tax returns. This relief is designed to give large estates, normally those over \$5 million, more time to comply with key tax law changes enacted late last year.

NEW LIMITS FOR HEALTH SAVINGS ACCOUNTS

The IRS has set the inflation-adjusted limits that will apply in 2012 to Health Savings Accounts and to out-of-pocket spending for high-deductible health plans.

Annual contribution limitation. For calendar year 2012, the annual limitation on deductions for someone with self-only coverage under a high deductible health plan is \$3,100. For a family, the annual limitation is \$6,250.

High deductible health plan. For calendar year 2012, a "high deductible health plan" is a health plan with an annual deductible that is not less than \$1,200 for self-only coverage or \$2,400 for family coverage.

IRS RELENTS AND INCREASES STANDARD MILEAGE RATE FOR LAST HALF OF 2011

After saying for months that it would not, the IRS has increased the standard mileage rate for computing the deduction for business use of a vehicle for the last half of 2011. Beginning July 1, 2011, the business mileage rate will be 55.5 cents, up from the existing 51 cents. The revised rate for medical or moving mileage is 23.5 cents, up from the existing 19 cents. The mileage rate for charitable use of an automobile is fixed by Congress and remains at 14 cents. This modification results from recent increases in the price of fuel. What this means for you is that for tax year 2011, miles driven in the first half of this year will be deducted at a lower rate than miles driven during the last half of the year. This split-year rate also occurred in 2008.

IRS AGAIN EXTENDS WITHHOLDING ON PAYMENTS TO GOVERNMENT CONTRACTORS

The IRS has extended for an additional year the 3% withholding on payments made to government contractors. Now the withholding obligation will not begin until 2013. Proposed regulations issued in 2008 require Federal, State, and local governments to withhold income tax when making payments to contractors for property or services. The rule is controversial and the effective date keeps getting extended. Congress may eventually repeal the provision.

BIG CHANGES FOR SMALL ORGANIZATIONS

Approximately 275,000 organizations have automatically lost their tax-exempt status because they did not file legally required annual reports for three consecutive years. Most of these are small nonprofits that are required to file the Form 990-N e-postcard. Many of these organizations are recreation sponsors, local art groups, or local environmental stewards. If your organization was dropped from the approved list, you can apply for reinstatement with the IRS by December 31, 2011. I will be glad to help you with this filing.

IRS GIVES UP ON TWO-YEAR LIMIT FOR MANY INNOCENT SPOUSE REQUESTS

In a complete reversal of its position, the IRS announced that it will eliminate the two-year limit it imposed on “equitable” innocent spouse claims. The IRS took the unusual action after a number of embarrassing losses in the Tax Court and under heavy pressure from Congress, including Republican presidential candidate Rep. Michele Bachmann, R-Minn. Innocent spouse relief is designed to help a taxpayer who did not know that his or her spouse understated or underpaid an income tax liability on a joint return.

Under regular innocent spouse relief, spouses must petition for status as an innocent spouse within two years of when the IRS first tries to collect. The equitable provisions, added later, allow a spouse to apply for innocent spouse status when the spouse does *not* qualify for regular relief but it would be inequitable to hold the spouse liable. Congress did not put a two-year limitation on equitable relief, but the IRS wrote regulations with the two-year time limit. Equitable innocent spouse relief is frequently sought in situations of spousal abuse.

PROPOSED RULES ON HEALTH INSURANCE TAX CREDIT

The Treasury Department has issued proposed regulations on the tax credit for health insurance premiums that is directed at the middle-class. The guidance also explains the rules for enrollment in plans through insurance exchanges. Under the Obama health care Act, individuals and small businesses can buy private health insurance through state-based insurance exchanges. To enable taxpayers to buy this insurance, the Act allows a refundable tax credit for health insurance premiums. The rules are effective beginning in 2014.

Eligibility and Advance Payments

The premium tax credit is available to individuals and families with incomes between 100% and 400% of the federal poverty level (\$22,350–\$89,400 for a family of four in 2011).

Larger tax credits apply for older Americans who face higher premiums. Projections show that individuals receiving the credits will get an average subsidy of over \$5,000 per year. For lower-income families, the Treasury department will make an advance payment directly to insurance companies as an advance on the credit. Later, the advance payment will be reconciled against the amount of the family’s actual premium tax credit, as calculated on the family’s federal income tax return.

Other requirements are:

- Covered individuals must be enrolled in a “qualified health plan” through an Affordable Insurance Exchange.
- Covered individuals must be legally present in the United States and not incarcerated.
- Covered individuals must not be eligible for other qualifying coverage, such as Medicare, Medicaid, or “affordable” employer-sponsored coverage.

‘Affordable’ Employer Plans

The credit is only available if the taxpayer does not have “affordable” coverage through his or her employer. Under the regulations, plans are not affordable if the self-only premium exceeds 9.5% of household income or the plan fails to cover 60% of total allowed costs.

IRS GIVES TRUCKERS 3-MONTH EXTENSION FOR HIGHWAY USE TAX RETURNS

The IRS has extended for three months the due date for federal highway use tax returns filed by truckers and other owners of heavy vehicles. Instead of being due on August 31st, the returns will be due on November 30, 2011. The \$550 per vehicle highway use tax applies to trucks, truck tractors, and buses with a gross taxable weight of 55,000 pounds or more. Ordinarily, vans, pick-ups and panel trucks are not taxable because they fall below the 55,000-pound threshold. Special rules apply to vehicles with minimal road use, logging or agricultural vehicles, vehicles transferred during the year and those first used on the road after July.

State Registration Process

Under new rules issued with the extension, states are required to accept as proof of payment last year’s stamped Schedule 1 of Form 2290 through the November 30th filing date. Normally, states can only accept a prior year Schedule 1 up until October 1st. If you acquire and register a new or used vehicle during the July-to-November period, your state must register the vehicle without proof that the highway use tax was paid. You must present a copy of the bill of sale showing that the vehicle was purchased within the previous

150 days. Some State governments may not be aware of this change. If you have tried to register a vehicle and had problems, let me know and I will provide you with the IRS Notice to take to your State registration office.

CLIENT ADVISORIES

YOUR ACCOUNTING SOFTWARE FILES FAIR GAME FOR IRS, USE CAUTION IN KEEPING RECORDS

The IRS maintains that, in conjunction with an audit, it has the authority to require taxpayers to turn over their complete electronic accounting records, including data files created by programs like QuickBooks® and Quicken®. The IRS recently instructed its auditors on how to handle these software requests. The IRS says it will ignore irrelevant data and confidential information, but this claim is not realistic, especially given that the rules of evidence do not protect the taxpayer in this situation.

Tax professionals are concerned about the potential for IRS receiving private or privileged records, information from years not under audit, and non-tax business information, such as customer lists. It is common for businesses to use their accounting software as their daily planner, their checkbook, and their business contact list. This broad use of electronic files becomes problematic when the data is released to the IRS during an audit. Handing over the entire data file can expose you to an expanded audit. Unfortunately, the software programs are not designed to let you block portions of the data from review by the IRS.

To the extent possible, the following types of information should be kept separate from your electronic accounting records to prevent disclosure to the IRS:

- A. Divorce Financial Affidavits;
- B. Client Lists;
- C. Client Addresses and Phone Numbers;
- D. Tax Planning Documents;
- E. Billing Information;
- F. TAX IDs of Customers, Clients, and Business Associates; and
- G. Payment Form (Check or Cash).

Example: An example of over disclosure can be illustrated by the inclusion of a Divorce Financial Affidavit in a taxpayer’s accounting software records. These affidavits show monthly income and expenses, with a proposed budget for the taxpayer going forward. If a divorce financial affidavit is included in the taxpayer’s electronic tax records, IRS could scrutinize any tax issue raised by the divorce, even if the IRS was not auditing the taxpayer on any divorce issue.

Multiple Years Another Problem

Another major issue is the number of years included in the electronic data. Every tax year stands independent of the other. Therefore, turning over multiple years of accounting data is a problem and can result in an audit of additional tax years. Software should allow for firewalls to exist between the years, but currently, it is difficult to separate different years in the accounting data, although there are some ways to work around the problem.

What Should You Do?

Extreme caution should be the focus when maintaining your electronic personal and business financial records going forward. To the extent possible, use different programs and data files to maintain your personal records, financial planning records, and nontax business records, such as customer lists. In addition, pressure should be brought upon software vendors to make them adjust their software to allow this partitioning of data.

I will be monitoring the IRS's practices in this regard and will keep you apprised of any new developments. I will be glad to discuss with you how to implement these suggestions.

RULES FOR DEDUCTION OF EMPLOYEE BUSINESS EXPENSES

If you itemize deductions and you work as an employee, you may be able to deduct certain work-related expenses. However, the rules for deducting employee business expenses can be complicated. One source of confusion for taxpayers is that, unlike the business expenses of self-employed persons, unreimbursed expenses of W-2 employees are treated unfavorably. Self-employed persons may take above-the-line deductions for business expenses. Regular employees must itemize to take business expense deductions and the deduction is limited.

Expenses that qualify for an itemized deduction include:

- Business travel away from home
- Business use of car
- Business meals and entertainment
- Travel
- Use of your home
- Supplies
- Tools
- Miscellaneous expenses

Only *unreimbursed* expenses qualify for the deduction. If your employer reimburses you under an IRS qualified plan, the reimbursements are not included in your income and you may not deduct the reimbursed amounts. Only employee business expenses that are in excess of 2% of your adjusted gross

income can be deducted. For example, if you have \$50,000 in adjusted gross income, 2% of that is \$1,000. Therefore, you may only deduct expenses that exceed \$1,000. Of course, it is important to keep good records to prove any unreimbursed business expenses you may have during the year.

SAFEGUARDING TAX RECORDS

It is important to keep your financial information safe. I have two important recommendations:

- You should create an electronic set of backup records and store the records away from the original set.
- You should document your ownership of valuables by photographing or videotaping your home and its contents.

START-UP AND ORGANIZATIONAL EXPENSES ARE DEDUCTIBLE

It is important to know that the tax laws allow you to deduct a portion of your business start-up expenses. Typical types of start-up expenses include fees paid to consultants, fees for legal services, advertising costs, employee training costs, and travel and related expenses to find potential distributors, suppliers and customers.

You can deduct up to \$5,000 of expenses in the year you begin your trade or business. The deduction is targeted to small businesses. Thus, if your start-up expenses exceed \$50,000, the \$5,000 must be reduced dollar for dollar by the amount that exceeds \$50,000. For example, if your start-up expenses are \$52,000, you may only take a \$3,000 deduction. The rest of the start-up expenditures can be deducted over 180 months beginning with the month the business begins.

VOLUNTEER TAX PREPARERS HAD DECLINING ACCURACY RATES, TREASURY STUDY FINDS

Fewer tax returns are being prepared accurately by volunteer tax preparers, according to a new Treasury Department study. The report found that accuracy rates for tax returns prepared at Volunteer Program sites during 2011 decreased from the 2010 filing season. Of the 36 tax returns prepared for Treasury auditors, only 14, or 39 percent, were prepared correctly. Volunteers prepared the tax returns inaccurately because they did not follow all guidelines, used intake sheets incorrectly or, in some cases, knowingly modified the facts the auditors presented, Treasury said. The Treasury study has been criticized as having been based on too small a sample of returns.

IRS's Numbers Better

In its own study, the IRS reported an overall, weighted accuracy rate of 87.18%. The errors the IRS found include interest income, other income, and itemized deductions. In most cases, the identified errors included incorrect tax law determinations. The IRS said it will use these findings to assist in updating quality forms and improving volunteer training materials for the 2012 filing season.

Observations: The Volunteer Income Tax Assistance program funded by IRS grants is an important service for low-income and elderly taxpayers. However, the volunteer preparers are not subject to the same standards imposed on private tax preparers. Given these findings, perhaps volunteer preparers also should be subject to the competency testing and continuing education requirements currently in force for private tax preparers.

Thank You for Your Business

As your tax professional, I assure you that I will be keeping a watchful eye on Congress and on IRS actions which may affect your personal finances and your business. I will be happy to address any concerns and answer questions you have about any of the issues covered in this newsletter. Thank you for the opportunity and privilege of allowing me to serve as your tax professional.

Best regards,

