# TAX NEWS

Winter 2010 TAX CLIENT NEWSLETTER

## CONGRESSIONAL UPDATE

### NEW SMALL BUSINESS HEALTH CARE CREDIT AVAILABLE ON 2010 RETURN

If you are a small employer and you paid at least half of the premiums for health insurance coverage for your employees in 2010, you may be eligible to claim the new small business health care credit. It is specifically targeted to help small businesses and tax-exempt organizations that primarily employ moderate- and lower-income workers. The IRS recently has released the form for claiming the new credit which contains a complicated calculation to determine eligibility and the amount of the credit. If you are eligible, I will file the new form with your 2010 return so you can get the credit as part of your general business credit.

Here is a summary of the eligibility rules.

- You must have fewer than 25 full-time equivalent employees for the tax year.
- The average annual wages of your employees for the year must be less than $50,000.
- You must contribute at least 50% of the employees' premiums.

The credit applies both to employers who offer health insurance coverage to their employees for the first time and those who maintain coverage they already have. You also can qualify if you cover your workers through a multiemployer health plan.

#### Amount of Credit, Time Limits

Small businesses can claim the credit for 2010 through 2013 and for any two years thereafter. For tax years 2010 to 2013, the maximum credit is 35 percent of premiums paid. Beginning in 2014, the maximum tax credit will increase to 50 percent of premiums paid by eligible small business employers. The maximum credit goes to smaller employers — those with 10 or fewer full-time equivalent (FTE) employees — paying annual average wages of $25,000 or less. The credit is completely phased out for employers that have 25 or more full-time equivalents or that pay average wages of $50,000 or more per year. Note that the eligibility rules are based not on the total number of employees but on the number of *full-time equivalent* employees. Therefore, if you use part-time workers, you still may qualify even if you employ more than 25 individuals.

### HEALTH CARE COVERAGE REPORTING DELAYED UNTIL 2012

In October, the IRS announced that reporting the cost of an employee's coverage under an employer-sponsored group health plan on Form W-2 will not be required for Forms W-2 issued for 2011. This announcement was a relief for payroll administrators. The IRS determined that the relief is needed to provide employers with more time to make any necessary changes to their payroll systems or procedures to prepare for complying with the reporting requirement. The new reporting requirement was enacted as part of the Health Care Act.

### BUSH TAX CUTS UPDATE

As I was preparing this newsletter, Congress and the President had reached an agreement on the expiring Bush tax cuts. The agreement still must go to a vote in Congress, but, if enacted, here are the major provisions. The Bush tax cuts will be extended for two years, 2011-2012. Expiring tax cuts also would be extended retroactively back to the beginning of 2010 through 2011. Alternative minimum tax relief would be in effect for 2010-2011. The estate tax will be reinstated in 2011 with a $5 million per person exemption and a 35% rate. (It is unclear at this point whether the compromise legislation will address the complete estate tax repeal in the 2010 tax year.) The bill also allows a 100% write-off of investments in business property and a 2% reduction in social security taxes for employees in 2011. For example, someone earning $40,000 a year would receive a $800 benefit and a $70,000 earner would save $1,400. This will result in an immediate increase in your take-home pay in 2011. Finally, the bill would extend unemployment benefits for another 13 weeks. I expect the measure will be passed by Congress and signed by the President before January 1, 2011.

### BUSINESS REPORTING RULES POSE HUGE COMPLIANCE BURDEN FOR SMALL BUSINESS

Beginning in 2012, business taxpayers must file an information return (Form 1099) for payments made to a single person or to an entity, such as a corporation or partnership, if the total payments to that person or entity exceed $600 in a taxable year. The new requirement was enacted as a $17 billion revenue raiser in the Health Care Act. The types of payments subject to the reporting rules include rent, salaries, wages, premiums, annuities, profits, commissions, fees, interest, royalties, and pensions. Returns will be due each year on January 31st. If a business fails to file the required return, the IRS will impose a penalty for each failure.

#### Credit Card Payments Are Exempt

If you pay for goods or services by credit card, you will not need to file the 1099 forms. Credit card transactions already must be reported credit card companies under different IRS rules. However, many small businesses still use cash and checks, as well as credit cards, to make payments to the same vendors. Since credit card

transactions will not be reported, businesses will have to track and keep separate reports for different types of payments made to the same vendor.

### Expanded Reporting

Some form of business reporting has been around for many years. However, the changes made by the Health Care Act greatly expand the business reporting rules and extend reporting to virtually all types of business transactions. The new rules require reporting of payments to corporations, and reporting of amounts paid for property, which were exempted under the old law. For example, if a business taxpayer purchases a used computer, the full amount paid for the computer must be reported to the IRS and a corresponding statement must be sent to the person selling the computer if it is over $600.

### Small Business Burden Significant

The new tax information-reporting requirement creates a tremendous new paperwork compliance burden for small business, according to many trade groups. Beginning in 2012, a small business owner will have to file two forms—one with the vendor and one with the IRS—for almost every business-to-business transaction. In addition, since the Taxpayer Identification Numbers of vendors is required on the form, business owners will have to track down the tax ID for each person they pay over $600 to a year. Also, business owners will have to keep track of their payments by credit card or by check or cash, so they can determine if the cash or check payments exceed $600. Small businesses usually do not have an in-house finance department to track this kind of reporting.

### National Taxpayer Advocate Issues Warning

National Taxpayer Advocate Nina Olson, in her 2010 Mid-Year Report, says her office is "concerned that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance." The report estimates that the new requirement would affect 26 million sole proprietorships, four million S corporations, two million C corporations, three million partnerships, and two million farming businesses. It is interesting that an official inside the IRS has sounded the alarm on this proposal.

### Repeal Efforts Keep Failing

Even with bipartisan opposition to the new business-to-business information-reporting requirement, Congress so far has failed to agree on several proposals to modify or abolish the rules. The Republicans blocked a repeal effort earlier in 2010 because it would have been paid for with tax increases on offshore income instead of with spending cuts. More recently in the lame duck session of Congress, both a Republican amendment and a Democrat amendment were separately voted down because each side disagreed with the other one's way to pay for the change. Besides outright repeal, other proposals still on the table include a plan to raise the annual reporting threshold from $600 to $5,000. Since the reporting requirement does not take effect until 2012, Congress has another year to work on repeal. It has been my observation that Congress does not act until the last minute. So, while I am hopeful for some modification to this provision, I am less optimistic that the issue will be settled any time soon.

### What This Means for Your Business

The effects of the new reporting requirements will be felt by all of my clients engaged in a business. For example, after 2011, you will have to file information returns for the rent you pay for your office, purchases of office equipment, and payments for delivery services, etc., if any of these transactions are not paid by credit card. What about the checks you write to Staples for office supplies? Or the amounts you pay for a leased copy machine? Unless the IRS narrows the focus of this provision, all of these normal daily transactions will have to be tracked and reported beyond the bookkeeping you already do to maintain your business. Hopefully, Congress will repeal this controversial requirement. If not, I as your tax professional stand ready to provide you with the guidance you need to comply with the new rules, and I can help you prepare the information returns you will need to file.

## NATIONAL FISCAL COMMISSION RELEASES BOLD PLAN TO REDUCE U.S. DEFICIT, TAX AND SPENDING CHANGES PROPOSED

On December 1st, the National Commission on Fiscal Responsibility and Reform issued its report containing a comprehensive plan to balance the U.S. budget by 2015. President Obama created the bipartisan Commission on February 18, 2010 by Executive Order. The panel's 66-page report, entitled "The Moment of Truth," proposes significant changes on both the spending side and the tax side of the U.S. Budget. The plan would reduce the U.S. deficit by $3.9 trillion by the year 2020 and cut debt as a share of the economy to below 60 percent by 2025. The deficit reduction would be phased in gradually to avoid harming the nation's economic recovery. Some specific proposals include cutting federal discretionary spending, increasing the income limit on social security contributions, and simplifying the tax code by eliminating or scaling back many individual deductions and credits and lowering tax rates for all taxpayers.

On December 3rd, the Commission voted 11-7 in favor of the plan. The final vote was short of the 14 votes needed to force immediate Congressional action according to the panel's rules. It was supported by three elected Republicans and three elected Democrats, along with five of Obama's appointees. Three Republicans and three Democrats voted no, along with one Obama appointee. Despite the shortfall in the vote, many members of Congress and commentators are predicting that with the bipartisan support shown by the Commission vote, Congress will at least use the final report as a comprehensive framework for addressing the U.S. deficit.

**2011 Payroll Tax Holiday:** The most immediate change advocated by the Commission is that Congress implement a temporary payroll tax holiday for employers in FY 2011 to spur economic growth. Although this would cost $50-100 billion in lost revenue, the Commission believes it would be an immediate boost to the economy and would result in job creation.

**Tax Rate Reductions and Elimination of Tax Breaks:** The plan calls for sharply reducing the tax rates, abolishing the

Alternative Minimum Tax, and eliminating or reducing most tax benefits, such as deductions, credits, and exclusions. Specifically, under one scenario, the plan would have three tax brackets, 12%, 22%, and 28%. It would eliminate all itemized deductions, so all taxpayers would take a standard deduction. All capital gains and dividends would be taxed at ordinary income rates. The mortgage interest deduction would be changed to a 12% credit and the amount of eligible mortgages would be capped at $500,000. Charitable contribution deductions would be abolished in favor of a similar 12% credit. The tax exclusion for health insurance plans and retirement contributions would be reduced. Finally, the earned income tax credit and the child tax credit would be retained, but possibly at a lower rate.

**Corporate Tax Reform:** On the corporate side, the current U.S. corporate tax rate of 35% would be lowered to 28%. The U.S. currently has one of the highest corporate income tax rates in the industrialized world. Reducing the corporate rate would help the U.S. compete for international business. The Commission also recommends that the U.S. adopt a "territorial tax system." This type of tax system taxes multinational companies only on the income they earn within the United States instead of on their worldwide income.

**Increase the Retirement Age:** The Commission also recommends increasing the social security retirement age by one month every two years after the normal retirement age reaches age 67. The Normal Retirement Age (NRA) is the age at which a person can start drawing the full amount of their social security. If a person applies for social security before reaching Normal Retirement Age, they will receive reduced benefits. At this pace, the retirement age would reach 68 in about 2050, and 69 in about 2075. The earliest age a person would be eligible for retirement would increase from 63 to 64 in step with the normal retirement age change.

**Gas Tax:** The Commission recommends gradually increasing the per gallon gas tax by 15 cents between 2013 and 2015 to fund the U.S. Transportation Trust Fund. Also, the Commission recommends limiting spending on transportation to match the revenues the trust fund collects each year.

**Congressional Action:** The Commission recommends requiring the House Committee on Ways and Means and the Senate Committee on Finance, in cooperation with the Department of the Treasury, to report out comprehensive tax reform legislation through a fast track process by 2012. Some leaders of key Congressional committees have indicated that they will put the plan to a vote, but it is unclear whether the new Republican leadership will advance the plan when they take control of the House of Representatives in 2011. Even if a bill gets introduced in Congress, there will be much opportunity for it to be revised during the legislative process.

**Fail-Safe Trigger**: The Commission also suggests that a "fail-safe" provision be put in place that will trigger across-the-board reductions of tax breaks and a corresponding reduction in tax rates if Congress and the Administration fail to act on a comprehensive plan by 2013.

**Observations:** It will be very difficult for a deadlocked Congress to enact such sweeping tax legislation. While Congress may start out with the Commission's report as a blueprint, it is unlikely that Congress will do away with such popular tax provisions as the full mortgage interest deduction, a generous charitable contribution deduction, and the lower capital gains tax rate. While I will be following the progress on the proposed sweeping plan, my interest will be focused on the possibility of a more immediate change that would benefit my clients—the 2011 payroll tax holiday.

## A SNAPSHOT OF SOCIAL SECURITY IN THE 21ST CENTURY

According to the National Fiscal Commission's report more than 50 million Americans – living in about one in four households – receive Social Security benefits, with about 70 percent going to retired workers and families, and the rest going to disabled workers and survivors of deceased workers. When Franklin Roosevelt signed Social Security into law, average life expectancy was 64 and the earliest retirement age in Social Security was 65. Today, Americans on average live 14 years longer, to age 78. They can retire three years earlier at age 62, and they spend an average of 20 years in retirement. In 1950, there were 16 workers per beneficiary; in 1960, there were 5 workers per beneficiary. Today, the ratio is 3:1 – and by 2025, there will be just 2.3 workers "paying in" per beneficiary.

# IRS UPDATE

## S CORPORATION OWNER SALARIES UNDER SCRUTINY

If you operate your business as an S Corporation and pay yourself as an owner-employee, you need to be aware of the increased attention the IRS is giving to the amount of your salary. The IRS believes that S Corporation noncompliance is a widespread problem, and it is focusing examination efforts on this type of business. Specifically, the IRS believes that S corporations tend to underpay shareholder wages, resulting in underpaid employment taxes for funding Medicare and Social Security.

### S Corporation Payroll Advantage

S Corporations are considered to have a "payroll advantage" over other forms of business. This is because an employee-owner can set the amount of his or her salary and then take the rest as profit, which is not subject to Social Security or Medicare tax. According to government reports, many S Corporation shareholders are declaring only a small amount of wages relative to the profits of the S Corporation, thereby minimizing their employment taxes. Partners who work for their firm do not have this advantage, because all partnership income is subject to employment taxes since partners are considered to be self-employed. The IRS is instructing its examiners to use comparable salary data to determine whether S Corporation owners are declaring a reasonable amount of compensation given the type of job they are doing. While it has been the conventional wisdom that you should declare at least one-half of your S Corporation income as a salary, you need to be aware of what the market rate is for the type of work you perform for your S Corporation. I will be glad to discuss this issue with you as you go into the new employment year.

## NEW IRS RULES REQUIRE ELECTRONIC DEPOSIT OF PAYROLL TAXES IN 2011

The IRS has issued regulations which require almost all businesses to use the electronic payment system for federal payroll tax deposits instead of using paper coupons. The new rules take effect beginning in 2011. Before this rule change, only those taxpayers whose annual deposits of taxes exceeded $200,000 were required to use electronic funds transfer (EFT) to make Federal tax deposits. The regulations eliminate federal tax deposits by paper coupon after 2010 because the paper coupon system will no longer be maintained by the Treasury Department. Some businesses paying a minimal amount of tax can continue making their payments with the related tax return, instead of using the electronic system. The electronic deposit system is available 24 hours a day, seven days a week. Deposits can be made online with a computer or by telephone.

## STANDARD MILEAGE RATES FOR 2011

The IRS has announced the 2011 Standard Mileage Rates used to calculate the deduction for business use of an automobile. Beginning in January 2011, the rates for use of a car, van, pickup truck or panel truck will be:

- 51 cents per mile for business miles driven
- 19 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

You always have the option of calculating the actual costs of using your vehicle rather than using the standard mileage rates, but you must be able to prove those actual costs with adequate records. The standard mileage rate for business is based on an annual study of the fixed and variable costs of operating an automobile, including the cost of gasoline.

There are some restrictions on using the standard mileage rate. A taxpayer may not use standard rates if they use certain depreciation methods. You also cannot use the standard rates for any vehicle for hire, such as a taxicab or limousine. You also must use actual costs if you use more than four vehicles simultaneously in your business.

## EMPLOYEE vs. INDEPENDENT CONTRACTOR: HOW'S A BUSINESS OWNER TO KNOW?

The classification of workers as employees or independent contractors is one of the hottest issues in tax compliance. The IRS has been conducting a payroll audit program which targets how workers are classified in different industries. The tax issue is, who is supposed to withhold and pay the payroll taxes, such as social security and Medicare? If a worker is classified as an employee, then the employer and the employee split the payroll taxes, and the employer has other responsibilities, such as contributing to Federal unemployment insurance. In that case, the employer must give the employee a W-2 form reporting the amount of the income and withholdings. On the other hand, if a worker is classified as an independent contractor, then the business that hires the worker does not have primary responsibility for employment taxes or income tax withholdings. Instead, the worker gets a Form 1099 and must pay self-employment taxes and make estimated tax payments.

Here are some things that business owners should know about hiring people as independent contractors versus hiring them as employees. If you are a business owner, the classification of your workers will affect how much you pay in taxes, whether you need to withhold from your workers' paychecks and what tax documents you need to file. If you are a worker, then it is generally better to be classified as an employee so you will not have to pay the entire amount of employment taxes by yourself.

The IRS uses three characteristics to determine the relationship between businesses and workers:

- BEHAVIORAL CONTROL: The issue here is whether the business has a right to direct or control how the work is done through instructions, training or other means.
- FINANCIAL CONTROL covers the issue of whether the business has a right to direct or control the financial and business aspects of the worker's job.
- TYPE OF RELATIONSHIP: This factor relates to how the workers and the business owner perceive their relationship.

**Here are some general guidelines that may help you determine the status of a worker:**

1. If a business has the right to control or direct not only what is to be done, but also how it is to be done, then its workers are most likely employees.
2. If a business can direct or control only the result of the work done — and not the means and methods of accomplishing the result — then its workers are probably independent contractors.

The consequences of getting this wrong can be dramatic. Employers who misclassify workers as independent contractors can end up with substantial tax bills. Additionally, they can face penalties for failing to pay employment taxes and for failing to file required tax forms. Workers can avoid higher tax bills and lost benefits if they know their proper status.

As your tax professional, I can help you make this determination. If you want to be sure that the IRS will accept your classification, I can ask the IRS for a determination of the status of your workers or, if you are a worker, of your status as an employee or independent contractor.

## IRS STOPS GIVING DEBT INFORMATION TO TAX REFUND LENDERS

Beginning with the upcoming 2011 filing season, the IRS will no longer provide tax preparers and financial institutions with a so-called "debt indicator" which lenders use to determine a taxpayer's eligibility for a refund anticipation loan (RAL). RALs are loans made to taxpayers in anticipation of their receipt of a tax refund. The IRS debt indicator signals whether a taxpayer's refund may be offset for delinquent tax or other debts such as unpaid child support or delinquent federal student loans. Without this information, many lenders are predicting that they will not be able to make refund anticipation loans to taxpayers. The large tax preparation firms have vigorously opposed the move as making it more difficult for low-income taxpayers to have access to this type of loan. On the other side, consumer groups approve the move, because they claim that refund anticipation loans represent extremely high-interest loans marketed to low-income, unsophisticated consumers. No matter which side you are on, it is likely that the IRS's decision will reduce the number of tax refund loans available to taxpayers this filing season.

## IRS ALLOWS INCREASED LIMIT ON MORTAGE INTEREST DEDUCTION

In a surprising move, the IRS has ruled that deductible home equity debt may exceed the $1 million limitation normally imposed on debt incurred by a taxpayer to acquire, construct, or substantially improve a principal residence. The Internal Revenue Code limits qualified residence interest to $1 million for "acquisition indebtedness" but also sets a limit of $100,000 for other home equity indebtedness secured by a qualified home. The new ruling holds that residence interest exceeding the $1 million limit may still be deductible as home equity indebtedness.

The ruling provides the following example. In 2009, an unmarried taxpayer purchased a principal residence for its fair market value of $1,500,000. The taxpayer paid $300,000 and financed the remainder by borrowing $1,200,000 through a loan that is secured by the residence. In 2009, the taxpayer paid interest on the indebtedness during that year. The taxpayer has no other debt secured by the residence. According to the IRS, the taxpayer may deduct, as interest on "acquisition indebtedness," interest paid on $1,000,000 of the $1,200,000 indebtedness used to acquire the principal residence. The taxpayer also may deduct, as interest on "home equity indebtedness," the interest paid on $100,000 of the remaining indebtedness of $200,000. Therefore, for 2009, this taxpayer may deduct interest paid on indebtedness of $1,100,000 as qualified residence interest. Any interest the taxpayer paid on the remaining indebtedness of $100,000 is nondeductible personal interest.

## TIPS FOR MAKING CHARITABLE DONATIONS

The rules for taking charitable contribution deductions have been tightened up significantly over the last several years. The IRS used to take it on faith that taxpayers were reporting charitable amounts accurately. Now, you must carefully document the amount of the deduction. Here are some important guidelines for claiming charitable contribution deductions.

1. Charitable contributions must be made to **qualified** organizations to be deductible. Qualified organizations are generally public charities, such as churches, schools, and service nonprofits. You can ask any organization whether it is qualified and most will be able to tell you. If you are not sure, contact me and I will check into it for you.
2. Charitable contributions are deductible only if you itemize your deductions. You cannot take a charitable contribution if you use the standard deduction.
3. Cash contributions and the fair market value of property donated to a qualified organization can be deducted. For household items, including clothing, furniture, appliances, electronics, and linens, the items must be in good condition or better.
4. For donations of cars, boats, or other vehicles, you can deduct the amount the organization sells the vehicle for, or, you can deduct the fair market value on the contribution date. The IRS is scrutinizing vehicle donations carefully, so you need to document the value of the vehicle when you donate it. **Hint:** One way to document the value is to print out valuations from the used car sites, such as Edmunds or Kelley Blue Book. You also can find similar items for sale on Ebay or AutoTrader. Print out and save your comparables.
5. If you make a contribution and receive something in return, such as a magazine, tote bag, or admission to a charity banquet or sporting event, you can only deduct the amount that exceeds the value of the benefit you receive in return. The charity sometimes will give you that value, but you also should be careful to note the approximate value of what you receive in return at the time of the donation.
6. Keep good records of any contribution, regardless of the amount. For contributions made in cash, there must be (1) a bank record, including a cancelled check or a bank or credit card statement, (2) a written record from the charity containing the date and amount of the contribution and the name of the organization, or (3) a payroll deduction record.
7. Deductions include credit card charges and payments by check in the year they are given to the charity, even if the credit card bill will not be paid or the bank account will not be debited until the next year.
8. For any contribution of $250 or more, you must have written acknowledgment of the gift from the organization to substantiate the donation. This written proof must include three things: 1) the amount of cash, 2) a description and good faith estimate of value of any property contributed, and 3) whether the organization provided any goods or services in exchange.
9. To deduct charitable contributions of property valued at $500 or more, you must include a special IRS form with your return. I can prepare this form for you, but I will need accurate records of the items contributed and the value of your contributions.
10. You must get an appraisal if you claim a deduction for more than $5,000 for a contribution of property. This type of deduction also must be included on the special IRS form.

## REPAIR COSTS RESULTING FROM CORROSIVE DRYWALL MAY BE TREATED AS CASUALTY LOSS

If you have suffered property losses due to the effects of imported drywalls installed in your home between 2001 and 2009, you may qualify for some relief. The IRS has issued guidance allowing homeowners who have suffered such property losses to treat the damages as a casualty loss. Homeowners with the so-called "Chinese drywall" have reported blackening or corrosion of copper electrical wiring and copper components of household appliances, as well as the presence of sulfur gas odors. In November 2009, the Consumer Product Safety Commission reported a strong association between the problem drywall and levels of hydrogen sulfide and corrosion of metals.

The new IRS rules allow taxpayers to deduct repair costs as a casualty loss. The amount of loss may be limited depending on whether you have a pending claim for reimbursement or if you intend to pursue reimbursement.

## IRS ANNOUNCES PENSION PLAN LIMITATIONS FOR 2011

The IRS has announced cost-of-living adjustments affecting dollar limitations for pension plans and other retirement-related items for tax year 2011. In general, these limits are unchanged, or the inflation adjustments for 2011 will be small. Highlights include:

- The contribution limit for employees who participate in section 401(k), 403(b), or 457(b) plans, and the federal government's Thrift Savings Plan remains unchanged at $16,500.
- The catch-up contribution limit under those plans for those aged 50 and over remains unchanged at $5,500.
- The phase-out range for the deduction for taxpayers making contributions to a traditional IRA remains unchanged for singles and heads of household at the income level of between $56,000 and $66,000. For married couples filing jointly, in which the spouse who makes the IRA contribution is a participant in an employer plan, the income phase-out range is $90,000 to $110,000, up from $89,000 to $109,000. For an IRA contributor who is not an active participant in an employer plan and is married to someone who is an active participant, the deduction is phased out if the couple's income is between $169,000 and $179,000, up from $167,000 and $177,000.
- The income phase-out range for taxpayers making contributions to a Roth IRA is $169,000 to 179,000 for married couples filing jointly, up from $167,000 to $177,000 in 2010. For singles and heads of household, the income phase-out range is $107,000 to $122,000, up from $105,000 to $120,000. For a married individual filing a separate return who is an active participant in an employer-sponsored retirement plan, the phase-out range remains $0 to $10,000.
- The income limit for the saver's credit for low-and moderate-income workers is $56,500 for married couples filing jointly, up from $55,500 in 2010; $42,375 for heads of household, up from $41,625; and $28,250 for married individuals filing separately and for singles, up from $27,750.

**Note:** The income limits apply to Adjusted Gross Income (AGI), not gross income. Therefore, you get to take certain deductions before measuring your eligibility for retirement plan contributions.

# TAX PLANNING

## YOU MAY GET CREDIT FOR 2010 ENERGY EFFICIENT IMPROVEMENTS

If you made improvements to your home during 2010 that resulted in energy efficiencies, you may be eligible to claim a generous credit on your 2010 tax return. The Nonbusiness Energy Property Credit, enacted as an economic stimulus measure, is a tax credit for making energy efficient improvements to homes. The credit is time-limited to years 2009 and 2010 unless Congress extends it beyond 2010. Here are several things you need to know about claiming this credit:

- The credit is for 30 percent of the cost of all improvements up to $1,500.
- The credit applies to improvements such as adding insulation, energy-efficient exterior windows and energy-efficient heating and air conditioning systems.
- To qualify as "energy efficient", products must meet set government standards.
- Manufacturers must certify that their products meet the standards, and they must provide a written statement to the taxpayer, such as with the packaging of the product or in a printable format on the manufacturers' website.

Note that the improvements must be made to your principal residence. If you have made these types of improvements, let me know and I will file the special credit form with your 2010 tax return. Tax credits are the most beneficial type of tax break because they reduce your actual tax liability dollar for dollar.

## AMERICAN OPPORTUNITY TAX CREDIT OFFERS BIG REDUCTION IN COLLEGE EXPENSES

The American Opportunity Tax Credit (AOTC) was created as part of the American Recovery and Reinvestment Act, enacted in February 2009. For tax years 2010, the law allows families with tuition expenses to receive a tax credit of up to $2,500 per student. Up to $1,000 per year of this amount is refundable. The new credit replaces the former Hope Scholarship credit for Tax Years 2009 and 2010, but it is set to expire after 2010. The American Opportunity Credit reduces the cost of college substantially because it is available for four years of college while the Hope credit was only available for the first two years of higher education. If the AOTC is made permanent, as proposed in the President's FY 2011 Budget, a student could receive a credit of up to $10,000 over four years.

The credit is computed as 100 percent of the first $2,000 in tuition and 25 percent of the next $2,000. Therefore, the full $2,500 credit may be available to a taxpayer who pays $4,000 or more in tuition expenses for an eligible student.

According to statistics released by the Treasury Department, the credit:

- Increased tax incentives for higher education by over 90%, or $8.7 billion, in 2009.
- 12.5 million students and their families received a tax benefit for college in 2009, an increase of 400,000 from 2008.
- Credit recipients in 2009 received an average tax credit of over $1,700.
- 4.5 million students received a refund from the credit in 2009 with an average value of $800.

### Income Limits

The full credit is available to taxpayers who make less than $80,000 a year or who make less than $160,000 for married couples filing a joint return. The credit is gradually reduced, however, for taxpayers with incomes above these levels.

### Filing Requirements

The student's name and taxpayer identification number (TIN) must be included on your return if you are claiming the credit. If the student is claimed as a dependent on someone else's return, the dependent cannot claim the credit on his or her own return. Note that it may be better for a parent not to claim the student as a dependent if the parent cannot claim the education credit because the parent's income is too high and if the student has enough tax liability to benefit from the credit.

## Coordination with Other College Benefits

In addition to the American Opportunity Tax Credit, college students and their parents are eligible for the Lifetime Learning Credit and the tuition tax deduction. However, note that you cannot claim the tuition tax deduction in the same year that you claim the American Opportunity Tax Credit or the Lifetime Learning Credit. You must choose to take either one of the credits or the tuition deduction and you should consider which is more beneficial for you. I will be glad to evaluate your individual situation and make a recommendation to you as to which education tax break would save you the most on your taxes.

## 10 MILITARY TAX TIPS

If you or a family member serve in the military, there are many special tax rules you may be able to benefit from. Set forth below is a list of some of these special tax provisions for those serving our country:

1. Members of the Armed Forces on active duty who move because of a permanent change of station can deduct unreimbursed moving expenses.

2. Individuals who serve in a combat zone as an enlisted person or as a warrant officer for any part of a month can exclude from income all pay received for military service that month. For officers, the monthly exclusion is capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received.

3. The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended for members of the military.

4. Military members prohibited from wearing certain uniforms when off duty can deduct the cost and upkeep of those uniforms. These expenses must be reduced by any allowance or reimbursement received.

5. When filing a joint return, if one spouse is not available due to military duty, a power of attorney may be used to sign the joint return.

6. Members of the US Armed Forces Reserves can deduct unreimbursed travel expenses for traveling more than 100 miles away from home to perform reserve duties.

7. Subsistence allowances paid to ROTC students participating in advanced training are not taxable. However, active duty pay – such as pay received during summer advanced camp – is taxable.

8. When transitioning back to civilian life, members of the military may be able to deduct some costs incurred while looking for a new job. Eligible expenses include travel, resumé preparation fees and outplacement agency fees. Moving expenses may be deductible if the move is closely related to the start of work at a new job location.

# COURT CASES

Hundreds of court cases between the IRS and taxpayers are decided each year. Tax professionals review these cases to understand how the courts and the IRS interpret the tax laws. Below are summaries of a few interesting cases which will give you insight into a few common issues facing taxpayers in their disputes with the IRS.

**Travel Expenses Not Deductible for Indefinite Long-Distance Employment:**
***PAUL DELTORO v. COMMISSIONER,***
**U.S. Tax Court, August 2010.**

**Issue:** The issue in this case was whether a taxpayer can deduct travel and living expenses incurred when the employment is away from his home, but is of a continuous, temporary nature in a single area. The resolution of the issue turns on whether the taxpayer's employment in the San Francisco Bay area was temporary rather than indefinite.

**Facts:** Paul Deltoro, a highly skilled oil refinery pipefitter, worked in his profession for 35 years while living in the Bakersfield, California area. In 2000, work started becoming scarce in the Bakersfield area, and Deltoro took temporary work in the Bay Area of California, a job that ran over into January 2001. Mr. Deltoro would commute to the area from Bakersfield every Monday, returning Friday evening. He rented an apartment on a month-to-month basis in the Bay Area. Throughout 2001, he worked the entire year in this fashion, missing only ten workdays while moving from job to job through his union. Deltoro claimed a deduction for the expenses he incurred away from home (Bakersfield). The IRS disallowed the deduction, and Deltoro contested that decision in U.S. Tax Court.

**Conclusion and Analysis:** The Court ruled in the IRS's favor. "Away from home" employment must be temporary, with an actual end in sight and may not be indefinite employment in a single area. In this case, the taxpayer chose not to move his personal residence to his work area. Thus, the San Francisco Bay area was the "tax home" of Deltoro since his work was all there, even though it was for an indefinite time period. Therefore, he could not take travel deductions for being away from home.

**Note:** A taxpayer's tax home is not always where the taxpayer lives, but is based on where the taxpayer works. If a taxpayer chooses to live away from his work area, the expenses incurred in traveling to work are not deductible. When the work is temporary, the expenses are deductible if the nature of the work is truly temporary, and the worker returns to work in his residence area when the temporary work ends. This issue is becoming more important to taxpayers as they travel farther to seek employment. The bottom line is that you can only take travel deductions when you are away from home if the job is truly temporary, with some fixed beginning and end.

**Appeals Court Faults IRS's Failure to Find Taxpayer's New Address in Innocent Spouse Case:**
***TERRELL v. COMMISSIONER,***
**U.S. COURT OF APPEALS, 5TH CIRCUIT, November 2010**

**Issue:** The issue in this case turned on whether the taxpayer requested innocent spouse relief on time when the IRS sent notices to her at an old address and the notices were returned to the IRS by the Post Office as undelivered. This case was an appeal of a Tax Court decision in which the Tax Court sided with the IRS.

**Facts:** Pamela R. Terrell, a resident of Texas, in September 2006 received a notice of deficiency of over $660,000 in unpaid taxes. Terrell filed a Request for Innocent Spouse Relief dated September 20, 2006 with the IRS. (Innocent spouse relief is available to married taxpayers who are not involved in improper tax filings by their spouses.) She listed her then-current address on her Request. Soon after filing the Request, she moved to a new address. The IRS mailed a confirmation of receipt of her Request to the old address, but the United States Postal Service (USPS) returned the letter to the IRS as undeliverable. The IRS sent two more notices which were returned as undeliverable. The IRS then mailed another Notice to the old address, denying innocent spouse relief. Meanwhile, Terrell filed her 2006 tax return, listing the new Dallas address as her current address. The IRS eventually searched its database and found the taxpayer's new address and re-mailed the denial Notice. Terrell filed a petition with the Tax Court for review, but the IRS and the lower court held that Terrell did not file for court review on time.

**Analysis and Conclusion: The** Circuit Court of Appeals reversed the Tax Court's ruling. They noted that the IRS had not done due diligence in discovering the taxpayer's current address, even though they had received returned mail. They determined that the returned notices were invalid, and that the taxpayer had 90 days from when she had actually received the notice of the rejection of her innocent spouse claim at her correct address to petition the Tax Court for review.

**Notes:** The Appeals Court came up with a common sense decision. The IRS had received several returned notices from the Post Office saying that they were undeliverable, yet continued to mail to this address and made no effort to find a new address or to search its own database. Had the IRS made any effort to determine the new address, including checking with the Department of Motor Vehicles or with Terrell's employer, the Court pointed out, the new address could have easily been found and the timing issue avoided. This case is significant because the taxpayer almost never wins a change-of-address case.

**Proving Separate Business Status for Schedule C Deductions:**
***SHPILRAIN V. COMMISSIONER,***
**U.S. Tax Court, September 2010**

**Issue**: The controversy in this case involved whether an employed taxpayer had a side business and could take regular business deductions for books, travel and computer expenses related to his side business.

**Facts**: Vladimir Shpilrain is a mathematics professor at City College of New York (CUNY). Besides being a professor, Shpilrain claimed that he had extensive research and travel expenses, including for trips to Russia, China and Korea, for the purpose of producing unique software elements to be sold to computer chip manufacturers. He bought over 70 books on the subject, as well as computer equipment to run the programs. Shpilrain deducted book and travel expenses on Schedule C and listed "Research and Writing" as his business. He listed his home address as the business address. None of Shpilrain's products have a commercial name. He has no patent or copyright on his works. As of trial, the professor had never sold a software program. Shpilrain's business has no Web site. Shpilrain produced no physical evidence of his product at trial and had no records to document his meetings with potential buyers.

**Analysis and Conclusion**: The IRS rejected the expense deductions and the Tax Court sided with the IRS. Although giving a number of different reasons for rejecting the expenses, including lack of potential profit, the Court stated that the taxpayer's lack of records documenting the business purpose for the expenses precluded the deductions. As the Court noted, the professor had, potentially, two trades or businesses. He was employed as a professor of mathematics, and he was engaged in research and writing on mathematical issues. "He 'wears two hats' but the 'hats' are so similar in appearance that it is difficult to tell the difference between them," the Court observed.

**Note:** If a particular expense is related to his employment as a professor, it might be deductible as an employee business expense on Schedule A, Itemized Deductions. The professor would have to show, however, that the expense was not subject to reimbursement from his employer, For an expense to be deductible as a trade or business expense on Schedule C, Shpilrain must show that the expense is not a personal expense and that the expense is that of a trade or business other than that of his services as an employee. Again, many taxpayers are holding two or more jobs during these difficult economic times. If you want to be able to deduct expenses of a side or supplemental business activity, you must keep good records and you must be able to prove the side business is a serious endeavor.

## 2010 ENDNOTE: STEINBRENNER'S ESTATE BONANZA

Never one to pass up a good deal when he saw it, New York Yankees owner George Steinbrenner managed to time his death in such a manner as to save his estate an estimated $518 million. Congress has been dragging its heels in enacting any new estate tax legislation, and so, for 2010, there is no estate tax. Publicity over the Steinbrenner case may pressure Congress to take action to reimpose the tax for 2010. Will Congress reinstate the tax and make it retroactive? Even if Congress manages to retroactively impose a tax, there will be more than a few legal challenges considering the amounts at stake. This is an another area where Congressional inaction is creating great uncertainty for tax professionals and their clients.

**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 business and your tax filings in the New Year. 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,

Service to the Tax Profession