



KEN BROWN, LTD.

Tax News

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With the end of the Congressional session nearing, tax legislation is starting to take shape. Members of Congress are notorious procrastinators, so most legislation is passed in the final weeks before the New Year. Congress surprised us this year by passing a bill in early November with several significant tax changes, including an extension of the popular homebuyers' tax credit and expanded loss deductions for businesses. The health care legislation also has significant tax provisions, including a proposed surtax on high-income earners with over \$500,000 in income in the House bill and an excise tax on health insurers in the Senate bill.

While the IRS usually does not "push" tax breaks, it has undertaken a number of public relations campaigns to remind taxpayers to take advantage of stimulus provisions before they expire. These provisions include the deduction for sales taxes on new car purchases, energy efficiency improvement credits, and the increased tax credit for higher education expenses, which are discussed in more detail below.

The somewhat Draconian IRS rules for deducting business use of cell phones are under review by the IRS and by Congress, and relief appears to be on the way. The problem is that the record keeping required to divide cell phone use between personal calls and business calls is out of proportion with the amount of the deduction for taxpayers and the cost of the deduction to the IRS.

IRS inflation adjustments are down, which will leave many tax benefits at last year's level. Another bit of bad news is that the Obama Administration is considering a program to allow the IRS to prepare tax returns for some taxpayers. As your tax professional, I find this idea alarming because of the inherent conflict of interest between the tax collector and the taxpayer. Read below for a news story on this issue and other significant tax developments in the second half of 2009.

CONGRESSIONAL UPDATE

NEW HOMEBUYERS CREDIT LAW PASSED WITH UNEMPLOYMENT BENEFIT EXTENSION

On November 6, President Obama signed into law H.R. 3548, the “Worker, Homeownership, and Business Assistance Act of 2009.” The major relief provisions are designed to further prop up the U.S. housing market and address unemployment and business losses. These tax breaks are paid for by an increase in the required estimated tax payments by corporations and by higher penalties for partnerships and S Corporations who fail to file tax returns. The Act also extends the surtax on the federal unemployment tax (FUTA) to help pay for an extension of unemployment benefits.

Homebuyers Credit Expanded

The legislation extends the \$8,000 first-time homebuyer credit through April 30, 2010, allowing homebuyers under a binding contract an additional 60 days to close after that date. (The credit was set to expire on December 1, 2009.) If homebuyers enter into a contract to buy a home before May 1, 2010, then they have until July 1, 2010 to close on the purchase and still claim the credit.

A new credit to allow homeowners to step up to a larger residence was added by the legislation. A \$6500 credit will now be available to new buyers who have lived in their current residence for at least five consecutive years during the eight-year period before the purchase of the new residence. (These credits are equal to 10% of the purchase price of the home up to either the \$8000 or the \$6500 limit.)

The Act also makes these credits available to higher-income taxpayers. Previously, the credit would phase out for single taxpayers with between \$75,000 and \$95,000 in income and married taxpayers with between \$150,000 and \$170,000 in income. The new law increases the income limits to between \$125,000 and \$145,000 for single taxpayers and between \$225,000 and \$245,000 for married taxpayers filing a joint return. As under the previous law, taxpayers will have to repay the credit if they do not live in the house for at least 36 months.

For the first time, there will be a dollar cap on qualifying residences. The credit is available only for principal residences with a purchase price of \$800,000 or less. If the new home costs more than this amount, the entire credit is lost. The Act also contains anti-fraud provisions to ensure that ineligible taxpayers do not claim the credit. Those measures include:

1. The taxpayer or the taxpayer’s spouse must be 18 years old to claim the credit.
2. Taxpayers cannot claim the credit if they are claimed as a dependent on someone else’s tax return.

3. The taxpayer must attach a copy of the settlement statement to the return on which the credit is claimed.
4. Purchases do not qualify if the taxpayer buys the home from a related person.

Service members have more liberalized rules for claiming the homebuyers credit. They are not subject to the same recapture rules, and they get additional time to qualify for the credit if they serve outside of the United States for at least 90 days in 2009 or 2010. Also, military personnel who receive payments under the Defense Housing Assistance Program (HAP) to assist them in selling a home that has declined in value do not have to report the payments as income.

Despite the fact that this credit is estimated to cost \$10.8 billion over 10 years, Congress was persuaded by statistics from the National Association of Realtors who reported in October that existing home sales rose 9.2 percent in September compared with sales in the same month in 2008 due to the homebuyer credit.

Extended Period to Take Business Losses

Under the tax law, businesses who have a loss for a particular tax year because their gross income was less than their business deductions can use the loss in another tax year. These so-called “net operating losses” (NOLs) can be carried back two years or carried forward for 20 years. The American Recovery and Reinvestment Act passed last February allowed small businesses to carry losses from 2008 or 2009 back up to five years if they had less than \$15 million in annual gross receipts. The new Act allows all businesses (except bailed-out banks) to use NOLs from 2008 or 2009 to offset profits from five previous years. In many cases, this rule will result in tax refunds for struggling businesses.

Unemployment Benefits and FUTA Surtax Extended

The new Act extends unemployment insurance benefits to out-of-work Americans in all 50 states by an additional 14 weeks. The legislation also extends benefits to jobless Americans for six additional weeks in states with unemployment levels over eight and a half percent. To pay for this extension, Congress has extended through June 30, 2011, the special surtax on employers who pay federal unemployment compensation taxes (FUTA). The permanent rate is 6%, but a temporary 0.2% surtax was added in the February stimulus law. The new Act extends this 0.2% surtax through the first half of 2011, making the FUTA rate on employers 6.2% for this time period.

Penalties on Partnerships and S Corporations

One of the revenue raisers in the Act increases the penalties for failure to file a partnership return or an S corporation return. For taxable years beginning after 2010, the base penalty will be increased by \$106 (from \$89 to \$195). This provision is estimated to raise \$1.2 billion over 10 years.

Increased Estimated Taxes on Corporations

Another revenue raiser in the bill increases the amount of required estimated taxes for large corporations with assets over \$1 billion. The tax law requires that corporations make quarterly estimated tax payments of their income tax liability. This bill increases the amount of those payments by 33%.

PROPOSALS WOULD EASE RULES FOR OFFERS IN COMPROMISE

Members of the tax-writing committee in the House of Representatives have introduced a bill to relieve taxpayers from making partial payments with their applications for an Offer in Compromise (OIC). This bill mirrors a proposal by President Obama, and so it may have a good chance of passing Congress in the next year. The bill is designed to help taxpayers who want to enter into payment agreements with the IRS, but do not have the required down payment available because they have recently lost jobs or are experiencing financial difficulties.

Under current law, a taxpayer offering to settle a tax liability must make a partial payment when submitting an offer in compromise proposal to the IRS. This partial payment can be as much as 20% of the offer amount. If the OIC application is turned down, the taxpayer's down payment is not refunded. This down payment requirement was passed into law in 2006. The National Taxpayer Advocate, Nina Olson, has reported that the number of OICs received by the IRS fell by 21 percent from Fiscal Year 2006 to Fiscal Year 2007. She attributed this decline to the down payment requirement, and she has testified before Congress that the IRS would actually bring in more money if the partial payment rules were suspended.

With the Administration, powerful Members of Congress, and the National Taxpayer Advocate all backing this change, it is likely to get some serious attention in Congress, but probably not until next year. Congress is focused on the health care legislation now and until that is out of the way, other tax reforms will have to wait.

HEALTH CARE TAX PROVISIONS

All of us are bombarded daily with information on health care reform, but usually without mention of the tax provisions in the legislation. The following is an outline of the major tax changes that may make it into any final legislation, including new taxes and penalties.

House Bill Taxes High-Income Earners

Under the House bill, which passed the House on November 7, 2009, a 5.4% income surtax would be paid by individuals earning more than \$500,000 and married taxpayers filing joint returns who make more than \$1 million per year. This surtax would be in addition to the regular 35% highest marginal income tax rate. This proposal is being criticized because the income thresholds would not be indexed for inflation.

Mandatory Coverage

Employers would be subject to new requirements that they provide health insurance to their employees. If they do not, they would be subject to a payroll tax to help fund their employees' health insurance. The new tax would be equal to 8% of their payroll earmarked to help cover expenses of employees who seek coverage through a new health insurance exchange. Small businesses with annual payrolls below \$500,000 would be exempt from coverage requirements, including the 8% payroll tax. Small businesses with 10 or fewer employees would be eligible for a tax credit for providing health care coverage.

All Americans except those below the income tax filing threshold would be required to have health insurance coverage. If they do not, they will have to pay an additional tax. The bill also limits contributions to health flexible spending arrangements to \$2,500, and imposes a 2.5% excise tax on medical devices.

Senate Plan Taxes High-Priced Health Plans

The Senate has been working on its own bill, S. 1796, the "America's Healthy Future Act of 2009." It would provide a "health care affordability tax credit" to small businesses and working families to enable them to purchase insurance through new insurance pools called "exchanges." The Senate has been cool to the idea of imposing a surtax on high-income earners or any other increased taxes on individuals. Instead, the Senate bill would pay for the new health insurance system by imposing an excise tax on health insurers who offer high-priced "Cadillac" plans. The tax would be 40% if an employer pays more than \$8,000 in premiums for individuals and more than \$21,000 for families. It would be effective for tax years beginning after 2012. Retired persons and high-risk professions, such as firefighters and construction workers, would be allowed a higher amount of employer health coverage without their health plans being subject to the tax.

Small Business Credit

The small business credit would be equal to 50 percent of the employer's contribution to health insurance for businesses with 10 or fewer employees. The credit would phase out for businesses with over 10 employees and an average wage for those employees over \$20,000. It would be unavailable for businesses with more than 25 employees and \$40,000 in average wages per employee.

Penalties and Deduction Limits

The bill captures more revenue by taxing individuals who go without health insurance coverage for three months and increasing the penalty from 10 to 20 percent for early withdrawals from health savings accounts. It disallows the use of health flexible spending plans and health savings accounts to pay for over-the-counter medicine. Like

the House bill, contributions to health flexible spending accounts would be capped at \$2,500.

Deductions for medical expenses would be even more difficult to take than they are now. Currently, you can only deduct medical expenses on your tax return if your expenses for the year exceed 7.5% of your adjusted gross income (AGI). The bill would raise this floor to 10%. So, for example, if your adjusted gross income was \$100,000, you could only deduct medical expenses which exceed \$10,000 for the tax year.

2012 Effective Date

Most provisions in the bills will not take effect until 2012, so we will all have time to study them and adjust our insurance plans and business practices. You can be assured that I will be following the health care legislation closely and will be prepared to get a jump-start on answering your questions.

IRS UPDATE

SALES TAXES ON CARS DEDUCTIBLE FOR 2009

The “cash for clunkers” program may be history, but you can still get a special deduction from the IRS if you purchased a new car before the end of the year. A provision in the American Recovery & Reinvestment Act of 2009 (ARRA) allows a deduction for state and local sales and excise taxes imposed on a car purchase. The deduction is limited to the sales and excise taxes and similar fees paid on up to \$49,500 of the purchase price of a new vehicle. You can take this deduction even if you do not itemize your deductions. However, it is subject to income limits, so you have to make under \$125,000 as an individual, or \$250,000 if you are married filing jointly to claim the full tax benefit. With 2010 models arriving in dealer showrooms, there is still time to get a new car for less.

INFLATION ADJUSTMENTS LOW FOR 2010

Inflation is a problem except when it comes to the inflation-indexing of certain tax provisions. More than three dozen tax benefits are subject to inflation adjustments. Every year, the IRS increases the value of the personal exemption, the standard deduction, tax brackets, and other tax benchmarks to keep up with the inflation rate. That is the good news. The bad news is that inflation has been so low that next year’s inflation adjustments are negligible. The returns for tax year 2010 that we prepare for you in early 2011 will reflect a slightly increased standard deduction but only for those taxpayers filing as head of household. The new amount is \$8,400, raised slightly from \$8,350. Almost all other numbers stay the same. Key provisions affecting your 2010 returns follow:

- The value of each personal and dependency exemption available to most taxpayers is \$3,650, unchanged from 2009.
- The new standard deduction for heads of household is \$8,400, up from \$8,350 in 2009. For other taxpayers, the standard deduction remains unchanged at \$11,400 for married couples filing a joint return and \$5,700 for singles and married individuals filing separately. Nearly two out of three taxpayers take the standard deduction rather than itemizing deductions, such as mortgage interest, charitable contributions, and state and local taxes.
- Various tax bracket thresholds will see minor adjustments. For example, for a married couple filing a joint return, the taxable income threshold separating the 15 percent bracket from the 25 percent bracket is \$68,000, up from \$67,900 in 2009.
- The annual gift tax exclusion remains unchanged at \$13,000.

Social Security and Nanny Tax Wage Bases Remain Unchanged

The Social Security Administration (SSA) has announced that the wage base for computing the Social Security tax in 2010 will remain at \$106,800. This means that once you have reached this amount of income for the year, you will not have to pay social security taxes on additional amounts of income for the year.

The SSA also has announced that the “Nanny tax” threshold will remain at \$1,700 for 2010. If you pay a domestic employee in your private home less than \$1,700 per year, you will not have to withhold and pay social security taxes on the employee.

IRS CONTINUES TO PUSH RECOVERY ACT BENEFITS

Although the IRS’s official position is that it does not advocate for tax benefits, its press releases recently have focused on reminding taxpayers to take advantage of 2009 tax breaks available under the provisions of the American Recovery and Reinvestment Act (ARRA). These benefits include tax incentives for those investing in energy-efficient property and for students with higher education expenses. An explanation of the first-time homebuyers’ credit appears earlier in this issue. Other Recovery Act incentives are briefly described below.

Energy-Efficient Home Improvements

The Recovery Act allows a credit for 30 percent of the cost of improvements for homeowners who make energy-efficient improvements to existing homes. Qualifying improvements include the addition of insulation, energy-efficient exterior windows and energy-efficient heating and air conditioning systems. The maximum credit is \$1,500 for improvements made in 2009 and 2010. Qualifying for this credit can be tricky, but most reputable energy contractors have information on which of their products are covered. For example, you cannot just buy an air conditioner which meets certain energy

efficiency standards. Your entire heating and cooling system must meet the standards. Here is a summary of items qualifying for the credit:

For 2009 and 2010, the following items are eligible for the credit:

- Windows and Doors
- Insulation
- Roofs (Metal and Asphalt)
- HVAC
- Water Heaters (non-solar)
- Biomass Stoves

Residential Energy Efficient Property Credit

If you are a homeowner who is thinking of going green, you should also consider a second tax credit designed to spur investment in alternative energy equipment. The residential energy efficient property credit equals 30 percent of what you spend on property such as solar electric systems, solar hot water heaters, geothermal heat pumps, wind turbines, and fuel cell property. Generally, labor costs are included when calculating this credit. Also, no cap exists on the amount of credit available except in the case of fuel cell property. Not all energy-efficient improvements qualify for these tax credits. For that reason, you should check the manufacturer's tax credit certification statement before purchasing or installing any of these improvements. The certification statement can usually be found on the manufacturer's website or with the product packaging. Normally, a homeowner can rely on this certification. The IRS cautions that the manufacturer's certification is different from the Department of Energy's Energy Star label, and not all Energy Star labeled products qualify for the tax credits.

Through 2016, the following items are eligible for this credit:

- Geothermal Heat Pumps
- Solar Panels
- Solar Water Heaters
- Small Wind Energy Systems
- Fuel Cells

Note that homebuilders and those taxpayers with commercial buildings have other tax credits available to them for energy efficiency improvements.

Tax Credit for First Four Years of College

The American Opportunity Credit is allowed for the cost of the first four years of college. The new credit modifies the existing Hope credit for tax years 2009 and 2010, making it refundable and available to more taxpayers, including those with higher incomes. Tuition, related fees, books and other required course materials all qualify now. The maximum annual credit is \$2,500 per student.

Computer Technology Purchases Allowed for 529 Plans

For 2009 and 2010, computer equipment and internet access can be paid by a qualified tuition program (QTP), commonly referred to as a 529 plan. Software designed for sports, games or hobbies does not qualify unless it is predominantly educational in nature.

GOVERNMENT PAYMENTS TO AT-RISK HOMEOWNERS ARE EXCLUDABLE

Under a new program designed to prevent foreclosures, the U.S. government offers incentive payments to homeowners who make their mortgage payments on time. The IRS has ruled that these payments, made under the Home Affordable Modification Program (HAMP), do not have to be reported as income.

Under HAMP, homeowners who make timely payments on their modified loans are eligible to have incentive payments made on their behalf to lenders/investors. Each month that a homeowner makes a mortgage payment on time, the homeowner accrues an amount toward a Pay-for-Performance Success Payment. The government then makes payments of the accrued amounts annually to the mortgage holder to reduce the principal balance on the homeowner's mortgage loan. The IRS has determined that Congress did not want these payments to be taxable, so they will be excluded from a taxpayer's income.

ROTH IRA ROLLOVER RESTRICTIONS LIFTED IN 2010

In 2008, taxpayers were for the first time allowed to roll over amounts in employer plans, such as 401(k)s, into Roth IRAs. Before then, taxpayers had to move the funds to a traditional IRA first, then to a Roth IRA. In addition, until the end of 2009, there is an income limit on Roth rollovers. Taxpayers can only do Roth rollovers if they have adjusted gross income that does not exceed \$100,000. In 2010, this income limitation is abolished and taxpayers will be able to roll over amounts from an employer plan or a traditional IRA into a Roth IRA without limit.

When you roll over fund into a Roth IRA, you usually have to pay income taxes on those amounts. If you do Roth rollovers in 2010, you will be able to take rolled over amounts into income over two tax years, 2010 and 2011. Allowing you to split the income over two years will reduce the tax rate you will have to pay on the rollover amounts. These law changes are very favorable to taxpayers and allow you great flexibility in reinvesting your retirement funds, but the rules are complex. Please contact me if you want to discuss your options.

IRS, CONGRESS PROPOSE CHANGES IN CELL PHONE TAXATION

Confronting the realities of employee cell phone usage, the IRS has proposed new, simplified approaches to taxing employees' personal use of business cell phones. Meanwhile in Congress, members of both the House and Senate tax committees have

introduced legislation to ease the rules on proving the amount of business use. Existing law requires burdensome record keeping by businesses to claim deductions for cell phones. Now, taxpayers can deduct business expenses associated with the use of cellular telephones only if they maintain detailed logs of all employee calls, text messages, and emails, including the date and amount of each use in a tax year. The logs must identify who was called and the business purpose of the call. If these records are not properly maintained, cell phone use can be taxed as income to the employee, and the business will not get a deduction for the cost of the phone.

IRS Considering Three Alternatives

The IRS has proposed three new alternative methods to substantiate business cell phone use, described below, and has asked for comments from tax practitioners on its proposals. Many comments have been sent to the IRS on this issue, but it has not announced a final decision yet. No matter which option is chosen, any business that wishes to use a simplified cell phone substantiation method will have to have a written policy that requires employees to use the employer-provided cell phones only for business and that prohibits personal use except for minimal personal use. Here are the three possible methods of calculating business use:

1. Minimal personal use method: If the employee has a personal cell phone as well as an employer-provided cell phone, then the business cell phone would be tax free. Alternatively, the employer could define a specified amount of personal use as "minimal" personal use that would be disregarded.

2. Safe Harbor method: An employer would treat a certain percentage of each employee's use of an employer-provided cell phone as business usage. The remaining percentage of use would be considered personal use. The IRS suggests a 75/25 allocation, where the employer treats 75% as business use and the remaining 25% as personal use taxable to the employee.

3. Statistical Sampling method: This method would allow employers to use statistics on personal versus business use to measure an employee's personal use of an employer-provided cell phone.

Cell Phone Changes Pushed in Congress

Republicans and Democrats in both the House and the Senate have joined together and introduced legislation to "modernize" the treatment of business cell phones. Both bills would eliminate the paperwork required for businesses to claim a deduction.

Observation: With the wide use of cell phones in both small and large-sized businesses, the existing rules are a significant burden on businesses. If you look at recent court cases it is obvious that the IRS challenges taxpayers' cell phone deductions on a regular basis. There is now an opportunity to change the law. If cell phone use is an important part of your business, you may want to weigh in on the proposed changes and submit your comments to the IRS or to Congress regarding easing of these rules.

OFFSHORE ACCOUNTS FOCUS OF INTENSIVE IRS ENFORCEMENT EFFORT

If you hold interests in offshore accounts or you are a signatory on an offshore corporate account, then you should be aware of a myriad of new rules affecting the reporting on these accounts. All taxpayers with offshore accounts now are required to file a new form, commonly known as “FBAR”, if the accounts have an aggregate value exceeding \$10,000 at any time during the tax year. A U.S. taxpayer is considered to have a financial interest in the accounts of an entity such as a corporation, partnership, or trust, if the U.S. person has more than a 50 percent ownership, income, or voting interest in the entity.

If you fail to disclose these accounts, you could be subject to very high civil penalties as well as criminal penalties. The filing requirements are complex, and the new form must be filed in addition to the taxpayer’s federal income tax return for the year, even if the full amount of foreign income is reported on the taxpayer’s income tax return. Not only does the FBAR have a different due date than a taxpayer’s income tax return, but it also must be sent to a different address.

If you hold any interest in an offshore bank account, you should contact me promptly to discuss how I can bring you in compliance with this new law. The IRS’s enforcement budget has extra funds this year to be targeted toward offshore compliance, so you can expect the IRS to be pursuing noncompliant taxpayers vigorously.

IRS ENFORCEMENT BUDGET TO INCREASE

The IRS's Fiscal Year 2010 budget request is \$500 million above its Fiscal Year 2009 enacted budget. More than half of this amount, approximately \$300 million, is intended for enforcement. Conventional wisdom says that IRS compliance activities recoup \$5 for every \$1 spent. The increased funds are supposed to go to international tax enforcement as well as to providing improved taxpayer services.

The IRS Commissioner, Douglas Shulman, has promised to have an additional 4500 IRS examiners on the payroll, and he expects them to generate an additional \$2 billion once the new hires reach full potential in FY 2012. Here are some interesting audit numbers cited by the IRS Commissioner in recent statements to Congress.

Enforcement Results

Revenue. Enforcement revenue has risen from \$33.8 billion in FY 2001 to \$56.3 billion in FY 2008, an increase of 67 percent.

Audit Numbers. In FY 2008, both the levels of individual returns examined and coverage rates rose substantially. The IRS conducted nearly 1.4 million examinations of individual tax returns in FY 2008, an 8 percent increase over FY 2006.

High-Income Earners. Most audits were of individuals with incomes over \$200,000. Audits of these individuals increased from 105,549 in FY

2007 to 130,751 during FY 2008, an increase of 24 percent. Their audit rate has risen from 2.68 percent in FY 2007 to 2.94 percent in FY 2008.

Partnerships and S Corps. Coverage rates for partnership returns stayed even as compared to FY 2007, while Subchapter S returns reflected a small .05 percent drop due largely to the increase in number of S-corporations.

Criminal Cases. The IRS has increased criminal charges against taxpayers for tax evasion, money laundering, and other financial crimes, with the overall number of individuals charged increasing from 2,323 in FY 2007 to 2,547 in FY 2008.

Foreign Enforcement. In FY 2008, IRS cases related to foreign and offshore issues resulted in 61 criminal convictions, and the average term for those going to jail was 32 months. For the first four months of FY 2009, there were 20 convictions, and the average sentence was 84 months.

COURT CASES ON LLCs AND LLPs FORCE IRS INTO 21ST CENTURY

The popular business types, Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs), have been around since 1977 but are still not fully recognized by the IRS in fashioning its tax rules for these entities. For the last reporting year, 2005, approximately 1,565,000 of these entities filed partnership returns. Since 1996, LLCs have grown at the rate of approximately 23 percent per year. However, the IRS has refused to confront key LLC and LLP tax issues, such as how the passive loss limitations apply to LLC and LLP members who actively participate in their businesses. As a result, within the last several months, the IRS has lost three court cases on the tax treatment of LLC and LLP members, with the courts holding that LLC and LLP members should not be treated as “limited partners” for purposes of the passive activity loss rules.

The passive loss rules prevent taxpayers from deducting losses from “passive activities” against their income from other sources. Passive losses can only be deducted against passive income. Thus, taxpayers can lose these deductions. Passive activities are defined as those activities in which a taxpayer does not “materially participate.” The IRS’s position is that LLC and LLP members should be treated like limited partners, who cannot participate in business management under state law. Limited partners are very restricted in their ability to deduct losses from their business interests. Even though state law allows LLC and LLP members to participate in the management of their businesses without losing their limited liability, the IRS insists they should still be considered nonparticipating limited partners. The Tax Court and the U.S. Court of Federal Claims have rejected the IRS’s treatment of LLC and LLP members and have allowed taxpayers in those entities to prove their participation in management. If taxpayers can prove their participation under any one of seven different tests of their involvement, their business activity will not be considered passive and they will be able to fully use their business deductions.

As a result of these court losses, the IRS has announced that it is studying the treatment of LLCs and LLPs and will issue new rules soon. The question remains whether the IRS will follow the Courts' liberalized loss rules or whether it will try to propose another solution that will continue to restrict LLC and LLP members' loss deductions. This issue could impact thousands of LLC and LLP members, especially now that our economy is generating much higher business losses. As your tax professional, I am closely watching developments in this area for all of my clients who hold interests in an LLC or LLP.

STATES LOOKING TO TAX SERVICES

With State revenues across the country down sharply in the current recession, State authorities are considering the imposition of a sales tax on services, such as household repairs, landscaping, diaper services, and even tax preparation services. For example, at this time North Carolina, California, and Colorado are seriously debating a broader sales tax base which would include services. We are watching locally on your behalf for any proposed new taxes on these categories of services:

- services primarily purchased by businesses, such as payroll processing and television advertising;
- services primarily purchased by households, such as a diaper service and cable TV;
- services frequently purchased by both households and businesses, such as landscaping and pest control.

A recent report by the Center for Budget and Policy Priorities identifies approximately 200 different types of services that could be brought into the tax base. The idea of taxing services has come about because of a shift in consumer behavior. According to the report, household spending has been shifting from goods to services. Thus, the states' traditional sales tax base, which consists largely of purchases of durable goods (like cars) and non-durable goods (like clothing), fell from 39 percent of household consumption in 1970 to 32 percent in 2007. Many state legislatures start new sessions in early 2010, and you can expect new tax proposals to be a major focus in the New Year.

MOST TAXPAYERS FILE ELECTRONICALLY

The IRS has released its yearly return statistics which show that a record number of taxpayers had their returns filed electronically. Some 95 million federal income tax returns were electronically filed during 2009, up almost 6 percent from last year's total of nearly 90 million. This represents 67 percent of returns, up from 59 percent last year. Taxpayers also are more frequently having their refunds electronically deposited into their bank accounts. These direct deposit refunds accounted for 66 percent of all refunds, up from 62 percent of refunds last year. Overall, the IRS issued 110 million refunds, averaging \$2,753 per refund; direct deposit refunds averaged \$2,997 per refund.

Undeliverable Refunds a Problem

The IRS also has announced that it has \$123.5 million in the form of 107,831 refund checks that were returned by the U.S. Postal Service due to mailing address errors. Average undeliverable refunds rose by 16 percent this year, which is in line with the 16 percent rise in average refunds for all tax returns in the latest filing season. Several changes in tax law likely played a role in boosting refunds, including the First-Time Homebuyer's Credit and the Recovery Rebate Credit.

Because of address and mailing problems, it is generally best to choose direct deposit when you file your tax returns because it puts an end to lost, stolen or undeliverable checks. You can receive refunds directly into your personal checking or savings accounts. Direct deposit is available for filers of both paper and electronic returns.

DO YOU WANT THE IRS PREPARING YOUR TAX RETURN?

The Obama Administration has proposed simplifying the tax preparation process by having the IRS prepare pre-filled forms for taxpayers. The argument goes that the IRS already receives most Americans' financial information directly from employers and banks. Under this program, the IRS would partially fill out the forms and then give them to the taxpayer to verify, sign, and return to the IRS or file online. Although some experts believe this will save American taxpayers time and money on tax preparation, we in the tax professional community believe this should set off alarm bells. The tax law is not always exact and any vagueness would be settled in the IRS's favor. In addition, the IRS could make errors which would be difficult for taxpayers to correct. Finally, the IRS is not in the business of advising taxpayers on how best they can legally minimize their tax burden, so many taxpayers would lose their financial advocates.

Volunteer Tax Preparation Falls Short in Accuracy

If the government-sponsored volunteer tax preparation program is any measure, tax return preparation is best left in the hands of the private sector. The accuracy rates for tax returns prepared at Volunteer Program sites decreased from 69 percent to 59 percent for the 2009 filing season. According to the Treasury Department's Inspector General, of the 49 tax returns prepared for Treasury auditors by Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites, 29 (59 percent) were prepared correctly and 20 (41 percent) were prepared incorrectly. If 17 of the incorrectly prepared tax returns had been filed, taxpayers would not have received \$4,138 in tax refunds to which they were entitled. For the other three, the IRS would have been entitled to more tax owed.

END OF THE YEAR TAX PLANNING TIPS

If you can move quickly, you can use some basic tax planning tools to reduce your 2009 business and individual income taxes. Here are some ways to save on this year's tax bill:

1. **Defer Income:** If possible under your accounting method, delay the receipt of payments you are owed until after the new year
2. **Increase Business Expenses:** Buy items for your business this year, with credit cards if necessary. That way you can maximize your deductions for this year. You can buy office supplies and equipment and pay some of your business bills early, such as phone services, utilities, insurance, rent, and professional subscriptions.
3. **Contribute to a Retirement Plan:** Make an extra contribution to your retirement plan before the end of the year.
4. **Make Charitable Contributions:** Donate to your favorite charity by the end of the year if you have not bumped up against your charitable contribution limits. If you have an estimate of what you have already given in 2009, I will be glad to advise you on whether or not it would be worth it to make additional donations.
5. **Prepay your State and Local taxes:** If your cash flow allows it, prepay state and local taxes before the end of the year.

CONCLUSION:

There is always mixed news about tax developments. For every new tax bill that makes it through Congress, there are winners and losers. Even if your tax burden may increase due to 2009 changes, there are legitimate, legal ways to rearrange your personal and business affairs to minimize any additional burden. I always stand ready to discuss your concerns and to advise you on our ever-evolving tax system. Please do not hesitate to make an appointment to see me soon if you need tax advice.

Thank you for reviewing the *Fall 2009 Tax Client Newsletter*, and I appreciate the opportunity and privilege of serving as your tax professional.

Sincerely,

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