JENNIFER A. JONES, CPA, LTD.

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Tax Planning Ideas for 2012:

Thanks to the extension of the so-called Bush tax cuts through 2012, the current federal income tax environment remains favorable through year-end. That said, now is the time to take advantage of the current provisions because we don't know what tax rates will be in 2013 and beyond. Some of these ideas may apply to you, some to family members, and others to your business. Click on title for more info.

2012 Year-End Tax Strategies for Business Owners:

Tax reform is one of the most contentious topics in this year's election, with both personal and corporate income tax rates under scrutiny. While leaders in both parties agree that corporate rates should be reduced from the current high of 35%, they differ on how to do so without further widening the budget deficit. Should deductible expenses be reduced or eliminated, and if so, which ones? And what will be the overall economic impact when 9 out of 10 businesses don't even pay corporate income taxes? Indeed, according to the Senate Finance Committee, 95% of all U.S. businesses are structured as "pass-through" entities, which means their income is reported on owners' personal income tax returns.

Regardless of whether you pay corporate or personal income tax on your business income, you probably know that time is of the essence when it comes to tax reform. If Congress doesn't act by December 31, the nation will face the ominously and now infamously named "fiscal cliff"--the series of impending tax code and budgetary spending changes that some economists say will propel us into another protracted recession.

So what should a business owner do--wait for Congress to act or plan now for the looming cliff? Perhaps a good move might be to plan ahead while remaining flexible enough to address last-minute changes. Follow this link for some strategies you might want to consider.

Unclaimed Property Laws and Audits:

Businesses holding unclaimed property are required to file annual reports and remit the property to the state. Given the current environment, many states may see unclaimed property as an untapped revenue source. Businesses should therefore be aware of the applicable laws, which vary considerably by state. Unclaimed property compliance may be a challenge, but it can be mastered. Early tracking and notification, along with diligent record-keeping, will ensure that issues are resolved before they attract the attention of a state administrator. All states have statutes that require all businesses holding items deemed to be unclaimed property to file annual reports and remit the property to the state. In our area, the due date is generally November 1st. Any financial asset, tangible or intangible, that remains unclaimed for a certain length of time is considered to be unclaimed property. Typical examples include:

Uncashed vendor checks
Uncashed payroll checks
Uncashed refund checks to patients/customers
Unredeemed gift certificates

Failure to comply with state statutes can result in huge audit assessments, significant interest accumulations, and civil and criminal penalties. These ramifications are not limited to a single state if a company has vendors, customers, or shareholders in multiple states. It is estimated that only 10% to 20% of businesses currently comply with unclaimed property laws. The others are at substantial risk, because states facing revenue shortfalls recognize this as an easy source of untapped revenue, and the penalties for noncompliance can be steep.

For more information on the local laws, see:

Virginia	http://www.trs.virginia.gov/UCP/overview.aspx
Maryland	http://compnet.comp.state.md.us/Compliance_Division/Unclaimed_Property/
DC	http://cfo.dc.gov/cfo/cwp/view,a,1326,q,590684,.asp

It is recommended that you review your policies and procedures to be sure you have a system established and properly utilized to insure compliance with these state laws. Some states recommend or require filing the annual report even when there is no unclaimed property to turn over to the state..

2013 Cost-of-Living Limits

IRA Contribution Limit $5,500
IRA 50 & Over Catch-up Contribution $1,000
401(k) Deferral Limit $17,500
401(k) 50 & Over Catch-up Contribution $5,500
SIMPLE Deferral limit $12,000
SIMPLE 50 & Over Catch-up Contribution $2,500
Annual Compensation limit $255,000
Defined Contribution IRC Sec 415 limit $51,000
Compensation limit for SEP eligibility $550
IRC Section 179 $25,000
Estate Tax Exclusion $1,000,000
Gift Tax Annual Exclusion $13,000
Social Security Wage Base $113,700
2012 & Prior Years' Limits

2012 Standard Mileage Rates:

Business mileage rate **$0.555**
Medical & Moving mileage rate **$0.23**
Charitable mileage rate **$0.14/mile**

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Special Accounting Rule for Non-cash Fringe Benefits: . Personal use of a corporate-owned vehicle is a common example of a non-cash fringe benefit that needs to be included in on the employee's W-2, This fringe benefit and other certain fringe benefits must be treated as paid no later than December 31 of the calendar year in which they are provided. Because calculating the FMV of fringe benefits provided during the last quarter of the year can be difficult, the IRS provides a special rule to allow employers time to accumulate all fringe benefit valuation information to meet the reporting deadlines (see Announcement 85-113, 1985-31 IRB 31). Employers may use any 12-month period that begins between November 1 and December 31, inclusive, rather than the calendar year, to compute personal use income for the calendar year. There is no formal election, and the employer need not notify the IRS. However, the employer must notify affected employees that the special rule has been used and the period for which it has been used. Personal use of a corporate vehicle is a common example of a non-cash fringe benefit that needs to be included in on the employee's W-2. For information on computing the value of a vehicle provided to an employee for personal use, and other non-cash fringe benefits, see IRS Pub 15b available at http://www.irs.gov/publications/p15b/ar02.html

Age-Related Tax and Financial Milestones: This article covers some important age-related tax and financial planning milestones that you should keep in mind for yourself and loved ones.

Don't Fall for Phony IRS Websites or Email: The Internal Revenue Service is issuing a warning about a new tax scam that uses a website that mimics the IRS e-Services online registration page. The actual IRS e-Services page offers web-based products for tax preparers and payers, not the general public. The phony web page looks almost identical to the real one. The IRS gets many reports of fake websites like this. Criminals use these sites to lure people into providing personal and financial information that may be used to steal the victim's money or identity. The address of the official IRS website is www.irs.gov. Don't be misled by sites claiming to be the IRS but ending in .com, .net, .org or other designations instead of .gov. If you find a suspicious website that claims to be the IRS, send the site's URL by email to phishing@irs.gov. Use the subject line, 'Suspicious website'.

Be aware that the IRS does not initiate contact with taxpayers by email to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels. If you get an unsolicited email that appears to be from the IRS, report it by sending it to phishing@irs.gov. The IRS has information at www.irs.gov that can help you protect yourself from tax scams of all kinds. Search the site using the term "phishing."

Deducting Home Internet Expenses: A taxpayer's home internet expenses are deductible as business expenses only to the extent that they are attributable to business use. The portion that is attributable to personal use is not tax deductible. You must be able to produce evidence or other reasonable basis for determining the business and personal portions. (Noz v. Commissioner, T.C. Memo 2012-272) Because home internet expenses are not subject to the strict substantiation rules of IRC Sec. 274, you can use any reasonable method to estimate your business v. personal use. Reasonable evidence includes a log of business and personal use or a log for one period, e.g. on month, if you can establish that usage for the period is representative of the entire year. If you are an employee, your home internet expenses can be deductible only if they are not reimbursed by your employer. If you deduct business expenses that are related to your job, you must either be able to establish that your request for reimbursement was declined by your employer or be able to produce a written employer policy against the reimbursement of such expenses.

IRS Tax Compliance Agenda: The following is an overview of areas the IRS is likely to focus on during the next decade, according to Jim Buttonow, vice president of product development, and Brian Howell, product manager, for Beyond415, a web-based software developed by New River Innovation Inc. of Greensboro, N.C. These areas include:

- High-income individuals.
- Worker classification: W-2 vs. independent contractor.
- S corp. losses claimed in excess of basis.
- Rental property losses: passive vs. active, as well as basis issues.
- General small business underreporting of taxable income.
- Form 1099 filing compliance.
- Review of international taxpayers/FBAR, etc.

The 2013 Medicare Contribution Tax: The Bush tax rates and other tax provisions are scheduled to expire at the end of 2012, while other taxes are scheduled to become effective for 2013. While predicting the future of federal and state tax systems and the economy is always difficult, predictions in an election year are all but impossible.

Of particular note, these tax provisions will become effective in 2013:

The 3.8% Medicare contribution tax on investment income
The .9% additional Medicare tax on high wage and Self-employed earners
Increase AGI threshold for deductible medical expenses from 7.5% to 10%

Virginia Tax Law Changes:

- All corporations will be required to file their income tax returns and make their tax payments electronically, effective January 1, 2013
- All sales and use tax returns and payments be filed electronically, for monthly sales tax filers -effective July 2012, less frequent filers-effective July 2013
- All refunds of individual income taxes will be electronic (debit cards or direct deposit), effective January 1, 2013
- Period of Collection reduced from 10 years to 7 years from date of assessment
- 100% disabled veterans exempt from real estate tax

2012 Tax Planning

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Thanks to the extension of the so-called Bush tax cuts through 2012, the current federal income tax environment remains favorable through year-end. That said, now is the time to take advantage of the current provisions because we don't know what tax rates will be in 2013 and beyond. Here are some tax planning ideas to consider this summer while you have time to think. Some of the ideas may apply to you, some to family members, and others to your business.

Consider Deferring Income or Doing the Opposite

It may pay to defer some taxable income from this year into next year, especially if you expect to be in a lower tax bracket in 2013. For example, if you're in business for yourself and a cash-method taxpayer, you can postpone taxable income by waiting until late in the year to send out some client invoices. That way, you won't receive payment for them until early 2013. You can also postpone taxable income by accelerating some deductible business expenditures into this year. Both moves will defer taxable income from this year until next year. Deferring income may also be helpful if you're affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (child tax credit, education tax credits, and so forth). By deferring income every other year, you may be able to take more advantage of these breaks every other year.

Warning: If you think the Bush tax cuts will be allowed to expire at the end of this year, the income deferral drill may not be advisable this time around. That's because pushing income from 2012 into 2013 could expose you to higher marginal tax rates next year. If you're convinced you'll pay higher rates next year, consider taking the opposite of the traditional approach by accelerating income into this year and deferring deductions until next year. That way, more income will be taxed at this year's lower rates.

Leverage Standard Deduction by Bunching Deductible Expenditures

Are your 2012 itemized deductions likely to be just under, or just over, the standard deduction amount? If so, consider the strategy of bunching together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2012 standard deduction for married joint filers is $11,900; the magic number for single and married filing separate filers is $5,950; it's $8,700 for heads of households.

For example, say you're a joint filer whose only itemized deductions are about $4,000 of annual property taxes and about $8,000 of home mortgage interest. If you prepay your 2013 property taxes by December 31 of this year, you could claim $16,000 of itemized deductions on your 2012 return ($4,000 of 2012 property taxes, plus another $4,000 for the 2013 property tax bill, plus the $8,000 of mortgage interest). Next year, you would only have the $8,000 of interest, but you could claim the standard deduction (it will probably around $12,500 for 2013). Following this strategy will cut your taxable income by a meaningful amount over the two-year period (this year and next). You can repeat the drill all over again in future years.

Examples of other deductible items that can be bunched together every other year to lower your taxes include charitable donations and state income tax payments.

Warning: If you think you'll pay a higher tax rate next year, you may want to claim the standard deduction this year and bunch your itemized deductions into 2013 where they can offset the higher taxed income.. This will boost your overall tax savings for the two years combined.

Take Advantage of 0% Rate on Investment Income

For 2012, the federal income tax rate on long-term capital gains and qualified dividends is 0% when they fall within the 10% or 15% federal income tax rate brackets. This will be the case to the extent your taxable income (including long-term capital gains and qualified dividends) does not exceed $70,700 if you are married and file jointly ($35,350 if you are single). While your income may be too high to benefit from the 0% rate, you may have children, grandchildren, or other loved ones who will be in one of the bottom two brackets. If so, consider giving them some appreciated stock or mutual fund shares that they can then sell and pay 0% tax on the resulting long-term gains. Gains will be long-term as long as your ownership period plus the gift recipient's ownership period (before he or she sells) equals at least a year and a day.

Giving away stocks that pay dividends is another tax-smart idea. As long as the dividends fall within the gift recipient's 10% or 15% rate bracket, they will be federal-income-tax-free.

If the Bush tax cuts are allowed to expire at year-end, the minimum tax rate on 2013 long-term gains for these taxpayers will be 10% (or 8% for gains from certain investments held for over five year), while the minimum rate on 2013 dividends will be 15%. So, consider doing what you need to do to take advantage of the 0% rate this year. Next year, it might be history.

Warning No. 1: If you give securities to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the parent's higher rates instead of at the gift recipient's lower rates, which would defeat the purpose. Please contact us if you have questions about the Kiddie Tax.

Warning No. 2: Be aware that if you give away assets worth over $13,000 during 2012 to an individual gift recipient, it will generally reduce your $5.12 million unified federal gift and estate tax exemption. However, you and your spouse can together give away up to $26,000 without reducing your exemptions.

Time Investment Gains and Losses and Consider Being Bold about It

As you evaluate investments held in your taxable brokerage firm accounts, consider the impact of selling appreciated securities this year. The maximum federal income tax rate on long-term capital gains from 2012 sales is only 15%. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling. On the other hand, now may be a good time to cash in some long-term winners to benefit from today's historically low capital gains tax rates.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a good idea. The resulting capital losses will offset capital gains from other sales this year, including short-term gains from securities owned for one year or less that would otherwise be taxed at ordinary income tax rates. The bottom line is that you don't have to worry about paying a higher tax rate on short-term gains if you have enough capital losses to shelter those short-term gains.

If capital losses for this year exceed capital gains, you will have a net capital loss for 2012. You can use that net capital loss to shelter up to $3,000 of this year's high-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you're married and file separately). Any excess net capital loss is carried forward to next year.

Important Point: Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might make sense. You can carry forward the excess net capital loss to 2013 and later years and use it to shelter both short-term gains and long-term gains recognized in those years. That will give you extra investing flexibility in 2013 and beyond because you won't have to hold appreciated securities for over a year to get better tax results. Remember: The maximum federal income tax rate on long-term capital gains is scheduled to increase to 20% starting in 2013 (up from

the current 15%) while the maximum rate on short-term gains is scheduled to increase to 39.6% (up from the current 35%). Contact us if you want help in identifying the best tax-smart options in a world where future tax rates are uncertain.

For the Charitably Inclined: Sell Loser Shares and Give Away the Resulting Cash;

Give Away Winner Shares

Say you want to make some gifts to favorite relatives (who may be hurting financially) and/or favorite charities. You can make gifts in conjunction with an overall revamping of your holdings of stocks and equity mutual fund shares held in taxable brokerage firm accounts. Here's how to get the best tax results from your generosity.

Gifts to Relatives. *Do not* give away loser shares (currently worth less than what you paid for them). Instead sell the shares, and take advantage of the resulting capital losses. Then, give the cash sales proceeds to the relative. *Do* give away winner shares to relatives. Most likely, they will pay lower tax rates than you would pay if you sold the same shares. In fact, relatives who are in the 10% or 15% federal income tax brackets will generally pay a 0% federal tax rate on long-term gains from shares that were held for over a year before being sold in 2012. (For purposes of meeting the more-than-one-year rule for gifted shares, you get to count your ownership period plus the recipient relative's ownership period, however brief.) Even if the shares are held for one year or less before being sold, your relative will probably pay a lower tax rate than you would (typically only 10% or 15%). However, beware of one thing before employing this give-away-winner-shares strategy. Gains recognized by a relative who is under age 24 may be taxed at his or her parent's higher rates under the so-called Kiddie Tax rules (contact us if you are concerned about this issue).

Gifts to Charities. The strategies for gifts to relatives work equally well for gifts to IRS-approved charities. Sell loser shares and claim the resulting tax-saving capital loss on your return. Then, give the cash sales proceeds to the charity and claim the resulting charitable write-off (assuming you itemize deductions). This strategy results in a double tax benefit (tax-saving capital loss plus tax-saving charitable contribution deduction). Give away winner shares to charity instead of giving cash. Here's why. For publicly traded shares that you've owned over a year, your charitable deduction equals the full current market value at the time of the gift. Plus, when you give winner shares away, you walk away from the related capital gains tax. This idea is another double tax-saver (you avoid capital gains tax on the winner shares, and you get a tax-saving charitable contribution write-off). Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to the IRS.

Convert Traditional IRA into Roth IRA

Here's the best scenario for this idea: Your traditional IRA is (or was) loaded with equities and has still not fully recovered from the beating taken during the 2008/2009 stock market meltdown. So your account is now worth less than it once was. Correspondingly, the tax hit from converting your traditional IRA into a Roth IRA right now would also be less than it would have been at the market peak. Why? Because a Roth conversion is treated as a taxable liquidation of your traditional IRA followed by a nondeductible contribution to the new Roth IRA. While even the reduced tax hit from converting is unwelcome, it may be a small price to pay for future tax savings. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals, will be totally free of any federal income taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today's rates.

Of course conversion is not a no-brainer. You have to be satisfied that paying the up-front conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher 2012 tax brackets, which would not be good. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on

your Roth IRA investments, and so forth. If the Roth conversion idea intrigues you, please contact us for a full analysis of the relevant variables.

Watch for Alternative Minimum Tax

While many recent tax-law changes have been helpful in reducing your regular federal income tax bill, they didn't do much to reduce the odds that you'll owe the dreaded Alternative Minimum Tax (AMT). Therefore, it's critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are complicated, you may want our assistance. We stand ready to help!

Take Advantage of Generous But Temporary Business Tax Breaks

Several favorable business tax provisions have a limited shelf life that may dictate taking action between now and year-end. They include the following.

Bigger Section 179 Deduction. Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. For tax years beginning in 2012, the maximum Section 179 deduction is $139,000. For tax years beginning in 2013, however, the maximum deduction is scheduled to drop back to only $25,000.

Note: Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction. Reason: You cannot claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your operation.

50% First-year Bonus Depreciation. Above and beyond the Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the 100% bonus depreciation break increases the maximum first-year depreciation deduction by $8,000 for vehicles placed in service this year. The 50% bonus depreciation break will expire at year-end unless Congress extends it. Contact us if you want more details about this generous, but temporary, tax break.

Note: 50% bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2012 tax year. You can then carry back the NOL to 2011 and/or 2010 and collect a refund of taxes paid in one or both those years. Please contact us for details on the interaction between asset additions and NOLs.

Don't Overlook Estate Planning

For 2012, the unified federal gift and estate tax exemption is a historically generous $5.12 million. However, the exemption will drop back to only $1 million in 2013 unless Congress takes action. In addition, the maximum federal estate tax rate for 2013 and beyond is scheduled to rise from the current 35% to a painfully high 55%. Therefore, planning to avoid or minimize the federal estate tax should still be part of your overall financial game plan. Even if you already have a good plan, it may need updating to reflect the current $5.12 million exemption and the uncertainty about next year's rules. Contact us for specifics.

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What Does the Supreme Court Ruling on the Health-Care Reform Law Mean for You?

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On June 28, 2012, the U.S. Supreme Court ruled, in a landmark decision, that the Patient Protection and Affordable Care Act (ACA), including the provision that most Americans carry health insurance or pay a penalty, is constitutional.

The ACA, signed into law in 2010, made sweeping reforms to health-care coverage in the United States. Many provisions of the law have already taken effect. A number of other provisions are scheduled to take effect in subsequent years, including the requirement that most Americans and legal residents have qualifying health insurance (exceptions apply) or pay a penalty in the form of a tax. Here's a summary of some of the important provisions that are already in place, and those that are on their way by 2014.

In effect now

- Children can no longer be denied insurance coverage because of pre-existing conditions
- Payment of $250 rebate to Medicare Part D beneficiaries subject to the coverage gap (beginning January 1, 2010) and gradually reducing the beneficiary coinsurance rate in the coverage gap from 100% to 25% by 2020
- Insurers will not be able to impose lifetime caps on insurance coverage
- All plans offering dependent coverage will be required to allow children to remain under their parents' plan until age 26
- Insurers cannot cancel or deny coverage if you are sick except in cases of fraud
- Adults with pre-existing conditions will be able to buy coverage from temporary high-risk pools until 2014, when coverage cannot otherwise be denied for pre-existing conditions

Key provisions effective on or before January 1, 2014

- Increasing the medical expense income tax deduction threshold to 10% of adjusted gross income, up from the current 7.5% (January 1, 2013)
- Increasing the Medicare Part A tax rate by 0.9% on wages over $200,000 for individuals ($250,000 for married couples), and assessing a new 3.8% tax on some or all of the net investment income for these higher-income individuals (January 1, 2013)
- All Americans must carry health insurance or face a penalty (in the form of a tax) of up to 2.5% of household income on individuals, with exceptions for economic hardship, religious beliefs, and other situations (January 1, 2014)
- Adults with pre-existing conditions cannot be denied coverage or have their insurance cancelled due to pre-existing conditions (January 1, 2014)
- A requirement that states establish an American Health Benefit Exchange that facilitates the purchase of qualified health plans and includes an Exchange for small businesses; also requires employers that contribute toward the cost of employee health insurance to provide free choice vouchers to qualified employees for the purchase of qualified health plans through Exchanges (January 1, 2014)
- Tax credits will be available to qualifying families to offset the cost of health insurance premiums (January 1, 2014)
- Employers with more than 50 employees must offer health insurance for their employees or be fined per employee (January 1, 2014)
- Imposing taxes or fees on health insurance providers and drug companies, while doctors and hospitals will receive less compensation from government sources (January 1, 2014)

So is this it?

While the Supreme Court has ruled the ACA constitutional, it may still face challenges as Congress may seek to repeal the law. The ultimate fate of the health-care reform law may be determined by the outcome of the November elections.

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2012 Year-End Tax Strategies for Business Owners

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Tax reform is one of the most contentious topics in this year's election, with both personal and corporate income tax rates under scrutiny. While leaders in both parties agree that corporate rates should be reduced from the current high of 35%, they differ on how to do so without further widening the budget deficit. Should foreign income continue to be taxed, and if so, how? Should deductible expenses be reduced or eliminated, and if so, which ones? And what will be the overall economic impact when 9 out of 10 businesses don't even pay corporate income taxes? Indeed, according to the Senate Finance Committee, 95% of all U.S. businesses are structured as "pass-through" entities, which means their income is reported on owners' personal income tax returns.*

Regardless of whether you pay corporate or personal income tax on your business income, you probably know that time is of the essence when it comes to tax reform. If Congress doesn't act by December 31, the nation will face the ominously and now infamously named "fiscal cliff"--the series of impending tax code and budgetary spending changes that some economists say will propel us into another protracted recession.

So what should a business owner do--wait for Congress to act or plan now for the looming cliff? Perhaps a good move might be to plan ahead while remaining flexible enough to address last-minute changes. Following are some strategies you might want to consider. Be sure to consult your tax advisor to see how these suggestions apply to your particular situation.

Reverse the rules

Typically, the advice for business owners at the end of any year is to defer income to the following year to help reduce the organization's current income tax obligation. However, because individual income tax rates are scheduled to rise in 2013, this year may call for a reverse strategy. If your organization is taxed as a pass-through entity and your accounting method permits it, you may want to consider accelerating revenue into 2012 to take advantage of the current lower rates.

Similarly, owners of C corporations may want to consider cashing in on appreciated stock or paying themselves in dividends to take advantage of lower capital gains and dividend rates slated to expire at the end of the year.

Another rule-reversal move would be to consider deferring deductions and capital losses until 2013 to maximize your company's tax profile in a higher-rate environment.

Buy needed equipment and put it to use

There is one case where you may not want to defer deductions: if you think you'll need new office furniture or equipment in 2013, you may want to make that purchase in 2012. That's because two special provisions enacted several years ago to help spur business investment will expire at year's end.

The first is a temporary increase in the Section 179 property-expensing deduction, which allows a business to deduct the entire cost of qualified equipment in the year it was purchased rather than utilize the standard depreciation schedule.** In 2012, businesses can deduct up to $139,000 of the cost of qualified property, up to a maximum total property purchase of $560,000. (Total property purchases above that ceiling will reduce the amount of the allowable deduction.) The second provision is a special first-year bonus depreciation allowance of 50% of the cost of the equipment, which is not subject to the $560,000 limit.** In 2013, the $139,000 and $560,000 Section 179 property-expensing limits are scheduled to plummet to $25,000 and $200,000, respectively, while the 50% bonus depreciation allowance will be eliminated.

The Section 179 deduction and the bonus depreciation allowance can be used in conjunction with one another. It's worth analyzing these two provisions and comparing them with the standard depreciation deductions to determine the best possible tax-planning moves for your business.

Vehicle purchases also receive favorable tax treatment until the end of 2012. This is particularly true for heavy sport-utility vehicles and pickups with a gross vehicle weight rating in excess of 6,000 pounds, which may qualify for special depreciation and Section 179 allowances.

Note that property must be *placed into service*, not merely purchased, by the end of 2012 in order to qualify.

Hire a veteran

In 2011, the Vow to Hire Heroes Act extended the Work Opportunity Tax Credit to encourage employers to hire unemployed veterans. The credit, which also expires at the end of this year, ranges from $2,400 to $9,600 depending on several factors, including length of employment and whether the veteran has a service-related disability. Note that the veteran must begin work prior to January 1, 2013. For more information on hiring a veteran, visit the Department of Labor's Veterans' Employment and Training Service web page at www.dol.gov/vets/.

Be watchful

Although there is some risk in not waiting to see if Congress acts by year's end, these are just some of the moves you may want to make now to take advantage of current, and potentially short-lived, tax benefits. In the meantime, keep a close eye on Washington to see what legislative changes may lie ahead.

**Source: "Baucus Examines Ways to Reduce Distortions in Business Caused by the Tax Code," Senate Finance Committee press release, August 1, 2012.*

***Certain conditions, limits, and exceptions apply.*

Employer-Provided Vehicles

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In general, the FMV of an employer-provided vehicle is the amount the employee would have to pay a third party to lease the same or similar vehicle on the same or comparable terms in the geographic area where the employee uses the vehicle. A comparable lease term would be the amount of time the vehicle is available for the employee's use, such as a 1-year period.

Do not determine the FMV by multiplying a cents-per-mile rate times the number of miles driven unless the employee can prove the vehicle could have been leased on a cents-per-mile basis.

Cents-Per-Mile Rule

Under this rule, you determine the value of a vehicle you provide to an employee for personal use by multiplying the standard mileage rate by the total miles the employee drives the vehicle for personal purposes. Personal use is any use of the vehicle other than use in your trade or business. This amount must be included in the employee's wages or reimbursed by the employee. For 2007, the standard mileage rate is 48.5 cents a mile.

You can use the cents-per-mile rule if either of the following requirements is met.

- You reasonably expect the vehicle to be regularly used in your trade or business throughout the calendar year (or for a shorter period during which you own or lease it).
- The vehicle meets the mileage test.

Maximum automobile value. You cannot use the cents-per-mile rule for an automobile (any 4-wheeled vehicle, such as a car, pickup truck, or van) if its value when you first make it available to any employee for personal use is more than an amount determined by the IRS as the maximum automobile value for the year. For example, you cannot use the cents-per-mile rule for an automobile that you first made available to an employee in 2007 if its value at that time exceeded $15,100 for a passenger automobile or $16,100 for a truck or van. If you and the employee own or lease the automobile together, see Regulations section 1.61-21(e)(1)(iii)(B).
Vehicle. For the cents-per-mile rule, a vehicle is any motorized wheeled vehicle, including an automobile, manufactured primarily for use on public streets, roads, and highways.
Regular use in your trade or business. A vehicle is regularly used in your trade or business if at least one of the following conditions is met.

- At least 50% of the vehicle's total annual mileage is for your trade or business.
- You sponsor a commuting pool that generally uses the vehicle each workday to drive at least three employees to and from work.
- The vehicle is regularly used in your trade or business on the basis of all of the facts and circumstances. Infrequent business use of the vehicle, such as for occasional trips to the airport or between your multiple business premises, is not regular use of the vehicle in your trade or business.

Mileage test. A vehicle meets the mileage test for a calendar year if both of the following requirements are met.

- The vehicle is actually driven at least 10,000 miles during the year. If you own or lease the vehicle only part of the year, reduce the 10,000 mile requirement proportionately.
- The vehicle is used during the year primarily by employees. Consider the vehicle used primarily by employees if they use it consistently for commuting. Do not treat the use of the vehicle by another individual whose use would be taxed to the employee as use by the employee.

For example, if only one employee uses a vehicle during the calendar year and that employee drives the vehicle at least 10,000 miles in that year, the vehicle meets the mileage test even if all miles driven by the employee are personal.

Consistency requirements. If you use the cents-per-mile rule, the following requirements apply.

- You must begin using the cents-per-mile rule on the first day you make the vehicle available to any employee for personal use. However, if you use the commuting rule (discussed later) when you first make the vehicle available to any employee for personal use, you can change to the cents-per-mile rule on the first day for which you do not use the commuting rule.
- You must use the cents-per-mile rule for all later years in which you make the vehicle available to any employee and the vehicle qualifies, except that you can use the commuting rule for any year during which use of the vehicle qualifies under the commuting rules. However, if the vehicle does not qualify for the cents-per-mile rule during a later year, you can use for that year and thereafter any other rule for which the vehicle then qualifies.
- You must continue to use the cents-per-mile rule if you provide a replacement vehicle to the employee and your primary reason for the replacement is to reduce federal taxes.

Items included in cents-per-mile rate. The cents-per-mile rate includes the value of maintenance and insurance for the vehicle. Do not reduce the rate by the value of any service included in the rate that you did not provide. (You can take into account the services actually provided for the vehicle by using the *General Valuation Rule,* earlier.)

For miles driven in the United States, its territories and possessions, Canada, and Mexico, the cents-per-mile rate includes the value of fuel you provide. If you do not provide fuel, you can reduce the rate by no more than 5.5 cents.

For special rules that apply to fuel you provide for miles driven outside the United States, Canada, and Mexico, see Regulations section 1.61-21(e)(3)(ii)(B).

The value of any other service you provide for a vehicle is not included in the cents-per-mile rate. Use the general valuation rule to value these services.

Commuting Rule

Under this rule, you determine the value of a vehicle you provide to an employee for commuting use by multiplying each one-way commute (that is, from home to work or from work to home) by $1.50. If more than one employee commutes in the vehicle, this value applies to each employee. This amount must be included in the employee's wages or reimbursed by the employee.

You can use the commuting rule if all the following requirements are met.

- You provide the vehicle to an employee for use in your trade or business and, for bona fide noncompensatory business reasons, you require the employee to commute in the vehicle. You will be treated as if you had met this requirement if the vehicle is generally used each workday to carry at least three employees to and from work in an employer sponsored commuting pool.
- You establish a written policy under which you do not allow the employee to use the vehicle for personal purposes other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home). Personal use of a vehicle is all use that is not for your trade or business.
- The employee does not use the vehicle for personal purposes other than commuting and de minimis personal use.
- If this vehicle is an automobile (any four-wheeled vehicle, such as a car, pickup truck, or van), the employee who uses it for commuting is not a control employee. See *Control employee* below.

Vehicle. For this rule, a vehicle is any motorized wheeled vehicle, including an automobile manufactured primarily for use on public streets, roads, and highways.

Control employee. A control employee of a non-government employer for 2007 is generally any of the following employees.

- A board or shareholder-appointed, confirmed, or elected officer whose pay is $90,000 or more.
- A director.
- An employee whose pay is $180,000 or more.
- An employee who owns a 1% or more equity, capital, or profits interest in your business.

A control employee for a government employer for 2007 is either of the following.

- A government employee whose compensation is equal to or exceeds Federal Government Executive Level V. (See the Office of Personnel Management website at www.opm.gov/oca/payrates/index.asp for 2007 compensation information.)
- An elected official.

Highly compensated employee alternative. Instead of using the preceding definition, you can choose to define a control employee as any highly compensated employee. A highly compensated employee for 2007 is an employee who meets either of the following tests.

1. The employee was a 5% owner at any time during the year or the preceding year.
2. The employee received more than $100,000 in pay for the preceding year.

You can choose to ignore test (2) if the employee was not also in the top 20% of employees when ranked by pay for the preceding year.

Lease Value Rule

Under this rule, you determine the value of an automobile you provide to an employee by using its annual lease value. For an automobile provided only part of the year, use either its prorated annual lease value or its daily lease value.

If the automobile is used by the employee in your business, you generally reduce the lease value by the amount that is excluded from the employee's wages as a working condition benefit. However, you can choose to include the entire lease value in the employee's wages. See *Vehicle allocation rules,* earlier.

Automobile. For this rule, an automobile is any four-wheeled vehicle (such as a car, pickup truck, or van) manufactured primarily for use on public streets, roads, and highways.
Consistency requirements. If you use the lease value rule, the following requirements apply.

1. You must begin using this rule on the first day you make the automobile available to any employee for personal use. However, the following exceptions apply.
   a. If you use the commuting rule (discussed earlier) when you first make the automobile available to any employee for personal use, you can change to the lease value rule on the first day for which you do not use the commuting rule.
   b. If you use the cents-per-mile rule (discussed earlier) when you first make the automobile available to any employee for personal use, you can change to the lease value rule on the first day on which the automobile no longer qualifies for the cents-per-mile rule.
2. You must use this rule for all later years in which you make the automobile available to any employee, except that you can use the commuting rule for any year during which use of the automobile qualifies.
3. You must continue to use this rule if you provide a replacement automobile to the employee and your primary reason for the replacement is to reduce federal taxes.

Annual Lease Value

Generally, you figure the annual lease value of an automobile as follows.

1. Determine the fair market value (FMV) of the automobile on the first date it is available to any employee for personal use.
2. Using *Table 3-1. Annual Lease Value Table,* read down column (1) until you come to the dollar range within which the FMV of the automobile falls. Then read across to column (2) to find the annual lease value.

Table 3-1. Annual Lease Value Table

(1) Automobile FMV	**(2) Annual Lease**
$0 to 999	$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750

(1) Automobile FMV	(2) Annual Lease
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

For automobiles with a FMV of more than $59,999, the annual lease value equals (.25 × the FMV of the automobile) + $500.

FMV. The FMV of an automobile is the amount a person would pay to buy it from a third party in an arm's-length transaction in the area in which the automobile is bought or leased. That amount includes all purchase expenses, such as sales tax and title fees.

If you have 20 or more automobiles, see Regulations section 1.61-21(d)(5)(v). If you and the employee own or lease the automobile together, see Regulations section 1.61-21(d)(2)(ii).

You do not have to include the value of a telephone or any specialized equipment added to, or carried in, the automobile if the equipment is necessary for your business. However, include the value of specialized equipment if the employee to whom the automobile is available uses the specialized equipment in a trade or business other than yours.

Neither the amount the employee considers to be the value of the benefit nor your cost for either buying or leasing the automobile determines its FMV. However, see *Safe-harbor value,* next.

Safe-harbor value. You may be able to use a safe-harbor value as the FMV. For an automobile you bought at arm's length, the safe-harbor value is your cost, including tax, title, and other purchase expenses. You cannot have been the manufacturer of the automobile.

For an automobile you lease, you can use any of the following as the safe-harbor value.

- The manufacturer's invoice price (including options) plus 4%.
- The manufacturer's suggested retail price minus 8% (including sales tax, title, and other expenses of purchase).
- The retail value of the automobile reported by a nationally recognized pricing source if that retail value is reasonable for the automobile.

Items included in annual lease value table. Each annual lease value in the table includes the value of maintenance and insurance for the automobile. Do not reduce the annual lease value by the value of any of these services that you did not provide. For example, do not reduce the annual lease value by the value of a maintenance service contract or insurance you did not provide. (You can take into account the services actually provided for the automobile by using the general valuation rule discussed earlier.)

Items not included. The annual lease value does not include the value of fuel you provide to an employee for personal use, regardless of whether you provide it, reimburse its cost, or have it charged to you. You must include the value of the fuel separately in the employee's wages. You can value fuel you provided at FMV or at 5.5 cents per mile for all miles driven by the employee. However, you cannot value at 5.5 cents per mile fuel you provide for miles driven outside the United States (including its possessions and territories), Canada, and Mexico.

If you reimburse an employee for the cost of fuel, or have it charged to you, you generally value the fuel at the amount you reimburse, or the amount charged to you if it was bought at arm's length.

If you have 20 or more automobiles, see Regulations section 1.61-21(d)(3)(ii)(D).

If you provide any service other than maintenance and insurance for an automobile, you must add the FMV of that service to the annual lease value of the automobile to figure the value of the benefit.

4-year lease term. The annual lease values in the table are based on a 4-year lease term. These values will generally stay the same for the period that begins with the first date you use this rule for the automobile and ends on December 31 of the fourth full calendar year following that date.

Figure the annual lease value for each later 4-year period by determining the FMV of the automobile on January 1 of the first year of the later 4-year period and selecting the amount in column (2) of the table that corresponds to the appropriate dollar range in column (1).

Using the special accounting rule. If you use the special accounting rule for fringe benefits discussed in section 4, you can figure the annual lease value for each later 4-year period at the beginning of the special accounting period that starts immediately before the January 1 date described in the previous paragraph.

For example, assume that you use the special accounting rule and that, beginning on November 1, 2006, the special accounting period is November 1 to October 31. You elected to use the lease value rule as of January 1, 2007. You can refigure the annual lease value on November 1, 2010, rather than on January 1, 2011.

Transferring an automobile from one employee to another. Unless the primary purpose of the transfer is to reduce federal taxes, you can refigure the annual lease value based on the FMV of the automobile on January 1 of the calendar year of transfer.

However, if you use the special accounting rule for fringe benefits discussed in section 4, you can refigure the annual lease value (based on the FMV of the automobile) at the beginning of the special accounting period in which the transfer occurs.

Prorated Annual Lease Value

If you provide an automobile to an employee for a continuous period of 30 or more days but less than an entire calendar year, you can prorate the annual lease value. Figure the prorated annual lease value by multiplying the annual lease value by a fraction, using the number of days of availability as the numerator and 365 as the denominator.

If you provide an automobile continuously for at least 30 days, but the period covers 2 calendar years (or 2 special accounting periods if you are using the special accounting rule for fringe benefits discussed in section 4), you can use the prorated annual lease value or the daily lease value.

If you have 20 or more automobiles, see Regulations section 1.61-21(d)(6).

If an automobile is unavailable to the employee because of his or her personal reasons (for example, if the employee is on vacation), you cannot take into account the periods of unavailability when you use a prorated annual lease value.

You cannot use a prorated annual lease value if the reduction of federal tax is the main reason the automobile is unavailable.

Daily Lease Value

If you provide an automobile to an employee for a continuous period of less than 30 days, use the daily lease value to figure its value. Figure the daily lease value by multiplying the annual lease value by a fraction, using four times the number of days of availability as the numerator and 365 as the denominator.

However, you can apply a prorated annual lease value for a period of continuous availability of less than 30 days by treating the automobile as if it had been available for 30 days. Use a prorated annual lease value if it would result in a lower valuation than applying the daily lease value to the shorter period of availability.

Unsafe Conditions Commuting Rule

Under this rule, the value of commuting transportation you provide to a qualified employee solely because of unsafe conditions is $1.50 for a one-way commute (that is, from home to work or from work to home). This amount must be included in the employee's wages or reimbursed by the employee.

You can use the unsafe conditions commuting rule for qualified employees if all of the following requirements are met.

- The employee would ordinarily walk or use public transportation for commuting.
- You have a written policy under which you do not provide the transportation for personal purposes other than commuting because of unsafe conditions.
- The employee does not use the transportation for personal purposes other than commuting because of unsafe conditions.

These requirements must be met on a trip-by-trip basis.

Commuting transportation. This is transportation to or from work using any motorized wheeled vehicle (including an automobile) manufactured for use on public streets, roads, and highways. You or the employee must buy the transportation from a party that is not related to you. If the employee buys it, you must reimburse the employee for its cost (for example, cab fare) under a bona fide reimbursement arrangement.
Qualified employee. A qualified employee for 2007 is one who:

- Performs services during the year,
- Is paid on an hourly basis,
- Is not claimed under section 213(a)(1) of the Fair Labor Standards Act of 1938 (as amended) to be exempt from the minimum wage and maximum hour provisions,
- Is within a classification for which you actually pay, or have specified in writing that you will pay, overtime pay of at least one and one-half times the regular rate provided in section 207 of the 1938 Act, and
- Receives pay of not more than $100,000 during the year.'>

However, an employee is not considered a qualified employee if you do not comply with the recordkeeping requirements concerning the employee's wages, hours, and other conditions and practices of employment under section 211(c) of the 1938 Act and the related regulations.
Unsafe conditions. Unsafe conditions exist if, under the facts and circumstances, a reasonable person would consider it unsafe for the employee to walk or use public transportation at the time of day the employee must commute. One factor indicating whether it is unsafe is the history of crime in the geographic area surrounding the employee's workplace or home at the time of day the employee commutes.

Age-Related Tax and Financial Milestones

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In an era filled with uncertainty, you can count on one thing for sure: Time marches on! This article covers some important age-related tax and financial planning milestones that you should keep in mind for yourself and loved ones.

Age 0–23: The so-called Kiddie Tax rules can potentially apply to your child's (or grandchild's) investment income until the year he or she reaches age 24. Specifically, a child's investment income in excess of the applicable annual threshold is taxed at the parent's marginal federal income tax rates. A child's investment income below the threshold is taxed at very favorable rates. Note that between ages 19 and 23, the Kiddie Tax is only an issue if the child is a student. For the year the child turns age 24 and for all subsequent years, the Kiddie Tax ceases to be a threat.

Age 18 or 21: A custodial account set up for a minor child comes under the child's control when he or she reaches the age of majority under applicable state law (usually age 18 or 21). If there's a significant amount of money in the custodial account, this issue can be a big deal. Depending on the child's maturity level and dependability, you may or may not want to take steps to ensure that the money in the custodial account is used for expenditures you approve of (like college costs).

Age 30: If you set up a Coverdell Education Savings Account (CESA) for a child (or grandchild), it must be liquidated within 30 days after he or she turns 30 years old. To the extent earnings included in a distribution are not used for qualified higher education expenses, they are subject to federal income tax plus a 10% penalty tax. Alternatively, the CESA balance can be rolled over tax-free into another CESA set up for a younger family member.

Age 50: If you're age 50 or older as of the end of the year, you can make an additional catch-up contribution to your 401(k) plan (up to $5,500 for 2013), Section 403(b) plan (up to $5,500 for 2013), Section 457 plan (up to $5,500 for 2013), or SIMPLE plan (up to $2,500 for 2013), assuming the plan permits catch-up contributions. You can also make an additional catch-up contribution (up to $1,000 for 2013) to your traditional or Roth IRA (the deadline for making IRA catch-up contributions for the 2013 tax year is 4/15/14).

Age 55: If you permanently leave your job for any reason, you can receive distributions from the former employer's qualified retirement plan(s) without being hit with the 10% premature withdrawal penalty tax. This is an exception to the general rule that the taxable portion of qualified retirement plan distributions received before age 59½ are hit with the 10% penalty tax.

Age 59½: You can receive distributions from all types of tax-favored retirement plans and accounts (IRAs, 401(k) accounts, pensions, and the like) and from tax-deferred annuities without being hit with the 10% premature withdrawal penalty tax. Before age 59½, the 10% penalty tax will hit the taxable portion of distributions unless an exception to the penalty tax applies.

Age 62: You can choose to start receiving Social Security retirement benefits. However, your benefits will be lower than if you wait until reaching full retirement age, which is age 66 for those born between 1943 and 1954. If you also work before reaching full retirement

age, your 2013 Social Security retirement benefits will be further reduced if your income from working exceeds $15,120 for 2013.

Age 66: You can start receiving full Social Security retirement benefits at age 66 if you were born in 1943–1954. You won't lose any benefits if you work in years after the year you reach age 66, regardless of how much money you make in those years. However if you will reach age 66 this year, your 2013 benefits will be reduced if this year's earnings exceed $40,080.

Age 70: You can choose to postpone receiving Social Security retirement benefits until you reach age 70. If you make this choice, your benefits will be higher than if you start earlier.

Age 70½: You generally must begin taking annual Required Minimum Distributions (RMDs) from tax-favored retirement accounts (traditional IRAs, SEP accounts, 401(k) accounts, and the like) and pay the resulting income taxes. However, you need not take any RMDs from Roth IRAs set up in your name. The initial RMD is for the year you turn 70½, but you can postpone taking that one until as late as April 1 of the following year. If you chose that option, however, you must take two RMDs in that year: one by the April 1 deadline (the RMD for the previous year) plus another by December 31 (the RMD for the current year). For each subsequent year, you must take another RMD by December 31. There's one more exception: If you're still working after reaching age 70½ and you don't own over 5% of the employer, you can postpone taking any RMDs from the employer's plan(s) until after you've actually retired.

IRS Compliance Trends for the Next Decade

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June 28, 2012
by Blake E. Christian, CPA

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Earlier this month, I attended the AICPA Practitioners Symposium and TECH+ Conference, along with more than 1,600 CPAs and marketing professionals. The three-day conference offered more than 150 interesting technical and marketing sessions. One such session was presented by Jim Buttonow, vice president of product development, and Brian Howell, product manager, for Beyond415, a web-based software developed by New River Innovation Inc. of Greensboro, N.C.

Buttonow started his presentation by asking the participants a question: “What does an average firm spend 66 days a year on, but only bills for 28% of the work?” His answer: “The flood of hundreds of millions of IRS notices being sent annually.” The IRS sends more notices annually than the number of taxpayers, so businesses and individual taxpayers can all expect to be contacted more than once by the IRS.

The increased volume of notices sent and audits conducted by the IRS and state and local tax authorities unnerves almost any client, and it can put a strain on the CPA-client relationship—even when the CPA didn’t make any errors.

Buttonow outlined the ongoing “tax gap” problem faced by Treasury. The problem is complex. The United States has one of the highest tax-compliance rates in the world, with an estimated underground economy of 8.7%, versus other countries’ higher rates, e.g., Russia, 45%; China, 20%; and Great Britain, 16%. However, because of the massive U.S. economy, the combined cost of noncompliance from underreporting, non-filing, and nonpayment is projected to be a whopping $450 billion annually. With an estimated U.S. deficit of more than $1.3 trillion for fiscal year 2012, according to the White House Office of Management and Budget, collecting a substantial portion of the $450 billion tax gap would allow Congress to keep tax rates down and/or retain certain programs—so the IRS is clearly focused on reducing the tax gap.

According to the IRS’s latest study, the projected federal tax gap has three causes: 84% is related to *underreporting* of taxable income and taxes on returns; 10% is related to *underpayment* of taxes reported by taxpayers or assessed by the IRS; and 6% is related to *non-filing* of tax returns.

Because state taxable income is generally tied to reported federal taxable income (assuming a return is filed), tax gaps are also present at the state level—as well as growing deficits resulting from the four-year economic downturn.

To close the federal tax gap and help reduce the federal deficit, the IRS is continuing to focus on some of its tried-and-true compliance enforcement techniques. It is also testing some new techniques.

The following is an overview of areas the IRS is likely to focus on during the next decade, according to Buttonow:

2. ***Do more with less.*** For fiscal year 2012, the IRS's budget was cut by $305 million. Even though the IRS is expected to receive a budget increase in 2013, it will have more programs to administer, including implementing provisions of the new health care law.

   The IRS employs more than 90,000 people and has more than 192 data systems. Streamlining these systems and using technology for compliance initiatives are some of the IRS's primary objectives.

   Technology provides the IRS with the best return on investment (ROI). The cost for GS-4 agents to handle mail audits is as low as $11.75 per hour, yet these audits can average returns of $4,578 per hour. Auditors who handle field audits are paid approximately $24 per hour, and these audits yield an average of $330 per hour in new assessments. Therefore, we can expect to see more computer-matching and mail-driven compliance programs now and in the future as the IRS seeks to leverage information and technology to close the tax gap.
3. ***Increase compliance rate to 90% by 2017.*** The voluntary compliance rate is the amount taxpayers actually pay versus what they should report and pay. The most recent IRS study of U.S. taxpayer compliance rates was completed in January 2012 and measured noncompliance on 2006 tax returns. The study reported a voluntary compliance rate of 83.1%, which falls within the 83% to 84% range that has prevailed for the past 27 years.

   The IRS goal for 2009, which will be measured in three years, is 86% voluntary compliance. The IRS hopes to raise the compliance rate to 90% by 2017, which would reduce the current $450 billion tax gap by about 40% to $266 billion. Every 1% increase in compliance would generate at least $27 billion—so a 6% improvement in the most recently published compliance rate of 83.1% would be expected to increase revenue by $184 billion.
4. ***Focus on high-yield assessments.*** Areas in which the IRS has found significant underreporting noncompliance will continue to be a focus of compliance activity, including audits, in coming years. These areas include:
   - High-income individuals.
   - Worker classification: W-2 vs. independent contractor.
   - S corp. losses claimed in excess of basis.
   - Rental property losses: passive vs. active, as well as basis issues.
   - General small business underreporting of taxable income.
   - Form 1099 filing compliance.
   - Review of international taxpayers/FBAR, etc.
5. ***Increase tax document matching.*** The IRS is pleased with its ability to computer match documents such as Forms 1099, W-2, etc., which results in a 99% compliance rate in reporting those amounts. However, for certain small businesses (e.g., S corps., partnerships, Schedule C filers), the compliance rate is only 44% because not all small business revenue is subject to computer matching of tax documents. As reflected above, automated compliance systems and office audits can produce significant ROI. In 2011,

70% of compliance audits were conducted via mail, and 30% were field audits. In 1995, the ratio was 54% mail audits to 46% field audits. Based on ROI, this trend toward more automated, higher ROI compliance activity will continue.

It is interesting that the annual volume of IRS notices has increased sevenfold since 2001. The IRS issued 201 million taxpayer notices in 2009, up from 30 million in 2001. These are invariably hardcopies, so we can conclude the IRS does not have a very effective paperless program.

6. ***Simplify the Code.*** There have been 4,426 tax law changes in the past 10 years, and the Internal Revenue Code gets more complex every year. Some portion of the tax gap is related to valid confusion among taxpayers as well as some CPAs. Simplifying the Code would greatly reduce unintentional errors. Buttonow noted that any progress toward tax simplification this year is highly unlikely, but late congressional activity to extend the Bush tax cuts is more likely. Any late changes to the Code would add to unintentional errors.
7. ***Regulate and deputize tax professionals.*** The IRS is spending resources in educating and regulating tax preparers to remove "bad players" in the tax preparation arena and, where necessary, is imposing and expanding significant penalties on preparers and their clients.

   The IRS's focus on requiring tax preparers to meet certain requirements and register to be part of a database has thinned the ranks from 1.2 million tax preparers to 850,000 registered tax return preparers. In theory, this raises the bar and compliance level of those remaining tax preparers. Of course, there will always be a "gray market" element with tax preparers who aren't registered in the database, but the IRS is watching.
8. ***Mandate disclosures.*** Over the past few decades, the IRS has increased the level of detail tax preparers must include in their returns. Failure to make those disclosures can result in civil penalties and sometimes even criminal penalties.

   Examples include:
   - Schedule UTP, *Uncertain Tax Position Statement*.
   - Form 8275, *Disclosure Statement*.
   - Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR).

Buttonow points out that these trends will also be adopted in whole or in part by state and local tax authorities. There are 50 states, 3,033 counties, 19,492 municipalities, and 16,519 towns throughout the United States—all looking to plug increasing deficits.

The bottom line? CPAs need to inform their clients that the IRS and other tax authorities are aggressively auditing taxpayers, and that clients can expect an increase in notices and audits. In many circumstances, compliance activity has little to do with how the return was prepared. The IRS and states are increasing compliance activity because they now have the ability to do so easily with more information and more sophisticated, automated compliance systems. With a $450 billion annual tax gap, those efforts could go a long way to reducing annual $1 trillion deficits. Expect the compliance activity to remain high as the government looks to balance its budget.

2013 Medicare Contribution Tax

on Investment Income, High Wages and SE Earnings

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Medicare Contribution Tax on Unearned Income: Individuals with Modified Adjusted Gross Income (MAGI) over $200,000 ($250,000 if Married, filing Jointly; $125,000 if Married, filing separately) are subject to a 3.8% surtax (the Medicare Contribution tax) on their net investment income, up to the excess of MAGI over the threshold amount. Net investment income includes interest, dividends, royalties, rents, gross income from a trade or business involving passive activities and net gain from the dispositions of property other than most property held in a trade or business, reduced by deductions allocable to such income. The tax also applies to estates and trusts.

For 2012, this tax does not exist.

A recent Congressional Research Service (CRS) report describes the application of homes sales to the calculation of the 3.8% unearned income Medicare contribution tax scheduled to begin in 2013. The tax applies to single taxpayers with Modified Adjusted Gross Income (MAGI) greater than $200,000 ($250,000 for MFJ), and is computed by multiplying 3.8% by the lesser of net investment income, or the amount MAGI exceeds $200,000/$250,000. A home sale may be subject to the tax if (1) the taxpayer's MAGI exceeds the threshold, (2) sale of a principal residence results in capital gain greater than the home sale exclusion ($250,000 single/$500,000 MFJ), and/or (3) the sale of a non-principal residence results in capital gain.

Additional Medicare Tax on High Wages: The Medicare portion of the FICA tax on Employees is 2.35% for wages over $200,000 ($250,00 if Married, filing Jointly; $125,00 if Married, filing separately). This additional 0.9% tax is computed on the combined wages of taxpayers filing a joint return.

For 2012, the Medicare portion of the FICA tax is 1.45% of all wages.

Additional Medicare Tax on High Self-Employment Income: The Medicare portion of the self-employment (SE) tax is 3.8% on self-employment income over $200,000 ($250,00 if Married, filing Jointly; $125,00 if Married, filing separately). The amount subject to the additional 0.9% tax is reduced by wages counted for FICA tax. This additional Medicare tax is not deductible for income or SE tax.

For 2012, the Medicare portion of the SE tax is 2.9% of all SE income, and 1/2 of the Medicare tax paid is deductible for income and SE tax computations.

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Planning for the 3.8 Percent Medicare Tax on Investment Income

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The health care reform package (the Patient Protection and Affordable Care Act and the Health Care and education Reconciliation Act of 2010) imposes a new 3.8 Medicare contribution tax on the investment income of higher-income individuals. Although the tax does not take effect until 2013, it is not too soon to examine methods to lessen the impact of the tax.

Net investment income. Net investment income, for purposes of the new 3.8 percent Medicare tax, includes interest, dividends, annuities, royalties and rents and other gross income attributable to a passive activity. Gains from the sale of property that is not used in an active business and income from the investment of working capital are treated as investment income as well. However, the tax does not apply to nontaxable income, such as tax-exempt interest or veterans' benefits. Further, an individual's capital gains income will be subject to the tax. This includes gain from the sale of a principal residence, unless the gain is excluded from income under Code Sec. 121, and gains from the sale of a vacation home. However, contemplated sales made before 2013 would avoid the tax.

The tax applies to estates and trusts, on the lesser of undistributed net income or the excess of the trust/estate adjusted gross income (AGI) over the threshold amount ($11,200) for the highest tax bracket for trusts and estates, and to investment income they distribute.

Deductions. Net investment income for purposes of the new 3.8 percent tax is gross income or net gain, reduced by deductions that are "properly allocable" to the income or gain. This is a key term that the Treasury Department expects to address in guidance, and which we will update you on developments. For passively-managed real property, allocable expenses will still include depreciation and operating expenses. Indirect expenses such as tax preparation fees may also qualify.

For capital gain property, this formula puts a premium on keeping tabs on amounts that increase your property's basis. It also puts the focus on investment expenses that may reduce net gains: interest on loans to purchase investments, investment counsel and advice, and fees to collect income. Other costs, such as brokers' fees, may increase basis or reduce the amount realized from an investment. As such, you may want to consider avoiding installment sales with net capital gains (and interest) running past 2012.

Thresholds and impact. The tax applies to the lesser of net investment income or modified AGI above $200,000 for individuals and heads of household, $250,000 for joint filers and surviving spouses, and $125,000 for married filing separately. MAGI is AGI increased by foreign earned income otherwise excluded under Code Sec. 911; MAGI is the same as AGI for someone who does not work overseas.

Example. Jim, a single individual, has modified AGI of $220,000 and net investment income of $40,000. The tax applies to the lesser of (i) net investment income ($40,000) or (ii) modified AGI ($220,000) over the threshold amount for an individual ($200,000), or $20,000. The tax is

3.8 percent of $20,000, or $760. In this case, the tax is not applied to the entire $40,000 of investment income.

The tax can have a substantial impact if you have income above the specified thresholds. Also, don't forget that, in addition to the tax on investment income, you may also face other tax increases proposed by the Obama administration that could take effect in 2013. The top two marginal income tax rates on individuals would rise from 33 and 35 percent to 36 and 39.6 percent, respectively. The maximum tax rate on long-term capital gains would increase from 15 percent to 20 percent. Moreover, dividends, which are currently capped at the 15 percent long-term capital gain rate, would be taxed as ordinary income. Thus, the cumulative rate on capital gains would increase to 23.8 percent in 2013, and the rate on dividends would jump to as much as 43.4 percent. Moreover, the thresholds are not indexed for inflation, so a greater number of taxpayers may be affected as time elapses. Congress may step in and change these rate increases, but the possibility of rates going up for upper income taxpayers is sufficiently real that tax planning must take them into account.

Exceptions. Certain items and taxpayers are not subject to the 3.8 percent tax. A significant exception applies to distributions from qualified plans, 401(k) plans, tax-sheltered annuities, individual retirement accounts (IRAs), and eligible 457 plans. At the present time, however, there is no exception for distributions from nonqualified deferred compensation plans subject to Code Sec. 409A, although some experts claim that not carving out such an exception was a Congressional oversight that should be rectified by an amendment to the law before 2013.

The exception for distributions from retirement plans suggests that potentially taxed investors may want to shift wages and investments to retirement plans such as 401(k) plans, 403(b) annuities, and IRAs, or to 409B Roth accounts. Increasing contributions will reduce income and may help you stay below the applicable thresholds. Small business owners may want to set up retirement plans, especially 401(k) plans, if they have not yet established a plan, and should consider increasing their contributions to existing plans.

Another exception covers income ordinarily derived from a trade or business that is not a passive activity under Code Sec. 469, such as a sole proprietorship. Investment income from an active trade or business is also excluded. However, SECA (Self-Employment Contributions Act) tax will still apply to proprietors and partners. Income from trading in financial instruments and commodities is also subject to the tax. The tax does not apply to income from the sale of an interest in a partnership or S corporation, to the extent that gain of the entity's property would be from an active trade or business. The tax also does not apply to business entities (such as corporations and limited liability companies), nonresident aliens (NRAs), charitable trusts that are tax-exempt, and charitable remainder trusts that are nontaxable under Code Sec. 664.

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