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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.

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%

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.

Virginia Tax Law Changes:

- All corporation 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

Supreme Court Ruling: 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.

Auto, Meals & Entertainment Expenses Denied: DE, a C corporation, both paid and reimbursed various expenses for its sole shareholder, who also was an employee. At tax time, DE deducted meal and entertainment expenses and automobile expenses. The IRS denied all of the deductions, so DE took the IRS to court. **Held:** For the IRS, for the following reasons:

Auto use. The taxpayer asserted that a vehicle was used 100% for business, but provided neither a log of mileage driven, beginning and ending points of each trip and its business purpose, nor testimony or other evidence that would establish this information.

2012 Cost-of-Living Limits

IRA Contribution Limit $5,000
IRA 50 & Over Catch-up Contribution $1,000
401(k) Deferral Limit $17,000
401(k) 50 & Over Catch-up Contribution $5,500
SIMPLE Deferral limit $11,500
SIMPLE 50 & Over Catch-up Contribution $2,500
Annual Compensation limit $250,000
Defined Contribution IRC Sec 415 limit $50,000
Compensation limit for SEP eligibility $550
IRC Section 179 $139,000
Estate Tax Exclusion $5,120,000
Gift Tax Annual Exclusion $13,000
Social Security Wage Base $110,100
2011 & 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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Meals and entertainment. Although the taxpayer offered either meal receipts or credit card statements, IRC §274, *Disallowance of certain entertainment, etc., expenses*, requires details that the taxpayer did not provide, such as time and place of meals and/or entertainment, the name of the client at the event and the business purpose of the event. And, the taxpayer offered no additional evidence that might provide the data. [*D'Errico* v. *Commissioner*, T.C. Memo. 2012-149]

IRC §274's strict substantiation rules apply to meals and entertainment *and* to business auto use. Providing receipts with the assertion that the expenses were for business is not sufficient.

2012 Mid-Year 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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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 ($250,00 if Married, filing Jointly; $125,00 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.

Another Article on this topic follows on next page, scroll down

Planning for the 3.8 Percent Medicare Tax on Investment Income

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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IRS compliance trends for the next decade

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June 28, 2012
by Blake E. Christian, CPA

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.

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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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