

The Kiplinger Tax Letter

CIRCULATED BIWEEKLY TO BUSINESS CLIENTS SINCE 1925

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Dear Client:

Washington, June 26, 2009

A showdown is ahead on health care reform:

The House and Senate are far apart on taxes.

The centerpiece of the Senate's tax plan will be a limit on the tax break that employees receive for the value of employer provided coverage. But that is an option that House tax lawmakers are intent on avoiding, though they are considering major revenue raisers likely to prove equally controversial and hard to pass.

Rising cost estimates make the task harder.

The 10-year cost for revamping the health care system would far exceed \$1 trillion by some new estimates.

With health care cost savings expected to pick up about 40% of the tab for overhaul, that leaves the tax committees having to find more than \$600 billion in revenues.

That's prompting House taxwriters to think big, mainly eyeing tax increases that would raise hundreds of billions of dollars. Among the options they are eyeing:

Charging a surtax of 2% or more on upper incomers...singles making more than \$200,000 a year and marrieds above \$250,000. These are the same taxpayers that Obama targets in his proposal to let the 33% and 35% top marginal rates rise to 36% and 39.6%, respectively. The idea is strongly supported by many Democrats.

Tinkering with payroll taxes. This could include raising the Medicare tax from its current 1.45% rate to 1.8% or higher. Or even imposing a new payroll tax on employers...3% or so of the amounts they spend on health care for employees.

Slapping a levy on employers that don't provide health benefits...8% of pay.

Ending the tax deduction for advertising expenses of drug manufacturers and health care companies. This wouldn't affect firms in other lines of businesses.

Imposing a value-added tax or national sales tax on top of the income tax... very tempting to taxwriters, because a rate of about 1.5% raises most of the funds lawmakers are seeking. But complaints about the regressivity of a consumption tax would force exemptions for food and the like. To offset that and still raise big bucks, the rate would have to be hiked to 3% or more, causing support for the tax to erode.

Senate taxwriters, meanwhile, are expected to change their approach a bit.

They had eyed taxing workers on the part of their health coverage that exceeds 110% of the value of the basic health plan for federal employees...thus capping the benefit of employer coverage at \$17,240 for families and \$6,800 for singles in 2013, the year the proposal would take effect. Now senators are eyeing repeal of the tax exclusion workers get for employer coverage and replacing it with an extra standard deduction of up to \$17,240. That's a tax cut for anyone with coverage valued below that level.

In the end, the House will go along with taxing employees on their coverage, but will set a cap that's high enough so only those with gold plated plans are taxed. Even with taxing some company provided coverage, the total price tag for overhaul is so large that some of the House's revenue options are likely to be approved, too.

This struggle will take months to play out. Lawmakers will have trouble meeting Obama's stated goal of signing a health care overhaul bill before year-end.

HIGHLIGHTS

Buying a Car Voucher program

Summer Tax Tips Roth IRAs

Real Estate Home buyer credit

Farm Taxes Crop insurance

Payroll Taxes Big win for IRS

Enforcement Small businesses

**BUYING
A CAR**

If you plan to use the government's "cash for clunkers" program...

You may lose a bit of your deduction for sales tax paid on the vehicle.

Many states impose sales tax on the price of the new vehicle net of any trade-in. Since participants in the program end up receiving more than the actual value of the trade in, filers in those states will pay, and deduct, less tax on the vehicle. For new vehicles bought after Feb. 16, 2009, purchasers can deduct the sales tax on up to \$49,500 of the cost. Except for buyers who elect to deduct state sales tax in lieu of any income tax paid, this sales tax break starts phasing out for marrieds with adjusted gross incomes over \$250,000 and singles with AGIs over \$125,000.

The cash for clunkers program will officially start in late July, after the feds issue regulations. Once it opens, if you trade in a car with an EPA rating of 18 miles per gallon or less, you will receive a \$3,500 credit at the dealer to buy or lease a car rated at 22 mpg or more. The credit is in lieu of any trade-in. You will get \$4,500 if the replacement gets at least 10 mpg more than your old vehicle. For light trucks and sport utility vehicles, the fuel efficiency rules are significantly more lenient. To qualify, your trade-in must be a 1984 or newer model that's in drivable condition. Also, you must have owned and insured it for at least one year prior to trading it in.

**BENEFIT
PLANS**

More IRS help for employers on the continued coverage health subsidy:

It won't challenge a firm's determination that an ex-employee is eligible

for the subsidy as long as the employer reasonably interpreted the subsidy rules. That clarification aids employers with cases that could go either way: They can err on the side of letting the ex-employee get the subsidy, and avoid the possibility of an appeal to the Labor Dept. if they were to declare the ex-worker ineligible. Murky situations include those where a firm offers a buyout to encourage workers to leave but it's not clear that folks will be terminated if they forgo the buyout.

The Labor Dept. will insist that plan sponsors e-file Form 5500 next year.

2009 returns for calendar year plans are due by July 31, 2010. The department had delayed the requirement to give sponsors time to gear up but won't do so again. It warns that paper returns will be rejected and the employer treated as a nonfiler. The e-filing rule doesn't apply to sole proprietors or partners that file Form 5500-EZ.

**SUMMER
TAX TIPS**

Here's a thought if your child or grandchild has a job this summer:

Consider making a contribution to a Roth IRA for him or her this year.

The annual payin limit is \$5,000, but not more than the child's earnings. However, that sum counts toward the \$13,000 annual gift exclusion (\$26,000 for couples).

The payin can help provide a nice nest egg for the child. A 16-year-old with \$5,000 in a Roth IRA that earns 7% each year will have \$137,000 at age 65 and \$193,000 at age 70. If the child works for a few summers and contributions are made each year, the future balance in the Roth account will be much larger.

Roth IRAs are tax favored, too. All withdrawals after 59½ are tax free.

And since contributions, but not earnings, can be pulled out tax free at any time, the child can withdraw them in the future to help when buying a first home.

And some reminders about taxes for students with summer jobs:

They can escape federal income tax withholding from their paychecks if they did not owe any tax last year and do not expect to owe any this year. Students who can be claimed as dependents can avoid income tax withholding if their unearned income is \$300 or less and their total income won't exceed \$5,700. But if their investment income is more than \$300, total income cannot top \$950.

Hiring your children can save tax as well. No Social Security tax is due when sole proprietors or husband-wife partnerships hire their under-age-18 kids. And federal unemployment tax isn't owed on the kids' pay until they reach 21.

REAL ESTATE If you're filing an amended '08 return for the first time home buyer credit... Be sure to enclose a copy of the settlement statement with your 1040-X.

The Service has noticed that many of the refund claims for the credit are fraudulent, so it is giving all such claims extra scrutiny. To avoid having your refund delayed, attach a copy of the HUD-1 form with your amended return. First time home buyers can claim the tax credit...10% of the purchase price, up to a maximum of \$8,000... on amended 2008 returns if they buy a primary home this year before Dec. 1, 2009.

Profits from the sales of subdivided land can be taxed as capital gain, the Tax Court says in a case involving a couple who purchased a 14-acre tract to build their dream home. After deciding that they didn't need the entire parcel, they carved up the excess land and sold lots, mainly to family members and friends, at the rate of about one lot a year. Their only advertising was a sign at the entrance of the subdivision. The sporadic sales indicated the lots weren't being held for sale to customers, so capital gain treatment is appropriate ([Rice, TC Memo. 2009-142](#)).

FARM TAXES Bad news for cash basis farmers who receive crop insurance proceeds: The proceeds are taxed up front unless more than 50% of the income from the destroyed or damaged crop would be reported in the following year, an Appeals Court says. Here, the farmers typically reported only 35% of the income from their sugar beets in the next year. The Court upheld an IRS ruling from 1974 that set the threshold to delay income tax on the proceeds at 50% ([Nelson, 8th Cir.](#)).

PAYROLL TAXES A huge victory for the Revenue Service on taxing medical residents' pay: IRS rules mandating payment of FICA tax are valid, an Appeals Court says in reversing a lower court ruling. Typically, students whose employment by a school is incidental to their studies are exempt from FICA tax. But beginning April 1, 2005, the IRS changed its regulations to impose FICA on the pay of students who worked at least 40 hours a week. In the Court's view, that's a reasonable interpretation of the student FICA exception ([Mayo Foundation for Med. Education, 8th Cir.](#)).

The ruling will give the IRS impetus to keep fighting this FICA tax battle. Although it has lost in other Appeals Courts, those disputes predated the 2005 rules. But if another Appeals Court rules against the Service, that would set up a conflict at the appellate level, and the Supreme Court would likely step in to resolve it.

BACK TAXES An overstated income tax basis won't give IRS more time to seek taxes. The six-year statute of limitations does not apply, an Appeals Court says in a case involving gain that a taxpayer underreported due to an inflated tax basis. The IRS argued it had six years, not three, to go after the taxpayer because the filer omitted more than 25% of adjusted gross income. But since the sale was reported, the Court decided there was no omission ([Bakersfield Energy Partners, 9th Cir.](#)).

The Revenue Service will keep litigating this issue. Two lower courts that are not under this Appeals Court's jurisdiction have agreed with its position.

IRAs If you are tapping an IRA early, don't do a rollover to or from it. You will void an exception to the 10% penalty on pre-59½ distributions, [the Revenue Service says in a new private ruling.](#) You are exempt from the penalty if you take a series of substantially equal payouts from the IRA for at least five years and until you've reached age 59½. But IRS treats any rollover into or out of the IRA during this time as a prohibited change in withdrawals, triggering the 10% penalty on all previous payouts. And once you've done a rollover, you can't beat the penalty by rolling the funds back into the IRA. You are stuck paying the 10% levy to IRS. The taxpayer involved in the ruling was concerned about the market's steep decline and wanted to switch her IRA money into CDs. She ended up doing the rollover to another brokerage firm because her IRA custodian didn't offer investments in CDs.



DEPEN- DENTS

Noncustodial parents: Bad news on claiming dependency exemptions.
Any conditions in the divorce agreement nix the exemption if the parent with custody hasn't signed Form 8332 to waive his or her right to the exemption. For divorces before July 3, 2008, a signed divorce decree awarding the exemption to the noncustodial parent is OK in lieu of the 8332. But now, [the Service says](#) that it will reject signed decrees that have conditions, such as requiring payment of a settlement, that must be satisfied before the noncustodial parent gets the break. This is so even if the parent has documentation showing that the condition was met. That's even more reason to ensure the custodial parent provides a signed Form 8332.

ENFORCE- MENT

Overstated claims for real estate tax deductions are costing IRS millions.
But there isn't much it can do about the problem, officials say. [A report](#) by the Government Accountability Office says a substantial number of taxpayers incorrectly claim nondeductible municipal charges added to property tax bills, such as service charges assessed for water usage or garbage collection. Problem is, the invoices often don't break out which portion of the total amount due is deductible on the federal return. The Service will try to better educate filers on this issue but doesn't expect to make much headway in getting localities to redesign the bills.

Good news for small firms: IRS will ease up on some tax shelter penalties.
Congress will force this change. It had hiked the penalties a few years ago but recently found IRS agents have been imposing them on small business owners who unwittingly bought benefit plans that the IRS deemed to be abusive schemes. Fines can run as high as \$200,000 and far exceed any tax benefits the owners got from the plans. IRS is being urged to hold off on imposing penalties in such cases until Congress reduces the fines to approximate the tax savings from the shelter. It's a safe bet that the Revenue Service will acquiesce with the taxwriters' request.

Although the Service has been crowing about stepping up enforcement...
It turns out IRS agents weren't tough enough on thousands of scofflaws during fiscal 2008. The agents were too slow to slap liens or levies on taxpayers who missed deadlines to pay up or ignored written warnings, [according to a report](#) by Treasury inspectors. Agents say big caseloads are to blame, as well as taxpayers who are getting more sophisticated in hiding assets. IRS is cracking the whip on its collection agents, but it hasn't mentioned any plans to ease workloads.

The veil of secrecy on Swiss bank accounts will be a bit more transparent.
The U.S. and Switzerland have reached a deal on a new information-sharing treaty that allows the Service access to information on funds that are held in Swiss banks when tax fraud is suspected. The current treaty limits access much more severely, only allowing administrative cooperation in cases of tax evasion. The revised treaty will take effect once the U.S. and Swiss governments give their official approval.

Congress will ease up on personal use of employer-provided cell phones and personal digital assistants. Under current law, if employees don't keep a log of their business and personal calls, usage of the phone is taxed as income to them and is hit with payroll taxes. IRS tried to ease up on recordkeeping requirements, but was met with a firestorm of protests that personal usage shouldn't be taxable. [Now IRS says it will work with Congress](#) to repeal the recordkeeping requirement.

Yours very truly,

The Kiplinger Editors

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