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INDIVIDUALS

2011 Proposed Tax Rate Increases

President Obama had indicated throughout his campaign that upper income individuals are likely to be taxed in the future at higher income tax rates and that capital gain tax rates would also increase. Now his administration, in its 2010 budget resolution, has taken a giant step forward in making those campaign promises a reality. Although not enacted into law yet, the Treasury Department's Budget Explanation states that the following changes will be effective for the 2011 tax year:

- The 33% and 35% income tax rates will increase to 36% and 39.6%, respectively. This will affect joint filers with taxable income over approximately \$230,000, and single filers above \$190,000.
- The 15% maximum tax rate on dividends and capital gains will increase to 20%, affecting the same group of upper income filers.
- The full phaseout of personal exemptions will be reinstated, as well as the up-to-80% phaseout of itemized deductions, effectively increasing the top tax rate to about 42%.

- To the extent itemized deductions of upper income filers survive the preceding phaseout, they will be limited to a 28% deduction rate (even though income will be taxed at 36% or 39.6%!)
- The alternative minimum tax (AMT) will not be repealed. Instead the exemption amount will be indexed for inflation.

With increased income, dividend, and capital gains tax rates on the horizon, high income taxpayers should consider accelerating income into 2009 or 2010 and deferring deductions to 2011 and beyond. That strategy is a 180° departure from the usual approach of deferring income to later years and accelerating deductions. Please let us know if we can assist in developing a strategy to deal with these near-certain tax rate increases.

Foreign Bank Account Reporting

Annual Report. You may not be aware that taxpayers who maintain foreign bank accounts or who have signature authority over foreign bank accounts (for example, an account owned by the taxpayer's employer or a trust account) are required to file Form TD F 90-22.1, "Report of Foreign Bank and Financial Account," if the account exceeds \$10,000 on any day during the year. This foreign bank account reporting form (FBAR) is filed with the U.S. Treasury and was due on June 30, 2009, for the 2008 year. No extension of the filing date is permitted and a 20% penalty applies to delinquent FBARs based on the highest value of the account during the year.

The IRS, on its web site (www.irs.gov), recently announced relief to taxpayers who were not aware of the FBAR filing deadline. The IRS recommends that such taxpayers, after filing their 2008 tax returns, file a delinquent FBAR (together with a copy of their 2008 return) and attach a statement explaining why the report is filed late. If the delinquent FBAR is filed before September 23, 2009, the IRS will not impose the 20% penalty. Taxpayers who have extended their 2008 Form 1040 may use this relief provision simply by filing the FBAR separately by September 23rd. To prove that the FBAR is timely filed, we recommend that taxpayers send the form by certified mail/return receipt.

Increased Offshore Bank Audits. The IRS has stepped up its program to enforce income tax reporting and criminal prosecution of both individuals and entities that have an offshore account (e.g., hold money in a non-U.S. bank). However, on March 23, 2009, the IRS initiated an amnesty program effective for a 6-month period (through September 23, 2009) in which taxpayers can voluntarily come forward, make a "voluntary disclosure request" to settle all their tax liabilities relating to any offshore issues they may have, and avoid criminal prosecution. Taxpayers will have to amend their returns and pay any unpaid taxes and interest for the 6-year period 2003 through 2008, as well as a limited amount of penalties.

This is a very complex area of the tax law. Please let us know if you have any questions regarding FBAR reporting or the IRS foreign amnesty program.

“Cash for Clunkers” Vouchers

Last month, Congress enacted a new law commonly referred to as “Cash for Clunkers.” The purpose of this program is to encourage persons who are driving older cars and trucks that get poor gas mileage (“gas guzzlers”) to trade them for more fuel-efficient new vehicles. The vehicle owner does not directly receive any tax benefits. Rather, if a purchase or lease qualifies for the program, the dealer selling the new vehicle will receive a \$3,500 or \$4,500 payment from the government for accepting the trade. The dealer must then apply the voucher towards the purchase price of the new vehicle in addition to any other rebate or discount it or the manufacturer offers. The dealer may not use the voucher to offset such offers.

To qualify, the traded vehicle must actually be drivable, insured and registered to the same owner for the last 12 months, be less than 25 years old, and have a fuel efficiency rating of 18 mpg or less. The dealer may not resell the trade-in and generally is required to scrap the vehicle. The new car must be purchased (or leased for at least 5 years) between July 1 and November 1, 2009, retail for \$45,000 (MSRP) or less, have a fuel rating of at least 22 mpg, and exceed the traded-in vehicle’s fuel rating by 4 mpg for a \$3,500 voucher or 10 mpg for a \$4,500 voucher. There is a separate set of rules for trucks. As a practical matter, vouchers will generally be used for older vehicles that are worth less than \$4,500. If the trade qualifies, the dealer applies to the government to receive the voucher on behalf of the purchaser. Businesses and individuals are entitled to use this program, and the voucher is not taxable as income.

The government has a website with more information on this voucher program (www.cars.gov), or new car dealerships can respond to questions. In addition to the voucher, certain buyers may also deduct on their income tax returns any qualified sales taxes paid on the vehicle (see the following topic). And energy efficient vehicles may qualify for tax credits (*e.g.*, the hybrid tax credit or the advanced lean burn technology motor vehicle credit).

New Car Sales Tax Deduction Update

In our Spring newsletter, we discussed the new car sales tax break available to certain taxpayers who purchase vehicles between February 17 and December 31, 2009. We noted that the law was not clear whether multiple purchases would qualify for this deduction. The IRS has now clarified that multiple purchases will qualify for the sales tax deduction, subject to the \$49,500 per vehicle cost limitation. Thus, a husband and wife can each purchase a new car in 2009 and claim on their joint tax

return the deduction for the sales tax paid on each vehicle. Alternatively, two or more car purchases by a single taxpayer would also qualify.

The IRS has also stated that if there is no state sales tax, taxpayers may deduct state or local excise taxes or fees paid on the vehicle purchase, provided they are based on the sales price or assessed as a per vehicle fee.

Hybrid Vehicle Credit

Back in 2006, Congress created a complicated tax credit system that applies to hybrid vehicles (*i.e.*, those powered by both gas and electricity). But the hybrid tax credit offsets regular income tax only and not the AMT, and many middle and upper income filers who purchased a Prius or other hybrid found that they did not benefit from the credit.

Beginning in 2009, a law change permits taxpayers to apply the various energy-efficient vehicle credits, including the hybrid credit, against the AMT. Thus, taxpayers subject to the AMT can now receive the full benefit of this tax credit. But the more popular hybrid vehicles have “phased out” of credit eligibility. Toyota, Lexus, and Honda models produce no tax credit, and Ford/Mercury models are in the midst of the phase out (further credit reduction after 9-30-09, and no credit after 3-31-10).

Taxation of Employer-Provided Cell Phones

Many businesses provide their employees with the use of a cell phone and pay for the cost of the phone and the monthly charges without any reimbursement by the employees. The tax law provides that an employee may exclude from gross income the *business* use of an employer-provided cell phone as a fringe benefit. However, employees must keep strict records to substantiate the business use of the phone. Any personal use of the cell phone and any unsubstantiated business use are considered taxable fringe benefits. But the IRS has acknowledged that there is widespread noncompliance with these rules.

Last year, Congress took steps to repeal the substantiation rule, but the bill never passed. Recently, the IRS and the Treasury Department announced various proposals to simplify the recordkeeping requirements for cell phone usage and requested public comment on these proposals. A leading proposal was a safe harbor that would require an employee to include in income 25% of the value of the employer-provided cell phone service without having to maintain records. After adverse public reaction, the Treasury decided not to proceed with its proposals and requested that Congress “make clear that there will be no tax consequences to employers or employees for personal use of work-related devices such as cell phones provided by employers [because the] passage of time, advances in technology, and the nature of communication in the modern workplace have

rendered this law obsolete.” We will continue to watch this development and advise you of any changes in the law.

First-Time Homebuyer Credit Update

In the last issue of this newsletter, we discussed the \$8,000 maximum tax credit that is available to first-time homebuyers through November 30, 2009. The IRS recently clarified that the credit is not available if a taxpayer uses the proceeds from tax-exempt mortgage revenue bonds to finance the purchase of the residence during the 2008 eligibility period. However, due to a 2009 law change, a taxpayer will be eligible for the credit if tax-exempt bond proceeds are used to purchase a home during the 2009 eligibility period. Please let us know if you have any questions in this regard.

BUSINESSES

Administration’s Tax Proposals

The Obama administration is proposing the following major changes to business taxation as part of its 2010 budget package, with effective dates as indicated below:

- *IRAs*: Effective January 1, 2010, employers in business for two years or more and with at least 10 employees would be required to provide an automatic IRA option on a payroll deduction basis, if the business does not offer any qualified retirement plan. A \$25 tax credit per employee would help to offset administrative costs.
- *Loss Carryback*: Although no specifics have been provided, the net operating loss carryback rules are likely to be enhanced to provide businesses with a longer carryback period, similar to the 5-year rule that Congress provided last year for small businesses having gross receipts under \$15 million.
- *LIFO Repeal*: Businesses using the last in, first out (LIFO) method of valuing their inventory would be required to change to the first in, first out (FIFO) method effective in 2012, spreading the resulting income ratably over an 8-year period.
- *Lower of Cost or Market (LCM) Repeal*: This repeal would prohibit businesses from adjusting their inventory to below cost. Any resulting income would be

reported ratably over a 4-year period, effective for the first tax year beginning after 12 months from the date of enactment.

- *Repeal of Oil and Gas Preferences:* Significant tax breaks that would no longer be available for tax years beginning after 2010 include intangible drilling cost expensing, the percentage depletion deduction, and the passive loss exception for working interests in oil and gas activities.

IRS Employment Audits

In late 2009, the IRS will begin implementing a program to enforce compliance with employment tax laws. Under this program, the IRS will randomly audit approximately 6,000 businesses over a 3-year period. The primary focus of these examinations will be on four areas: 1) proper treatment of workers as employees versus independent contractors; 2) fringe benefits, such as personal use of business vehicles and compliance with discrimination standards applicable to other fringe benefits; 3) unreasonable compensation paid by closely held businesses to their owners; and 4) compliance with the accountable plan rules for the reimbursement of business expenses.

To prepare for a possible audit, businesses should review their policies and procedures in these areas. We are available to help undertake this review and ensure, for example, that the business maintains proper documentation for business expense reimbursements, or that persons hired by the business are properly treated as employees or independent contractors depending upon the particular circumstances.

Employer-Owned Life Insurance Update

In the Winter 2009 newsletter, we discussed new regulations that address the information reporting rules for employer-owned life insurance contracts (EOLI contracts). These are life insurance contracts owned by an employer who is the beneficiary of the policy and which insures the life of an employee. Under a 2006 law change, the death benefits received by the employer will be taxable unless the employer complies with certain notice and consent requirements under IRC §101(j)(2). However, the new regulations did not address those requirements and we expressed concern that employers might be taxed on benefits from EOLI policies issued after August 17, 2006 (the date of the law change) for which employee consent had not been obtained because of the lack of IRS guidance. At that time, we recommended that employers with these EOLI contracts immediately secure documentation of employee notification and consent, in an attempt to comply with IRS future guidance and ensure that any death benefits received in the interim will be tax-free.

The IRS has now issued comprehensive guidance (Notice 2009-48) that addresses various issues relating to EOLI contracts, including the correction of an inadvertent failure to comply with the notice and consent requirements. In that case, the IRS stated that it will not challenge the taxability of the death benefits paid to an employer if (1) the employer made a good faith effort to comply (e.g., by maintaining a formal system for providing notice and securing consents from new employees); (2) the failure was inadvertent; and (3) discovery and correction of the failure occurred by the due date of the employer's tax return for the year in which the policy was issued. For periods before June 15, 2009, the effective date of the new guidance, the IRS stated that it will not challenge a taxpayer who made a good faith effort to comply with the notice and consent requirements based on a reasonable interpretation of those rules. Thus, documentation in accordance with our prior suggestion should be acceptable notice and consent. If you would like additional information regarding these new rules, please contact us.

THE ESTATE TAX

Pending Legislation

Under present law, the status of the federal estate tax system is a mess. For 2009, each individual has an exemption of \$3.5 million, with a 45% flat tax imposed on the decedent's net worth in excess of the exemption. But in 2010, the tax is to be repealed for one year, then in 2011 and after revert back to a former exemption amount of \$1 million and a graduated rate system.

Based on pending legislative proposals from the Congress, as well as the President's statements, it appears to be a virtual certainty that the \$3.5 million exemption will be permanently extended, as will the 45% tax rate on estate values exceeding the exemption.

In one sense, this is a positive development, as we now can determine who is and is not likely to face the estate tax and take more effective planning actions. But that's not the only reason to act soon with respect to estate planning and will or trust revisions.

The administration's pending tax proposals would place a 10-year minimum term on Grantor Retained Annuity Trusts (GRATs). By eliminating today's ability to create a short term GRAT, there is greater risk of estate inclusion of GRAT property if the donor dies within the GRAT term. But this proposal is only effective for GRATs created after enactment, so act now if sophisticated estate planning techniques could be of benefit.

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