

# The Kiplinger Tax Letter

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Dear Client:

Washington, Sept. 18, 2009

As the health care reform battle continues... Senate tax lawmakers are in the spotlight. Finance Committee Chairman Max Baucus (D-MT) is trying to stake out a middle ground in the debate. Baucus' plan avoids broad new tax hikes, such as a surtax or an extra payroll tax on employers, because the cost of the overhaul was trimmed back. Still, Senate passage will be a struggle because some provisions are drawing a lot of flak from Democrats, while Republicans aren't signing on.

Look at the flash points in Baucus' plan:

Insurance firms would be hit with a 35% excise tax on gold plated policies offered by firms...policies valued above \$8,000 for singles and \$21,000 for families... starting in 2013. These thresholds would be indexed for overall inflation, not pegged to hikes in the health care cost index. Firms that self-insure would pay this tax, too. Critics say the tax would hit plans covering lower-incomers, such as union members and folks in states where medical costs are high. Baucus would raise the thresholds in the 17 highest cost states for three years after enactment to deflect that criticism.

Individuals would pay a tax if they didn't have basic coverage by 2013.

Middle and high income singles would have to send in \$950 with their tax returns. Families...up to \$3,800. Singles making between 100% and 300% of the poverty level would pay \$750, and families, \$1,500. Using 2009's figures, the reduced penalties would hit singles with incomes between \$10,800 and \$32,500 and families of four between \$22,000 and \$66,000. To help them purchase coverage, low incomers would be allowed to take credits of up to 13% of their income. But many Democrats say the credits still wouldn't be enough to cover the financial burden being imposed.

And firms would have to pay a fee if they didn't insure their own workers.

Baucus' legislation does not contain an explicit mandate for employer coverage, but companies with more than 50 full-time workers would owe a fee for each worker who claims tax credits to buy his or her own insurance. The fee would be based on the average cost of insurance sold through state run exchanges set up by the bill. But the levy couldn't exceed \$400 times the total number of a company's employees.

Baucus would give small firms tax credits as an incentive to buy coverage, similar to those in the House's bill. He would let employers with 25 or fewer workers receive a tax credit of up to 35% of their health premium costs for 2011 and 2012. Beginning in 2013, a small firm could qualify for a 50% credit in the first two years after buying employee coverage through state health exchanges set up under the bill.

Some other tax changes in the Baucus bill will spark controversy, too:

Capping the payin limit on health care flexible spending plans at \$2,000 starting in 2013 and nixing the use of payouts for nonprescription drugs as of 2010.

And expanding W-2 reporting to include the value of health care benefits, so workers will know the value of their coverage. The benefits will remain tax free.

## HIGHLIGHTS

**Benefit Plans** 401(k) changes

**Real Estate** Tax deferred swaps

**Exempt Groups** Higher IRS fees

**Payroll Taxes** Classifying workers

**Enforcement** Audit selection

**Damages** Long-awaited IRS rules

## BENEFIT PLANS

The value of an employee's unused leave can be transferred to a 401(k) or profit sharing plan annually instead of being paid to the worker in cash, the IRS says. This can help employees who have leave that can't be carried over, so they don't have to forfeit it or accept a taxable cash payout ([Rev. Rul. 2009-31](#)). Plans also can be amended to allow the value of the unused leave to be contributed when an employee separates from service ([Rev. Rul. 2009-32](#)). In both situations, firms must make sure that transferred amounts don't exceed plan contribution caps.

Employers will find it easier to add automatic enrollment to their 401(k)s. The Service just released two types of model amendments that 401(k)s can adopt to speed the approval process. For the complete details, see [IRS Notice 2009-65](#). And 401(k) plans can have the payins by employees go up automatically each year, as long as the employees are notified that they can opt out ([Rev. Rul. 2009-30](#)).

Sponsors of SIMPLE IRAs get similar easings. A sample plan amendment for SIMPLEs to use to add the automatic enrollment feature is in [Notice 2009-67](#).

If your firm's plan is making hardship payouts to workers, follow the rules. Such distributions are permitted only when the employee has an immediate need for the money. Also, the withdrawal must be limited to the amount of money needed, plus any tax and penalty. The payouts are taxed as income, and a 10% penalty is due unless the recipient is 59½ or the funds are used for deductible medical costs. If your plan prevents recipients of hardship payouts from making plan contributions for a set period of time, make sure that this ban is enforced. If it isn't, your plan will have to seek relief under IRS' voluntary error correction program and pay a fee.

Plans get help on advising payees of their tax options...from the IRS. If a plan makes a lump sum distribution or other payment that can be rolled over to an IRA or another plan, the payee must be given an explanation of the tax rules.

The Service now has an up-to-date model summary that plans can use. It reflects the tax law changes in recent years, including the easings of the rules for rollovers to Roth IRAs and special rules for reservists called to active duty. Go to [kiplinger.com/letterlinks/rolloverexplanation](http://kiplinger.com/letterlinks/rolloverexplanation) for a copy of the new notice.

IRS finally has a form for reporting violations of the COBRA coverage rules. Employers that run afoul of the continued health coverage rules will file [Form 8928](#) with the Service. For example, employers can be assessed a \$100 per day penalty for not notifying ex-workers terminated after Aug. 31, 2008 and before Jan. 1, 2010 that they can get a subsidy for 65% of the premium if they continue health coverage. The requirement to file the 8928 goes into effect for 2009 returns filed next year.

## TAX REFUNDS

Next year, filers can opt to take tax refunds in the form of savings bonds. But few taxpayers are likely to do so. The bonds, called [Series I bonds](#), carry interest rates that are tied to the inflation rate. Currently, these bonds pay no interest because severe deflation wiped out the fixed interest on the bonds. The interest rate will be reset Nov. 1, but with recent inflation being relatively tame, I bonds that will be issued during the filing season won't carry a high interest rate.

## IRAs

Although the income cap on converting an IRA to a Roth ends after 2009... High incomers still can't make Roth IRA payins. Contributions are barred for couples with AGI of \$176,000 or more and singles with AGI of \$120,000 and up. But there's a loophole: They can make a nondeductible IRA payin for 2010 and then switch the IRA to a Roth and pay tax only on the earnings. They can do so for every year after 2010, too. But there's a trap if the taxpayer already has an IRA with deductible payins. In that case, the tax free portion of the Roth conversion is based on the ratio of nondeductible payins to the total of all regular IRA balances.

**REAL  
ESTATE**

Tax deferred swaps between related parties are subject to extra scrutiny.

A profitable firm had offers to buy two of its properties, but selling them would have triggered a big capital gains tax bill. Instead, it transferred the realty to an unrelated intermediary, which sold the properties and bought replacement land from a subsidiary that the firm controlled. The subsidiary didn't pay any income tax on the gain resulting from the sales of its realty because it had other large losses.

The exchange is not a qualified tax deferred swap, an Appeals Court says, because it occurred between related parties and the main reason for the exchanges was to reduce the overall tax bills of the buyer and seller ([Teruya Bros., 9th Cir.](#)).

**BUSINESS  
TAXES**

Good news for firms that didn't timely elect how they wanted to be taxed.

They now have longer to get relief from the IRS...three years plus 75 days from the date the election was supposed to take effect. For example, that helps LLCs that failed to timely file Form 8832 to be taxed as corporations or to be disregarded for tax purposes. Those firms can avoid the cost of obtaining a private letter ruling. See [kiplinger.com/letterlinks/lateelections](#) for full details on all the requirements.

Mining firms can't use hedging gains to boost their depletion deduction, the IRS says in a private ruling. The companies can claim a deduction for depletion of the minerals they mine equal to a percentage of their gross income from mining. Hedging, which is used to ensure a minimum price for the minerals, is not a part of the mining process, and thus hedging gains cannot be treated as mining income.

Note, too, that hedging losses won't reduce depletion deductions, either.

A concert pianist cannot deduct the cost of fancy clothing that she wore while performing, a district court says. She shopped at high-end department stores for special gowns and dresses, along with jewelry and shoes, to wear at concerts, and deducted the cost as work related clothing. Even though she didn't wear any of the outfits outside of the concert hall, the court disallowed her deduction because other people wear similar clothing in other settings ([Tilman, D.C., N.Y.](#))

**ANNUITIES**

Taking a premature withdrawal from an annuity will draw a 10% penalty,

the Tax Court says to an annuity owner who took a payout before age 59½ and put it in investments that he did not tap until he was 59½. The rule is similar to the penalty for IRAs, in that payments due to death or disability are exempted, as are a series of substantially equal distributions that run for at least five years and until the recipient is 59½. The 10% penalty is applicable to the taxable portion of the withdrawal...the earnings on the contract ([Liu, TC Summ. Op. 2009-137](#)).

**EXEMPT  
GROUPS**

Applying to become an exempt organization? It'll cost you more next year.

For applications postmarked Jan. 3, 2010 or later, the fee will rise to \$400 for organizations that have gross receipts of \$10,000 or less over a four-year period, up from \$300. Those with gross receipts over \$10,000 will pay \$850, up from \$750.

But you will be able to get a discount by applying via the Internet, IRS says. Once the new Web based system is in place in 2010, organizations using that system for their exemption applications will pay a fee of just \$200, regardless of their size. However, IRS will then eliminate the special \$400 application fee for small groups.

A veterans' group that runs a bar and restaurant can get a tax exemption.

But the requirements are very hard to satisfy, IRS says in a private ruling.

At least 75% of the membership must be current or former armed forces members and substantially all other members must be spouses, survivors or descendants of service members. Thus, no more than 2.5% of the members can be outsiders. In addition, the organization must earn less than 5% of its gross receipts from sales or facility rentals to the general public or else it loses its income tax exemption.



PAYROLL TAXES
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Giving W-2 forms to workers you claim are contractors is a big mistake: Doing so lets the IRS reclassify the contractors as employees, a court says. Under a 1978 law, the Revenue Service can't argue that contractors are employees if the firm always gave them 1099s, regularly treated similar workers as contractors and had a reasonable basis for that treatment. In this case, a livestock feed firm classified its salesmen as contractors, even though it reimbursed their expenses and provided company cars to them. But the firm lost an IRS payroll tax challenge because it gave the sales force W-2s one year and it couldn't prove that it relied on professional advice to treat the workers as contractors ([Porter, D.C., Iowa](#)).

Employers being audited for payroll taxes can avoid paying IRS interest

on any extra payroll taxes due if the firm files Form 2504 to adjust the original 941 and pays the tax with the 2504. If the additional tax is not paid with the return, interest is owed from the date the 2504 is filed until the date the payment is made, the Service says privately. Remember, too, that if the employer finds the error itself before an audit and pays the extra tax, no interest is due on that payment as well.

ENFORCE- MENT
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IRS is doing fewer no-change exams of filers, now that its audit formulas have been updated to incorporate data from a recent set of random audits. For tax year 2006 returns, the no-change rate is 13%, down from 18% five years ago. And the average additional tax recommended per examination also went up by 16%.

But IRS could be even more efficient, according to Treasury inspectors.

They found that revenue agents didn't do a very good job of screening tax returns that IRS computers flagged as audit targets. The Service will train its agents better so fewer returns with low audit potential are selected. That way, the Revenue Service can better use its limited resources and stop wasting the time of compliant filers.

Federal contractors, take note. You have a new administrative headache:

A worker verification requirement for contracts signed after Sept. 7, 2009, if the project costs more than \$100,000 or lasts longer than 120 days. Contractors must use the Social Security database to verify that their employees are eligible to work in the U.S. Contractors that have never used the electronic system before must enroll in the verification program within 30 days after the contract is awarded. They then have 90 days to begin the verification process for all existing workers.

The Service is expanding its mediation process...settling tax disputes

so taxpayers don't have to go to court to get a resolution of legal or factual issues. Mediation is now available for disputes involving failures to send payroll taxes to IRS and for battles over offers taxpayers make to settle tax debts for less than they owe. The mediator is a specially trained IRS employee who was not involved in the audit. Taxpayers can pay to have an independent outside co-mediator join the proceedings. See [kiplinger.com/letterlinks/mediation](http://kiplinger.com/letterlinks/mediation) for all the requirements of the program.

DAMAGES
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IRS is updating its regulations on the tax treatment of damage awards.

Only damages for physical injuries or physical sickness are nontaxable, with two exceptions: Payments for mental anguish arising from physical injuries are tax free. Ditto for reimbursements for medical treatment of emotional distress. The proposed regulations are in response to a tightening Congress enacted in 1996. It only took the Revenue Service 13 years to finally issue official guidance to filers.

Yours very truly,

*The Kiplinger Editors*

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