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I. TAX UPADTE

A. Income Tax Developments

1. Romney Tax Return

By now, most of you know Mitt Romney has released his income tax returns. For 2011 he earned just over $14 million, and paid tax of just under $2,000,000 an effective tax rate of 14.1%. No comment on that – however some are reminded of the so called "Buffet Rule" – that is anyone with an income over $1,000,000, should pay at least at least 30% in tax.

2. The Self Employed Can Take Medicaid Premiums as Insurance

In CCA 201228037, the Service determined that all Medicare parts are "insurance" that qualify as medical care under Section 162(l). Thus, Medicare premium payments are similar to other health insurance premiums that can be deducted pursuant to Section 162(l) for coverage of a self-employed individual, as well as the individual's spouse, dependent, or child who is under age 27 as of the end of the tax year. This includes partners in partnerships if certain conditions are met and 2% or more shareholders in S Corporations. The premiums are included in the deduction for health insurance on the front page of the 1040.

A self-employed individual also may file an amended return, subject to the statute of limitations, if he or she did not previously deduct premiums previously.

3. More Victories for Same Sex Couples

In *Gill v. OPM*, the First Circuit held that a Federal statute which barred a same sex couple from being treated as married under federal law even though they were legally married under state law was unconstitutional. Look for this case to be appealed to the Supreme Court. Therefore same sex couples cannot currently file joint tax returns. Consider filing a protective refund claim by filing a 1040X.

In *Pedersen v. OPM,* D.C., Conn., the District Court not only held the statute invalid, but also held that there's no other basis in the tax law to deny joint filing status to same-sex couples who are legally married.

4. Payroll Taxes

The IRS has held that mandatory tips, for example 18% added for a party of six or more - are wages subject to withholding and cannot be included in the tip rate to determine if servers are fairly reporting there tips. Employers have until year end to come into compliance.

5. Business Taxes

The IRS has changed its mind on reconciling gross receipts with 1099-K forms. Businesses won't be required to separately report amounts shown on 1099-Ks on a special line on Schedule C and on Forms 1065, 1120 and 1120-S after all. The IRS initially waived the requirement for 2011 but now has waived it permanently.

6. Employer Provided Cell Phones Are Not Taxable

Employer provided cell phones if reasonably related to business are a tax free fringe benefit – Likewise for cash reimbursement

7. Reliance on Software Does Not Avert Penalties

The Tax Court says. Although a filer used the TurboTax program to do her return, she made several mistakes, and IRS assessed a 20% penalty because the deficiency was more than $5,000. She argued that she should not be liable for the penalty because she used tax software, but the Court said no (Bartlett, TC Memo. 2012-254). The errors were caused by her faulty input, not by a mistake in the tax program. In the Court's view, tax software is only as good as the information entered into it.

8. Earmarking Donation for One Person's Benefit Kills the Deduction

Earmarking a donation for one person's benefit kills the tax deduction, the Service privately rules. Donor who contributed to her church's scholarship fund wanted the church to use the money she gave for the college tuition costs of the minister's daughter. The contribution is recast as a gift from the donor to the minister's daughter, and no deduction is permitted.

9. IRS Advises on Penalty for Employers That Fail to Report Backup Withholding

In CCA 201224033, the IRS has made clear that the failure-to-file penalty under Section 6651(a)(1) may apply if an employer fails to file Form 945, "Annual Return of Withheld Federal Income Tax" . The penalty is 5% of the amount of tax required to be shown per month (or fraction of a month), with a maximum aggregate amount of 25%. As a result in cases where employers misclassify employees as independent contractors the IRS also may impose the addition to tax for fraudulent failure to timely file the Form 945 .

10. How Small Can a Partner's Interest Be: More Evidence 0.1% (or Less) is the 'New' 1%

In Ltr. Rul. 201220012, the IRS found that a partnership with a general partner with only a 0.01% was a valid tax partnership. Prior to the check-the-box Regulations, for advance ruling purposes the general rule of thumb was that a general partner had to have a 1% interest in all items of partnership profits and losses as a prerequisite to obtaining a favorable IRS letter ruling

B. Estate Tax Developments

1. Regs issued on Portability

An interesting change made by the Tax Relief Act which will no doubt have a significant impact on federal estate tax planning now and in the future was the addition of the concept of "portability".

Portability allows the unused estate tax exemption or Basic Exclusion Amount of the first of a married couple to die to be utilized by the surviving spouse either to offset gift tax or by the surviving spouse's estate to offset estate tax.In June, the IRS issued temporary and proposed regulations regarding how the portability rules will operate. Among the highlights -

- *The Temp regulations define certain relevant terms* – including "applicable credit amount" the "applicable exclusion amount", the "basic exclusion amount', the deceased spouses unused exclusion amount, and the terms "last deceased spouse".
- *Guidance is provided in regard to making the portability el*ection – In order to elect portability - the executor of the estate of the deceased spouse must have filed an estate tax return whether or not it would be otherwise required. The regulations provide that the election of portability is irrevocable once the due date of the 706 of the First spouse to die has passed. And filing of that return is necessary. The temporary regs do however contain an easing of the filing requirements providing that detailed values for property passing to a charity or surviving spouse is not required
- *Guidance in regard to how the Deceased Spouses Unused Exclusion amount is calculated and how its can be used by the Surviving Spouse* - The Regs also clarifies that a surviving spouse can make gifts with his or her DSUEA, and then get a new DSUEA by remarrying and surviving another spouse; merely remarrying does not affect one's DSUEA—only surviving the second spouse does that; and
- *Finally the temporary Regs provide Explanation of the Applicability of the Portability Rules to Nonresident/Noncitizens and those benefiting from QDOTs.* The Temp Regs provide that a surviving spouse cannot use any of the DSUEA received from a deceased spouse, as long as the QDOT remains in effect.

2. Form 706 Issued

The IRS has released a draft version of Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return for estates of decedents dying after December 31, 2011 and before January 1, 2013. The draft form includes a new Part 6, Portability of Deceased Spousal Unused Exclusion and a new Schedule PC, Protective Claim for Refund[1].

3. Gift of FLP Interest

In *Wimmer*, the Tax Court has held that a deceased taxpayer's gift of interests in a family limited partnership (FLP) to various family members and trusts for their benefit over a five-year period qualified for the annual gift tax exclusion under Section 2503(b). The FLP was funded with publically traded and dividend paying stocks.In this case the even though the donees did not receive unrestricted and non contingent rights to the use, possession, or enjoyment of the partnership interest themselves. The court found that the limited partners received a substantial present economic benefit sufficient to make the

[1] In Rev Proc 2011-48 – The IRS established a procedure for filing or claiming a Protective Claim for a refund for federal estate tax. If decedent died on or after January 1, 2012 a protective claim for refund can be filed using a Schedule PC or Form 843.

transfers gifts of a present interest, because there was little doubt the partnership would genertate insome, some portion of the income would stedaly flow to the donessand that portion was readily asceratable.

4. Discretionary Permission Granted for Late Election Out of the Estate Tax for 2010 Decedent

For estates of decedent's dying in 2010 an election out of the federal estate tax was allowed. That election was to be made on a timely filed - Form 8939. The IRS announced that the final due date for filing the 8939 was January 17, 2012, and also that it would not grant extensions of time in order to file the Form 8939 or accept a Form 8939 or an amended Form 8939 filed after that date.In PLR 201231003 (Aug. 3, 2012), the Service did permit a taxpayer to make a late election out of the federal estate tax with respect to a 2010 decedent. In this case the decedent's executor had relied upon a qualified tax professional to prepare the Form 8939, electing into carryover basis and out of the estate tax, and the professional had not done so.

5. Two Cases in Which Fiduciaries Were Found to be Personally Liable

In United States v. Michel, 2012 WL 3011124(E.D. N.Y., July 23, 2012), a U.S. district court held that an executor was personally liable, because the executor made distributions to an estate beneficiary after receiving an IRS levy notice.

In United States v. MacIntyre, ___ F.Supp.2d ___, 2012 WL 2403491 (S.D. Tex. June 25, 2012), an executor of the estate of J. Howard Marshall, and the trustee of a trust to which he made indirect gifts also held personally liable for gift tax deficiencies. The court held that the two, after being advised by their legal counsel that the gift tax claim was not valid, had made distributions without first providing adequately for unpaid gift taxes. The court stated that relying on bad legal advice does not excuse failure to provide for the gift taxes, as required by 31 USC 3713.

6. Transfers from Taxpayer's Parents Were Business Income, Not Gifts

In *Kazhukauskas v. Comm'r, TC Memo. 2012-191* (July 12, 2012), the Tax Court held that the taxpayers underreported income from their automobile import-export business, and that transfers from the husband's parents were business income, rather than gifts. The court found that the taxpayers did not meet their burden of proof that the transfers from the husband's parents were made from "detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses. (*Comm'r v. Duberstein, 363 U.S. 278*, 285 (1960)).This case applies the principal of the Duberstein case that transfers within a business context presumptively do not constitute non taxable gift – evn in a family context – an places the burden on the taxpayer to prove otherwise.

II. Tax Provisions of the Patient Protection Act

See the **TaxNews** Special Supplement - Tax Provisions of the Patent Protection Act for a review of these provisions.

III. Year End Planning

A. Overview

1. Unless Congress acts, the Bush-era tax breaks will come to an end (i.e., they will sunset) at the end of 2012.

2. Depending on how the November elections play out, the sunsets may be: (1) abolished for everyone, (2) deferred for everyone (as they were in December of 2010, when they originally were to sunset), or (3) deferred for all taxpayers other than those with higher incomes. Still a fourth, albeit unlikely, possibility is that the parties will not be able to agree on remedial legislation and the Bush-era tax breaks actually will sunset at the end of 2012 for everyone.

3. There are scores of income tax rules that would be altered if the Bush-era tax breaks sunset at the end of 2012, but arguably the most important ones are as follows:

- *Tax brackets.* The 10% bracket will disappear (lowest bracket will be 15%); the 15% tax bracket for joint filers & qualified surviving spouses will be 167% (rather than 200%) of the 15% tax bracket for individual filers; and the top four tax brackets will rise from 25%, 28%, 33% and 35% to 28%, 31%, 36% and 39.6%.
- *Taxation of capital gains and qualified dividends* - Currently, most long-term capital gains are taxed at a maximum rate of 15%, and qualified dividend income is taxed at the same rates that apply to long-term capital gains. Under the sunset, most long-term capital gains will be taxed at a maximum rate of 20% (18% for certain assets held more than five years). And dividends paid to individuals will be taxed at the same rates that apply to ordinary income.

4. As discussed above for tax years beginning after Dec. 31, 2012, a 3.8% surtax called the Unearned Income Medicare Contribution, would be placed on net investment income of a taxpayer earning over $200,000 ($250,000 for a joint return).

5. For tax years beginning after 2012, the allowable sec. 179 expense election is reduced to $25,000 with a $200,000 investment-based ceiling.

6. MACRS bonus depreciation ends

7. The work opportunity tax credit (WOTC) expired at the end of 2011 for all new qualifying hires except for veterans, but here, too, there's a sunset. The qualifying veterans must begin work for the employer before Jan. 1, 2013.

8. Estate and Gift Tax Basic Exclusion Amount reverts to $1,000,000, and a top rate of 35%

B. *Year End Planning for Investments*

1. Sell Appreciated Assets

An individual taxpayer who is considering selling some appreciated assets, e.g., because he believes the assets are close to their peak price, or because he needs funds to make other investments that he believes will be even more profitable, should consider the extent to which he should sell all or part of those assets in 2012. While it is often better to defer receipt of income (including capital gains) so as to also defer the payment of tax, for the following reasons it may be better to sell appreciated assets this year.

2. Accelerate Home Sales

The sale of a residence after 2012 can trigger the 3.8% surtax in one of two ways. It also can expose taxpayers to a higher capital *gain tax rate if the sunset rules affect them next year.*

C. Year End Planning for Business

1. Take Money Out of a Corporation

A lot of complicated rules make it difficult to take money out of a corporation by means of a stock redemption and have the transaction produce capital gains. However, the good news here is that a maximum 15% rate (Code Sec. 1(h)(1)(C)) will apply in 2012 whether the distribution in redemption is treated as a dividend or as a payment for stock entitled to long-term capital gains treatment, or indeed if a pro rata distribution is made to all the shareholders without regard to any redemption. Even though the maximum rate is the same for both dividends and long-term capital gains, there is an extra benefit in getting capital gain treatment in that basis in the stock redeemed will reduce the amount subject to tax. This is not so if the redemption distribution is treated as a dividend.

2. Expense otherwise capitalized tangible property costs if a de minimis rule is met

This year, businesses have the first-time-ever opportunity to expense otherwise capitalized tangible property costs if a *de minimis* rule is met. The new rule can create extra year-end deductions for enterprises that need to purchase equipment, materials, and supplies before year-end. That's particularly true for enterprises that can't use Code Sec. 179 expensing.

How the de minimis rule works - In general, taxpayers must capitalize amounts paid to buy or produce tangible property. However, under temp regs issued late last year, a *de minimis* rule applies to amounts paid or incurred (to acquire or produce property) in tax years beginning after Dec. 31, 2011. Under the *de minimis* rule (also called the book-tax conformity rule) in Reg. § 1.263(a)-2T(g), amounts paid to acquire or produce a unit of real or personal property (but not inventory or land) don't have to be capitalized if: (i) the taxpayer has an applicable financial statement (AFS), such as one required to be filed with the Securities and Exchange Commission, or a certified audited financial statement accompanied by an independent CPA's report and used for credit or reporting purposes;, and (ii) the taxpayer has written accounting procedures in place at the beginning of the tax year for expensing amounts paid for such property under certain dollar amounts; (iii) the taxpayer treats such amounts as expenses on its AFS in accordance with its written accounting procedures; and (iv) the aggregate of amounts paid and not capitalized under the *de minimis* rule for the tax year are less than or equal to the greater of (A) 0.1% of the taxpayer's gross receipts for the tax year as determined for federal income tax purposes; or (B) 2% of the taxpayer's total depreciation and amortization expense for the tax year as determined in its AFS (this is referred to as the *de minimis* ceiling).

3. Bonus Depreciation

The depreciation deduction under Code Sec. 167(a) for “qualified property” for the tax year in which the property is placed in service includes an allowance equal to 50% of the “adjusted basis” (of the qualified property (bonus depreciation). “Qualified property” is new property that is generally placed in service before 2013 and meets the following four requirements: (i) the property must be MACRS property with a MACRS recovery period no longer than 20 years, water utility property, computer software or “qualified leasehold improvement property”; (ii) the original use of the property must begin with the taxpayer

after Dec. 31, 2007; (iii) the property must be acquired by the taxpayer *either* after Dec. 31, 2007 and before Jan. 1, 2013, and (iv) the property must be placed in service by the taxpayer before Jan. 1, 2013.

4. Sec. 179 Expense Election

Taxpayers, except trusts, estates and certain noncorporate lessors, can elect to expense, up to a specified maximum amount, the cost of certain MACRS property purchased and placed in service during the tax year. The expense election can be made only for qualifying personal property used in the active conduct of a trade or business. The maximum amount that can be expensed by regular taxpayers is $500,000 for tax years beginning in 2010 or 2011, $139,000 for tax years beginning in 2012, and $25,000 for tax years beginning after 2012.

Qualifying for the expense election is property acquired by "purchase" for use in the active conduct of a trade or business which is Code Sec. 1245 property (as defined in Code Sec. 1245(a)(3), and which is either: (i) tangible MACRS property, (ii) certain computer software (as defined in Code Sec. 197(e)(3)(B) which is described in Code Sec. 197(e)(3)(A)(i) (readily available for purchase by the general public, to which the depreciation rules of Code Sec. 167 apply (off-the-shelf computer software) and which is placed in service in a tax year beginning after 2002 and before 2013, and (iii) qualified real property in tax years beginning in 2010 or 2011.

5. Hire Veterans before 2013 to qualify for enhanced WOTC

The work opportunity tax credit (WOTC) expired at the end of 2011 for all new qualifying hires except for veterans, but here, too, there's a sunset. The qualifying veterans must begin work for the employer before Jan. 1, 2013. Although Congress may extend the break for hiring veterans (and perhaps retroactively extend the WOTC for all qualifying new hires), it's far from a sure thing. Thus, employers who will add to payroll before year-end, and are thinking of enlisting qualified veterans, should make their move before year end to lock in valuable credits.

D. Should You Make Gifts in 2012?

1. Overview

If the law remains unchanged the Basic Exclusions Amount which applies for Federal Estate and Gift Tax will revert to $1,000,000, and a 35% marginal tax rate, in 2013. In 2012 the Basic Exclusion Amount stands at $5,120,000 gift tax exclusion with a 35% marginal tax rate. The question of whether or not to make gifts in 2012 is a difficult one to answer. The enticement of the $5,120,000 gift tax exclusion and the 35% tax rate is difficult to resist. If one could predict with certainty that the Basic Exclusion Amount would revert to $1,000,000, and a 55% marginal tax rate in 2012, the answer would be easier to answer. However that is only one of several possibilities - others include complete estate tax repeal – the Obama proposal of a $3,500,000 exclusion for estates, and a $1,000,000 exclusion for gifts, coupled with a top tax rate of 35%, or something in between.

2. Do Old Principles Apply?

To what extent do old principles apply? Gifting assets with a low basis relative to fair market value is generally not tax advantageous in the context of gifting strategy since a low basis will increase the value of the loss of basis step up. If one assumes high basis the value of the loss of step up goes down. If the

value of the basis step up is eliminated or relatively low – it may be worth it to risk losing the step up in order to obtain potentially greater estate tax savings. Lower net worth individuals will gain less if anything and may lose value by making gifts. One must also factor in that the estate tax is based on entire fair market value of property on the date of death, while the value of basis step up is based only on the difference between the fair market value at the date of death and the adjusted basis of the property in the hands of the decedent.

Generally one is on safe ground gifting high basis assets even in this uncertain environment. As a general rule estates within the application exclusion amounts – twice that for a married couple- should not consider gifts. It is generally true that because the estate tax rates are higher than at least capital gains rates the value of estate tax savings should be worth more than step up in basis. However, when one factors in the effect of the Basic Exclusion Amount that conclusion may change. For instance the effective estate tax rate under President Obama's budget proposal does not exceed the 2013 capital gains rate of 18.8% until the taxable estate exceed $6,000,000 - $3,000,000 over the $3,500,000 exemption. If one assumes a $1,000,000 exemption, and a 55% rate on estates over $3,000,000, the effective estate tax rate exceeds the capital gains rate at about $1,870,000 - $870,000, over the exemption. This also means that higher net worth individuals will gain more by making gifts because the highest marginal estate tax bracket will generally also be the effective tax rate which applies to the gifted property.

The question in every case is still the same, *"Will the gift result in more after tax value passing ultimately to the transferor's heirs?"* In answering this question under the Method of Analysis, recited above you are asked as the planner to make certain assumption is making your calculations to determine the answer in a particular case. These included the following:

- *The level of income produced by the property interest transferred.*
- *The fair market value of the owner's assets other than the property transferred, and their potential to appreciate.*
- *The Transferor's and the transferee's marginal income tax brackets.*
- *The Transferor's basis in the assets held by the Transferor.*
- *The value of any other lifetime gifts made by the client before the transfer in question.*
- *The annual rate at which the property interest transferred will appreciate.*
- *The annual rate at which the assets not transferred will appreciate.*
- *The discount rate to be used for determining present and future values.*
- *The life expectancy of the client.*

In the unified transfer tax system the fundamental objective is to make it a tax neutral decision as to whether one makes a lifetime gift or transfers his or her property at death. Generally, the federal estate tax and the federal gift tax work in tandem toward this objective. As a result an individual who owns assets worth $10,000,000, for example, disregarding appreciation will pay basically the same transfer tax whether he retains the assets until death, or gives them away during lifetime, or gives them away in part and retain them in part[2] That been said there are that are differences in the may make a lifetime transfer more or less advantageous than one made at death. These differences were highlighted above in section III.

[2] Under current law the estate tax on $10,000,000 would be $1,708,000; a gift of $$5,128,000, would result in no gift tax but and a estate tax of $1,708,000, and a gift of $10,000,000 would be $1,708,000.

That being said because of the way the estate and gift tax are calculated the estate tax savings is really normally based on the appreciation in the property removed from the tax base between the date of transfer and the date of death. In a more settled environment, the question could be stated more simply as *"Is the estate savings realized by lifetime gift worth more than the loss of basis step up incurred by retaining the asset in the estate?"* Even in ideal circumstances many of the assumptions are no better than educated guesses. In order to determine the potential estate tax savings you have to know or at least assume the estate tax rate and the Basic Exclusion Amount, applicable at the time of the transferor's death; and in order to calculate the value of the loss in basis step up in have make assumptions as to the marginal tax rate applicable at that time. Because of the scheduled end to the Bush Tax Cut in 2013 – that marginal income tax rate also comes into question.

In the current tax environment we can therefore add to the list of unknowns:

- The estate tax exemption
- The gift tax exemption
- The estate and gift tax rate
- The tax rate on capital gains
- The highest marginal income tax rate
- The existence of the unified transfer tax system

3. Where Does That Leave Us?

Where does that leave us? All of this uncertainty makes intelligent planning almost impossible. It is probably a better strategy to wait until more definition of the estate and also the nature of the income tax comes into focus. That will probably not occur until after the Presidential election at the earliest. At that point the Method of Analysis described above can be applied with more certainty to aid in the decisions making process.