CLIENT NEWSLETTER

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S Corporation Concerns

A CPA set up an S Corporation to be a partner in an accounting firm. The S Corporation paid the practitioner wages and substantial profit distributions. An Appeals Court said the pay was unreasonably low and reclassified a ***portion*** of the profits as salary. The S Corporation has asked the Supreme Court to reverse the ruling. Timing here is everything: recently Congress has considered treating all S Corp profits as wages for the shareholders (subject to Social Security and Medicare taxes). Now we may get a Supreme Court ruling on the **partial** conversion of profit distributions to resemble a 'reasonable salary.' Since IRS has also argued 'excessive salary' situations for C Corps this ruling may spell out appropriate tax considerations.

On another front, if you forget to file your annual report with the state (that pesky annual $150 fee), and the corporation becomes administratively dissolved by the state, it is not terminated by the federal government. If the firm continues to operate, files tax forms and eventually reincorporates in the state there is no impact to S Corporation status.

Where's My Refund?

Many of us have used the IRS website feature of *"Where's My Refund?"* to find out just when we can expect that big chunk of change to hit our account. Unfortunately, slower tax refunds are guaranteed for next year's filing season. In an effort to protect the rightful refund owners, the IRS is instituting slower payout procedures in its efforts to combat identity theft. Currently if a social security number has been compromised, it can take six to nine months for the Service to build the case proving the rightful identity and confirming the fraudulent filing.

The Fiscal Cliff!

The Budget Control Act of 2011 takes effect midnight December 31, 2012: both tax cuts expire and budget sequestration occurs. Taxes will rise on all taxpayers an average of 5% and spending cuts will combine to reduce the deficit by $560 billion. This compromise was passed to increase the debt ceiling through the next election. In May the Wall Street Journal estimated the impact presented by J.P. Morgan economist Michael Feroli as withdrawing $280 billion from the economy from the expiration of the Bush tax cuts, $125 million from the sunset of the Obama payroll tax cuts, $40 million from extended unemployment benefits and $98 billion from budget cuts. The capital withdrawal signals another recession. The main sectors for spending cuts are Defense and Medicare. Social Security, federal pensions and veterans benefits are exempted.

State and local budget cuts have increased the unemployment rate by 0.5%, and the slated Defense spending cuts will cost "hundreds of thousands of jobs" according to Mitt Romney's acceptance speech. Once the results of the elections are in, the lame duck Congress will be faced with changing this inevitable with a more reasoned approach, something the Super Committee has proposed, but was deemed unacceptable by tea party members.

We have been promised that when Congress reconvenes all of these issues will be handily dealt with. The cynic in me suspects the cliff will be enacted and Congress will act in retrospect to put things in better order. If tax hikes automatically go in to effect Jan. 1 and Congress moves to "fix" some or all of them, then no one can be accused of raising taxes!

NEW 3.8% MEDICARE TAX

In 2013 the Affordable Care Act will impose a 3.8% Medicare contribution tax on the unearned income of taxpayers with adjusted gross income in excess of $200,000 for single filers, $250,000 for married filing jointly and $125,000 for married filing separately. The tax applies to income from interest, dividends, annuities, royalties and rents that are not received in an ordinary trade or business, excluding active S Corporation or partnership income. Gross income does not include items which are excluded from gross income under the income tax, like tax-exempt bonds or veterans' benefits. If capital gains on a primary home sale exceed $250,000 for an individual or $500,000 for a married couple, the excess realized gain is subject to the Medicare tax. Not the entire gain and not the entire sales price as has been reported on the internet!

The tax is not imposed on all adjusted gross income, but on the results of a computation to determine the amount of unearned income realized in excess of the $200,000/$250,000 threshold. Taxpayers will determine the LESSER of their net investment income or the excess of adjusted gross income over the threshold amounts. If a married couple has $300,000 in W-2 earnings and $600 of dividend income to report, the 3.8% tax applies only to the $600 dividend income ($22.80 tax). A single person has $60,000 wages, but sold that stock they bought way back when and reports capital gains of $150,000. The new tax is calculated on only $10,000 ($60,000 + $150,000 = $210,000, on $10,000 is over the threshold amount), and pays $380.00.

The revenues generated from this tax will be allocated to the Medicare Trust Fund to help stabilize the shaky financial footing. So, while the tax is indeed a Medicare contribution, unlike the Medicare payroll tax, this is an unearned income tax. Federal income taxes are not deductible against gross income.

In anticipation of the impact of this new assessment, high income taxpayers who have the opportunity to realize capital gains, Roth IRA rollovers or other extraordinary income increases should consider accelerating those events in to the remainder of 2012, before the tax comes in to play. In the case of Roth rollovers, a taxpayer is allowed a "do over" to reconsider the move and roll it back in to a traditional IRA if circumstances change. In the event a new Congress and/or administration brings tax law changes that include a 'gentler' taxation approach the acceleration of that particular type on income can be undone.

DATELINE: IRS (IRS Tax Tip 2012-10)

Tips for Safeguarding Tax Records

Here are four tips from the IRS to help you prepare in case any kind of disaster strikes.

1. **Backup records electronically** Taxpayers should keep a set of backup records in a safe place away from the original set. Keeping a backup set of records, bank statements, tax returns, insurance policies, etc is easier now that many financial institutions provide statements and documents electronically. Even if the original record is only available on paper, it can be scanned into an electronic format. You can download them to a portable backup storage device such as an external hard drive, CD or DVD that you can take with you in the event that you need to evacuate.

2. **Document valuables** Taxpayers should photograph or videotape the contents of their home, especially items of higher value. A photographic record can help an individual prove the market value of items for insurance and casualty loss claims. Photos should be stored at an outside location. To document your valuables, the IRS has a disaster loss workbook, Publication 584, Casualty, Disaster and Theft Loss Workbook, which can help taxpayers compile a room-by-room list of belongings.

3. **Update Emergency Plans** Emergency plans should be reviewed at least once a year. Personal and business situations change over time as do preparedness needs. When employers hire new employees or when a company changes functions, plans should be updated and employees should be informed.

4. **IRS Ready to Help** If a disaster strikes, affected taxpayers can call 1-866-562-5227 to speak with IRS specialists trained to handle disaster-related issues. You can request copies of previously-filed tax returns by filing Form 4506, Request for Copy of Tax Return, or request transcripts showing most line items on a return online at irs.gov.

OFFICE NEWS

Time to get serious about all we've meant to accomplish in 2012. My activities for the fourth quarter are:

- September 27 – October 1: WY (for my birthday!)
- October 26 – 28: Practice Mgmt Shareshop
- Nov 17 – 25: Thanksgiving with family
- Dec 3 - 4: 2012 Tax Update
- December 22 – 25: Christmas Holiday
- December 29 – January 1: New Year's

and then it's my favorite time of year.....

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