



Tax Hints

From Abraham I. Horwitz, CPA

DECEMBER 2009 - VOLUME 2009, NUMBER 1

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Welcome to our newsletter. Once again we are getting near year-end and as there has been a great deal of recent activity in taxes, this newsletter allows us to share information that we would like you to be aware of. It contains information on the good, the bad and the ugly.

The New and Improved? IRS – Reporting of Information

Sale of Securities (Stocks and Bonds): While we have been predicting it for several years, it doesn't take effect until "after 2010", but it is here. The IRS has long been looking to improve reporting and compliance with reporting of capital gains transactions. Beginning in 2011, for most stocks, bonds and several other investments, brokers will be required to report the customer's adjusted basis and whether the gain or loss was short-term or long-term. It begins for stocks bought after Dec. 31, 2010, bonds bought after Dec. 31, 2011, and everything else bought after Dec. 31, 2012. In some ways this is helpful, such as when there is a spin-off of another company from one that you own, but again the government is getting more and more information about our financial transactions.

Gift Tax on Transfer of Ownership: While it is fairly common to add a child to a deed, the IRS has decided to go digging to see if a gift tax return has been filed. The IRS has entered into agreements with many localities to get information on changes in deeds. In the event someone is added to a deed, don't be surprised to get a letter from the IRS asking for the gift tax return for gifting an interest in real estate to someone.

The New and Improved? IRS – Statute of Limitations

Statute of Limitations on Tax Returns with Basis Overstatement: The normal statute of limitations is extended to 6 years, if gross income is omitted from a return where the omitted income is greater than 25% of the amount of gross income stated in the return. Under recent temporary IRS regulations, overstated cost basis on the sale of an asset, including investments, is considered an omission of gross income and could potentially extend the statute of limitations on the tax return to 6 years.

The New and Improved? IRS – Alternative Minimum Tax (AMT)

Alternative Minimum Tax: Many taxpayers get caught by this bizarre, parallel tax system. The IRS has identified ten primary tax triggers: personal exemptions, standard deductions, state and local income tax, sales and property tax, mortgage interest on refinanced or second mortgages and home equity loans not used to buy, build or improve a home, medical expenses, miscellaneous itemized deduction subject to the 2% floor, exercise of incentive stock options, long-term capital gains, tax-exempt interest from private activity bonds and business tax deductions. Unfortunately, in the NY area we are faced with high state and local income taxes and property taxes, which increase the likelihood of getting caught by the AMT trap. If you are subject to AMT, the final state and local estimated payments give you no benefit from being paid before year end.

The New and Improved? IRS – Possible Withholding Issue

Making Work Pay Tax Credit: Early in 2009, the Making Work Pay Tax Credit was passed. Most people noticed a jump in their paychecks based on the revised withholding tables issued. However, we are now being told that some people may have received too much of a reduction in withholding, which may mean that a larger balance will be due with the tax returns filed in April. Some of the potential categories, depending on the wage amount, are married couples with both spouses working, individuals with two or more jobs, dependents who receive wages, and people with a large amount of non-wage income. According to a report by the Treasury Inspector General for Tax Administration, more than 15.4 million taxpayers could unexpectedly owe taxes for 2009 due to the Making Work Pay Credit.

Standard or Itemized Deductions – Taxes

Sales Tax on Automobiles: If you bought a new car, light truck, motorcycle or motor home, you may be eligible for a deduction of the sales tax on the purchase. This deduction is also available to non-itemizers who take the standard deduction. It is limited to the sales tax on up to \$49,500 of the purchase price, and is phased out at modified adjusted gross incomes above certain limitations.

Itemized Deductions – Interest Expense

Home Equity Debt: An IRS legal memo concluded that acquisition debt can qualify as home equity debt to the extent it is greater than \$1 million. Of course the equity debt is still subject to the \$100,000 and fair market value limitations. This means that if a home is acquired for \$1.1 million or more, the first \$1 million borrowed qualifies as acquisition debt and therefore the mortgage interest is deductible. The next \$100,000 borrowed qualifies and the interest on it is deductible as home equity interest.

Refinancing and Acquisition Costs: A hot area with the IRS this year is reviewing mortgage interest. In order for interest to be deducted, the debt must be used to purchase, construct or substantially improve a principal residence or second home. When a refinancing takes place and additional debt is taken out, it does not qualify for the mortgage interest deduction; unless the additional debt was used to substantially improve the residence. It is important to recognize that the Internal Revenue Service can look at the current year's deduction and try to trace it back to prior refinancing.

Itemized Deductions – Charitable Contributions

Contributions of Merchandise: A recent tax court ruling (The Tokh Case) upheld the IRS. The taxpayers in question donated over 300 items of used clothing and household items. They received forms provided by the charity, but the details, including the time of donation, estimated and fair market value, etc., were attached by the taxpayers. The IRS said that although the receipts were contemporaneous, it didn't show the original cost, age or condition of the donated items. The tax court upheld the IRS and noted that the receipts created by the taxpayer were unreliable.

Expense for Charitable Work: While expenses related to charitable work should be deductible, it should be noted that if \$250 or more is incurred in expenses for a single charitable event, you must also have an acknowledgement letter from the charity. Additionally, the letter must be received by the date your tax return is filed.

Disallowance of Charitable Contributions: In a Tax Court case that many of us find particularly upsetting, the taxpayers made approximately \$6,500 in charitable contributions to their church. At least ten checks for a total of \$6,100 were for more than \$250 each. The IRS challenged the deduction and disallowed all the checks that were for \$250 or more. As the case went to trial, the taxpayers obtained a letter from the church acknowledging the contribution. The Tax Court confirmed the IRS disallowance, stating that it is required that the written acknowledgement be "contemporaneous" with the contribution and received before the tax return is filed. In this case the acknowledgement letter was only obtained when the case went to court.

Itemized Deductions – Miscellaneous Deductions

Job Seeking Expenses: As a reminder, in order to deduct Job Search expenses, the search must be for a job in the same occupation. Unfortunately, this means that if you are changing occupations or are a first-time job seeker (recent graduate, etc.) the costs of searching for a job are not deductible.

Tax Credits

First Time Homebuyer Credit: This credit has been extended through April 30, 2010. Any home under a binding contract by April 30, 2010 has until June 30, 2010 to close and may still qualify for a credit of up to \$8,000. As an added bonus, an existing homeowner who has owned and used the same residence for any 5 consecutive years in the last 8 years now qualifies as a first-time homebuyer for purposes of this credit. For existing homeowners who qualify, the credit is limited to \$6,500 (rather than the normal \$8,000.) The extension came with a whole series of new rules. If the home cost exceeds \$800,000, the credit is disallowed. There are also income limitations. Dependents and individuals under the age of 18 are now ineligible for the credit. (Under the previous rules, there were at least two 4 year olds who took the credit, and there were many violations of the rules.) In addition, along with Form 5405, a copy of the closing statement must now be attached to your return.

Education Credits: American Opportunity Tax Credit: The Hope Credit has been replaced by the American Opportunity Tax Credit for 2009 and 2010. The credit is up to \$2,500 for taxpayers who pay \$4,000 or more in qualifying expenses for an eligible student. There are income limitations for the credit. Unlike the Hope Credit, this credit is partially refundable so even if you owe no tax you can get some benefit. The credit has been extended to cover the first four years of post-secondary education.

This opens up a potential elective opportunity. If the student has a lower income and the parents aren't eligible for the credit, the parents might elect not to claim the student as a dependent which could result in lower total taxes paid.

For more information on education tax benefits, you might want to visit the IRS website's Tax Benefits for Education: Information Center at <http://www.irs.gov/newsroom/article/0,,id=213044,00.html>.

Energy Credits: Recent legislation has provided a number of new and expanded tax breaks for energy-saving investments. There is an increase to a credit of up to \$1,500 for qualified improvements including energy-efficient windows and doors, furnaces, water boilers and circulating fans placed in service in 2009 or 2010. The 30% credit for residential energy-efficient property was expanded by removing the dollar caps for qualified solar water heating, geothermal pump, small wind energy, and solar electric property. The credit for plug-in electric drive vehicles has also been expanded.

Education Related

Qualified Expenses for Tax-Free 529 Plan Distributions: Computer costs and internet access charges and related expenses paid or incurred after 2008 are considered qualified higher education expenses, provided they are for use by the beneficiary of the plan during the year they are enrolled in an eligible educational institution.

The Fine Print

Rental Activities: Under section 183 of the Internal Revenue Code, losses for activities not engaged in for profit are not allowed. These are known as the hobby loss rules. The Internal Revenue Service is looking at rental properties with an eye toward whether they are actually activities engaged in for profit.

Sale of Residence: Some of the rules have changed and there are some things in the fine print that need to be remembered.

\$500,000 Exclusion: Among other requirements, to qualify for the full \$500,000 exclusion on a joint return, *both* spouses must have used the property as their principle residence for two of the last five years and neither spouse can be ineligible because more than one sale or exchange has been used during the previous two years.

Non-Qualified Use: For sales occurring after 2008, a portion of the gain from the sale of a principle residence allocated to periods of nonqualified use is not eligible for the exclusion. Nonqualified use includes periods where the residence was a rental property, vacation home, investment property or used in trade or business after 2008. This means that you can no longer simply convert the property back to a principle residence and exclude the entire gain.

Disappearing Tax Benefits in 2010

Expiring Tax Breaks: The following are scheduled to expire and not be available in 2010:

- Deduction for educator expenses.
- Tuition and fee deductions in figuring adjusted gross income.
- Increased standard deduction for real estate taxes.
- Itemized or increased standard deduction for sales tax on the purchase of a new motor vehicle.
- Deduction for state and local sales tax.
- The exclusion from income of up to \$2,400 in unemployment benefits.
- The exclusion from income of qualified charitable distributions made from IRA accounts.

Enforcement

Tax Audits: The Internal Revenue Service will be doing more random employment tax audits than originally planned. Over the next three years, the IRS will do 6,000 exams. The IRS will be looking at businesses that classify employees as independent contractors, for S corporations that pay their owners little or no salary, and for violations of tax rules for employee fringe benefits and executive compensation.

Backup Withholding: The IRS is also concerned that many companies don't do backup withholding for independent contractors who provide an invalid tax ID number or simply don't supply one. The IRS will audit 100 firms that sent 1099s with incorrect or missing numbers and did not file Form 945 to report backup withholding.

The Unbelievable

Dependency Exemption for Divorced Parents: For tax years beginning after July 2, 2008, amended regulation 1.142-4(e) (3) allows a custodial parent to *unilaterally* revoke an earlier release to the non-custodial parent of the right to claim the designated child as a dependent.

IRS Errors: The National Taxpayer Advocate's Annual Report to Congress reported that the Internal Revenue Service miscalculates the failure-to-pay penalty on approximately 2 million taxpayers per year. Additionally, manual calculations of interest are incorrect nearly one third of the time. So, if you do receive a notice from any taxing authority, it is important that you contact us before acting on it.

And finally, the IRS recognizes that we are in a difficult economic time. On the IRS website www.irs.gov you can find a page called "The What Ifs of an Economic Downturn". It includes several job, debt and tax related scenarios and how to handle them during these economic times. You can link the page directly at <http://www.irs.gov/newsroom/article/0,,id=201853,00.html>.

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