

December 7, 2009

End of Year Client Newsletter

Substantiation and Documentation

The number one key to prevailing in an audit situation is substantiation and documentation. It is critical to document every item on your tax return in accordance with IRS rules. This means you must have a receipt for every deduction, an auto mileage log, a cell phone log, stock basis records, meals and entertainment expenses and real estate purchase closing statements, for a start. In addition, I am required to review certain documents in order to report them on your tax return, or I am subject to preparer penalties of \$1,000, \$5,000 or more.

Did you notice cell phones have been added to the substantiation requirements? Sure have. Cell phones are "listed" property and as such have increased documentation requirements. You cannot deduct personal usage of the cell phone, only business. The IRS is considering three methods of allowing cell phone deductions: a straight 25% is considered personal use of a business phone but only if the employee has another cell phone for strictly personal use; the employer can use a sampling method to determine business use; or the employee has to account to the employer for business use and it's all deductible. This is going to be a big audit issue in the future. I would advise at this time to stop deducting 100% of cell phone usage and start deducting only 75%. Plus, you should keep your itemized bills if you get them.

2010 Rates

The FICA limit for 2009 will be \$106,800.

The age 62-64 earnings limit for Social Security is \$14,160.

The Standard Mileage Rate is 50 cents per mile for business.

Charitable Mileage Rate - 14 cents per mile.

Medical and Moving Mileage Rate - 16.5 cents per mile.

Motorcycle Mileage Business Rate - 30.5 cents per mile.

The Estate Tax Unified Credit Equivalent - at this time, no limit
The Annual Gift Tax Exclusion is \$13,000.

Retirement Contribution Limits:

IRA	\$5,000	>age 50 add'l	\$1,000
Simple IRA	\$11,500		\$2,500
401(k)	\$16,500		\$5,500

Note: the amount of the phase-out of itemized deductions for high-income taxpayers has been decreased.

Dependency Exemptions

This seems like an easy area, but it's really not so simple. To claim a child as a dependent, you must meet seven tests:
relationship (child, adopted child, eligible foster child, grandchild, brother, sister, stepbrother, stepsister, or other descendent),
residency (must live with you over half the year),
support (child cannot have provided over half of his/her own support),
age (under 19 or under 24 if full-time student),
joint return (child cannot file a joint return),
"younger than" test (child must be younger than the taxpayer), and
AGI test (if a child's parent can claim the child but do not, then another taxpayer can claim the child but only if that taxpayer's AGI is higher than the highest AGI of any parent of the child).

Does it sound like a foreign language? Seems like it sometimes. Notice the gross income test for the child is gone now; so the child has no limit on gross income, but there is a limit on support. Notice also that the taxpayer no longer has to provide over one-half of the child's support; just that the child cannot do so.

There are also rules for Qualifying Relatives - if the dependent does not qualify as a child, he/she could qualify as a relative. Five tests: relationship, support, gross income, citizenship, and joint return. Call or email me for more details.

The dependency exemption is not a choice - you cannot pass dependency exemptions around to various taxpayers. If you qualify to take it, you can. If you don't qualify, you cannot. Except for divorced parents, with a specific agreement.

There are complex tie-breaker rules for determining entitlement to an exemption. If you have a question about it, call me and we'll figure it out.

Head of Household Filing Status

Head of household is no longer available to taxpayers who have maintained homes for adult children who are not dependents.

Divorce

As you know the IRS has issued Circular 230 which governs the conduct of CPA's and tax preparation. As a result, I cannot represent both clients when they are divorcing or after a divorce, it's classified as a conflict of interest. Please be aware that if this applies to you, one of you must find other representation. I will be happy to make a referral if needed.

Also, please note that there are special rules for tax reporting in Texas, a community property state. Please contact me if this applies to you.

One more note - make sure that if you and your spouse are divorcing and splitting up retirement benefits, you must use a Qualified Domestic Relations Order (QDRO) in order to assign the tax liability to the spouse receiving the retirement benefits.

Making Work Pay Credit

The American Recovery and Reinvestment Act of 2009 created a refundable credit for 2009 and 2010. The credit partially offsets the regressive nature of the social security tax and raises the income of eligible workers. The credit amount is the lesser of \$400 (\$800 for joint filers), or 6.2% of the taxpayer's earned income. So the maximum credit is \$400 (\$800 for joint filers).

For retired workers, there is an **Economic Recovery Payment** for adults eligible for social security benefits, and some other retirees. If you fall into this category you should have received a check for \$250 by June 17, 2009. The Making Work Pay credit is reduced by the Economic Recovery Payment, so you must let me know if you received this payment.

A Note About Other Income

Gross income means all income from whatever source, unless specifically excepted by the Internal Revenue Code. Income includes Alaska permanent fund dividends, children's unearned income over \$1,900, income from the rental of personal property even if occasional or one-time, prizes and awards, jury pay, gambling winnings, cancelled debt, and scholarships just to name a few. Whether or not you receive a Form 1099 for the income, you are still required to report all income.

Unemployment Compensation

However, there is good news about unemployment income. For 2009, up to \$2,400 of unemployment compensation is EXCLUDED from gross income.

New 1099 Reporting Requirements

The American Housing Rescue Act, signed July 2008, triggers new 1099 reporting requirements starting January 1, 2011. Payments on third party networks, such as eBay and Amazon and payments to merchants will be reported on 1099's. This includes credit and debit card transactions. Any business that accepts credit and debit card payments will receive a Form 1099 from the processor.

Issuing 1099's

Speaking of 1099's, you are required to issue a Form 1099 to any individual, partnership or LLC if you pay that entity over \$600 during the year for services. The Form 1099 amount must include all payments for services, merchandise and supplies paid during the year. You are only required to issue 1099's if you are a business. However, owning rental property puts you into this category, so if you have repair work performed on your rental property and the amount you pay is over \$600, you are required to issue a Form 1099.

Standard Deduction Enhancements

There's a new Schedule L! This form allows some deductions in addition to the standard deduction, such as real estate (up to \$500 single, \$1,000 joint), sales tax on qualified new motor vehicles, or a net disaster loss. A disaster loss is defined as personal casualty losses from a federally declared disaster.

Mortgage Interest

There are two kinds of mortgage interest on your residence - qualified and non-qualified. Qualified mortgage interest is interest on debt used to buy, construct or remodel your residence and is fully deductible. Non-qualified mortgage interest is mortgage debt used for any other purpose and is limited to \$100,000 of debt. The IRS requires me to report this information separately. You must provide this information to me for each mortgage interest statement. Please note on each Form 1098 how much of the mortgage principal was used for any purpose not related to the structure.

Charitable Contributions

You are required to have an appraisal for a charitable contribution exceeding \$5,000. Guess what this includes now? Goodwill contributions made throughout the year that exceed a total of \$5,000 - you got it, must have an appraisal on all of them in order to deduct them.

Homebuyer Credit

The first-time homebuyer credit has been extended to April 30, 2010. If you have a binding contract by April 30, 2010, and close by June 30, 2010, you will be eligible for the credit.

There's a new credit of up to \$6500 for homebuyers that have lived in their old residence for five consecutive years out of the last eight years, and buy a new residence in 2010.

To take this credit in 2009 you have to attach a copy of the settlement statement, which means paper-filing your return.

IRA's

There is no minimum age for IRA's - if you are self-employed this provides a great planning opportunity to employ your children and get them started early contributing to an IRA. This can be an enormous benefit for your child.

Beginning in 2010, the AGI limitation for converting IRA accounts to Roth accounts will be eliminated. For conversions done during 2010 only, the taxes owed are paid over two equal installments in 2011 and 2012, or you may elect to completely pay

the tax in 2010. If you think tax rates will increase in the future, then converting to a Roth account could be a good strategy.

For those of you that are self-employed, don't forget the benefits of a SEP-IRA - you can fund these up to October 15th of the following year with a proper extension.

The maximum limits for contributions to IRA's did not change this year, but the deadline is still April 15th, 2010. Keep in mind that compensation for purposes of becoming eligible to contribute to an IRA includes wages and salaries, net self-employment income, alimony and separate maintenance, non-taxable combat pay, partners distributive share of earned income, and scholarship and fellowship payments if reported on a Form W-2.

The Worker, Retiree and Employer Recovery Act requires retirement plans to offer non-spouse beneficiaries the opportunity to roll over inherited plan account balances. So, if you inherit an IRA remember that you are allowed to roll over the balance to your IRA account if you choose.

Give my colleague Paul Jacobs a call at 512-615-3563 to set up your IRA and make your contributions; he can also help you with Roth conversions.

Required Minimum Distributions

Although Required Minimum Distributions were suspended for 2009, you must remember to start them back up for 2010.

You are allowed to pay your Required Minimum Distribution directly to a charity of your choice. This is a good strategy if you do not itemize deductions, since the direct payment is not taxable to you. It's a way to make a deductible charitable contribution without itemizing.

Reporting IRA Basis

The amount of contributions to nondeductible traditional IRA accounts must be reported each year with the tax return even though the contribution is not deductible. In addition, the amount of contributions to a Roth IRA must be tracked each year. It is critical to report this each year so that when you start taking distributions from your IRA you are not taxed again on these amounts.

Please make sure that you provide this information to me each year as well as giving me your end of the year IRA statements. A Form 8606 is required to be filed annually.

Alternative Minimum Tax (AMT) Credits

If you have ever paid AMT, please make a note in your tax documents this year. There is a new provision that allows a larger recapture of your Minimum Tax Credit. If I have not prepared your prior year tax returns, I do not know if you ever paid AMT. Please check - this can save you a lot of money!!

Below Market Interest Rates

Unless a specific legal exception applies, all loans must bear a minimum rate of interest. If one is not state, the law imputes interest as if the parties had agreed to the charge. There are specific rules for "deeming" interest. Let me know if you have one of these situations when you send me your tax documents.

Dividends

2010 is the last year for zero percent tax on dividends if you qualify, or a maximum of 15% tax on dividends. If you control a corporation, then you might consider paying dividends in 2010 to take advantage of this law.

IRS Hot Topic - Foreign Bank Accounts

If you had a foreign account or had signature authority over or an interest in any foreign financial account, a special form must be completed if the combined value of all accounts was more than \$10,000 at any time during the year. Financial accounts include both bank and brokerage accounts. The IRS is VERY interested in this area, so this form must be filed. The form is Treasury TD-F 90-22.1. The form is submitted separately to the US Treasury and is due by June 30. Penalty for failure to complete and submit this form is a fine up to \$500,000 and a jail term of up to ten years. The IRS will enforce these penalties. Many of you have legitimate foreign accounts, so let's remember to get these forms filed properly.

Mortgage Comfort Letters

Many of you in the past have asked me to write letters for a mortgage lender requesting confirmation of self-employment. The AICPA has warned against preparing these letters. The following statement is recommended "My client has self-employment revenues and deductions that allow completion of a Schedule C". Please discuss this with your mortgage company should they ask for such a letter.

Providing Copies of Your Tax Return to Third Parties

I receive requests from many of you throughout the year to provide a copy of your tax return to a third party; a mortgage lender, banker, or some other entity. The IRS has announced restrictions that allow me to provide these tax returns only if I receive a written consent from you, originally signed, with very specific language. I will no longer be able to provide these copies to third parties without following these rules. However, each of you has a portal which contains your 2006, 2007 and 2008 Form 1040, and will contain your 2009 Form 1040 when it is completed. You can download your tax return at your convenience from your portal. To access your portal go to my website, saradolphcpa.com, and select the client portals button on the left side. Your user id is usually your last name, all caps, and your password is your SSN, no hyphens. If you have problems accessing your portal please let me know.

More Social Security

To become eligible for retirement benefits, workers must meet a minimum work requirement. A worker must have accumulated ten years of earnings contribution experience, which is forty quarters, or credits, of tax payments. The Social Security system uses the highest 35 years of earnings to calculate your retirement benefits. If there are fewer than 35 years, years without earnings are assigned a value of zero in the calculation. So it is very important to review your annual Social Security statement and make corrections if needed.

Medicare

Individuals who wait to draw any form of Social Security until age 65 or later must apply for Medicare. Failure to apply can lead to higher premiums and delayed coverage. So if you are approaching 65 and not taking Social Security, you must remember to apply for Medicare between the ages of 64 and 9 months and 65 and 3 months.

Sale of Residence

Generally, taxpayers may exclude up to \$250,000 (\$500,000 for joint filers) of the gain realized on the sale of a principal residence. Gain attributable to periods of nonqualified use after 2008 may not be excluded. What does this mean? Nonqualified use is any use other than as a principal residence after 12/31/08. Use as a secondary home, vacation home or rental is nonqualified use starting in 2009. Also, it's only for the first time use of the property. If the property is used as a principal residence first, then later used as a vacation home or rental, this rule does not apply. It's ONLY if the ORIGINAL use is as a secondary home, vacation home or rental - starting in 2009 - and then it's converted to the principal residence. Then you won't get the full exclusion if you sell the property later - only a partial exclusion, and it depends on how long you occupy the property as a principal residence.

Insurance Stock Received in Demutualization

You may have received insurance stock during demutualization sometime in the past few years, or you may receive some in the next few years. Recent court cases have established that your basis in this stock is equal to its fair market value on the day you received the stock. When you sell the stock the gain you recognize is only the increase in value from the day you received the stock.

Material Participation

This is a new interest for the IRS for coming years. Material participation is important because it has an impact on the deductibility of losses and the income classification for various activities, such as S corporations, partnerships, LLC's, farms and ranches, sole proprietorships and investments in REIT's and limited partnerships. The material participation rules determine if the activity is active or passive. There are two types of passive activities. One is any activity which involves the conduct of any trade or business in which the taxpayer **does not** materially participate; and any rental activity. This is a complex area so if you have any concerns regarding this issue let me know and I will send you more detailed information.

Revisited from Last Year

Kiddie Tax

The Small Business and Work Opportunity Act of 2007 has provisions that come into play for 2008 and 2009. The main provision is that the effective age of a child subject to the kiddie tax - which means the child has to pay tax at the parent's tax rate - is 18 for 2008, or is a full-time student from age 19 to 23. If your child falls into this category and their earned income does not exceed one-half of their annual support and their income is more than \$1900, then their tax return has to be prepared in accordance with this new law.

Wills, etc.

Make sure your wills, Power of Attorney, and directive to the physician are up-to-date. State laws change periodically; you need to update these documents at least every five years.

Beneficiaries

It is very important to perform an annual review of your beneficiaries. You need to check the beneficiaries on your IRA's, rollover retirement accounts, annuities, life insurance and all transfer-on-death accounts. You may be surprised to learn that you have neglected to change a beneficiary on one of these accounts - please check!

Transfers of Assets

Many times you, your family, your friends and your neighbors desire to transfer assets to someone else. Two techniques that will not work are as follows: "just transfer the house to the kids, it will keep it out of your estate so you won't have to pay taxes"; or "put the asset in one of the kid's names and then they can just divide it up when you die". These methods are not good and do not work. Please do not let your family members transfer assets prior to death. There are only disadvantages to doing this and no advantages. Your family members, friends and neighbors really should heed the advice of a professional for estate planning.

Rental Properties

Each rental property you own should be held in an LLC. Please contact your attorney for a discussion of the liability protection issues. Each LLC can be a single-member LLC which is reported on your personal Form 1040 on Schedule E. A single-member LLC does not require a separate tax return.

Unreimbursed Expenses

Many times you, as a shareholder, LLC member, or partner, will pay out of pocket some of the company's expenses. There are specific rules regarding this practice. If you want to deduct LLC member or partnership expenses paid out-of-pocket, your written partnership agreement or LLC document must explicitly state that "partners must pay expenses on behalf of the partnership", must specifically list the type of expenses, and must state that "partners will not be reimbursed". One category of expenses that fits this example would be expenses related to the use of an office in the home by the partner/member. Shareholders in an S Corporation or a C Corporation **cannot** deduct expenses paid out-of-pocket. Shareholders must submit an expense report with full documentation to the corporation for reimbursement.

I know I repeat some things from year to year, but it's really important. Call me and make an appointment if you need further information. I am in the Austin office every Wednesday; I will also be happy to make a phone appointment with you.

I am sending the engagement letter and the required documents information separately. I'll also be sending a separate letter with education information.

I hope that all of you have a wonderful holiday season - stay healthy and happy!

I look forward to hearing from you next year!

Sara