

# TAXOLUTIONS



►► *ideas on taxes*

## CONGRESSIONAL SUPER COMMITTEE MAY PROPOSE CHANGES TO THE TAX CODE

Ending a heated debate over raising the Federal government's debt ceiling, Congress passed and President Barack Obama signed the Budget Control Act of 2011 into law in August. The legislation includes nearly \$1 trillion in Federal deficit reduction over fiscal years 2012 through 2021, but did not include revenue increases. However, the Joint Select Committee on Deficit Reduction (JSC), or the "Super Committee," which has been assigned the task of agreeing by late November on a further \$1.5 trillion in deficit reduction over the coming decade, will be reviewing current tax policy, and could propose sweeping changes to the Federal tax code.

The Budget Control Act, which marks the first time that Congress has linked an increase in the Federal government's debt limit to budget decisions, allowed the government to raise the debt ceiling by \$900 billion, and permitted the U.S. Treasury to continue to fund the government's operations through 2013. However, the legislation also called for offsetting the \$2.4 trillion increase in the amount the Treasury Department is authorized to borrow through a reduction in the deficit, due to occur in two stages between 2012 and 2021. The first set of deficit reduction measures, amounting to \$917 billion in spending

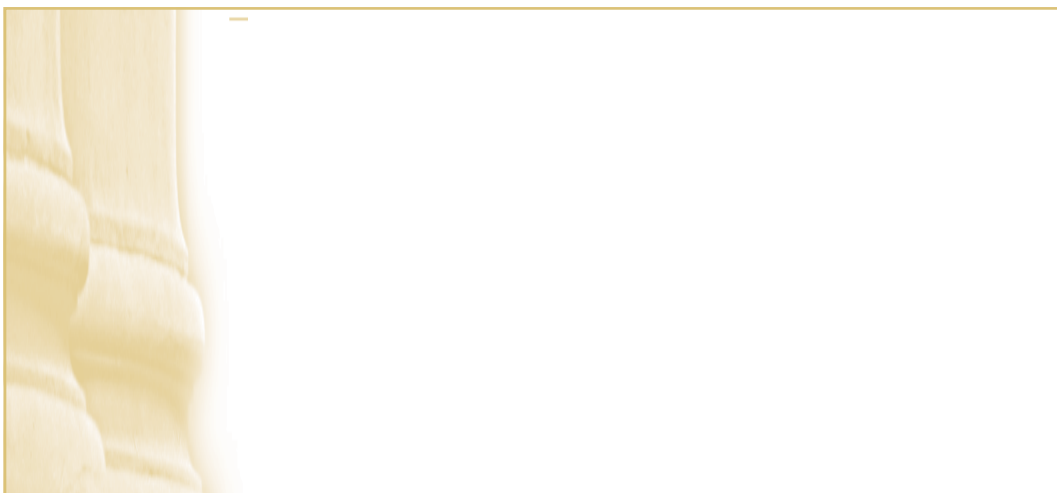
cuts, was included in the legislation. The second round of deficit reduction, which must amount to at least \$1.5 trillion, will be based on the recommendations of the JSC.

The JSC is comprised of 12 members of Congress, six from each chamber, including six Democrats and six Republicans. Under the Budget Control Act, the committee is required to announce its recommendations on November 23, and Congress must vote on the proposals in an up-or-down vote with no filibusters or amendments by December 23. If the recommendations are enacted, President Obama will be permitted to raise the debt ceiling by up to \$1.5 trillion. If voted down, the president would

still be allowed to raise the debt ceiling to \$1.2 trillion, but a set of mandatory budget cuts, equally divided between defense and non-military spending, including Medicare, would be triggered.

To hit their target of trimming \$1.5 trillion from the Federal deficit, the JSC is expected to use as its starting point a bipartisan plan released in July by a group of senators called the "Gang of Six," to reduce the deficit by \$3.7 trillion over 10 years through a mix of spending cuts and tax hikes. The JSC may also be influenced by the work of a number of other congressional commissions that have studied ways to lower the deficit, including the recommendations of the

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## IRS ISSUES GUIDANCE ON CARRYOVER BASIS RULES FOR DECEDENTS IN 2010

The Internal Revenue Service (IRS) recently issued guidance on the treatment of basis for certain estates of decedents who died in 2010 to assist executors who are electing to opt out of the estate tax and have the carryover basis rules apply. The agency also clarified how donors can opt out of the automatic allocation of the generation-skipping transfer (GST) tax exemption for direct skips in 2010.

Under the new guidance, an executor must file Form 8939, Allocation of Increase in Basis for Property Acquired from a Decedent, to opt out of the estate tax and have the new carryover basis rules apply. The IRS expects to issue Form 8939 and the related instructions early this fall. Form 8939 must be filed by November 15, 2011. Executors using this form will be required to provide extensive details of property and property valuations. To remain in the estate tax regime, the IRS has instructed executors of the estates of decedents who died between January 1, 2010 and December 17, 2010 to file the form that is used for taxable estates, Form 706, by September 19, 2011.

With the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax was gradually reduced and was repealed altogether in 2010. After 2010, the estate tax was scheduled to revert to the previous maximum tax rate of 55% and an exclusion amount of \$1 million. But under

the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (Tax Relief Act) of 2010, each taxpayer's first \$5 million, or \$10 million for married couples, are exempt from estate taxes. Above that amount, estates are subject to a maximum 35% rate. The estate tax provisions of the Tax Relief Act apply to decedents who died after December 31, 2009 and before January 1, 2013. The new law also eliminates the modified carryover basis rules that were in effect in 2010 only, and replaces them with the unlimited step-up basis rules that had previously applied.

While the Tax Relief Act retroactively reinstated the estate tax for the estates of decedents who died in 2010, it allowed executors to opt out of the reinstated tax. Therefore, executors of the estates of individuals who died in 2010 may choose between having the estate taxed under the Tax Relief Act, or under the EGTRRA provisions that were in effect in 2010, when the estate tax rate was zero, but estates were subject to a modified carryover basis regime in section 1022 of the Internal Revenue Code.

Under the step-up basis rules, the value of an inherited asset is "stepped-up" from the original purchase price to the higher market value of the asset at the time of inheritance, and the heirs are freed from paying capital gains taxes on the increase in the value of the asset over the decedent's lifetime. Yet, under the modified carryover basis rules, heirs

of property from a decedent who died in 2010 were allowed to step up only \$1.3 million of the decedent's assets to the current fair market value, and property bequeathed to the decedent's spouse could be stepped-up by an aggregate amount of \$3 million, for a total of \$4.3 million. Assets above this level would be subject to capital gains taxes when sold by the heirs. Family members who inherited less than \$5 million from a decedent in 2010, but who were subject to modified carryover basis rules, may prefer to be taxed under the Tax Relief Act in order to benefit from the unlimited step-up basis.

The guidance also clarifies that, if the executor of the estate of a decedent who died in 2010 chooses the modified carryover basis regime, the executor must allocate the decedent's available generation-skipping transfer (GST) exemption by attaching Schedule R to Form 8939. To elect out of the automatic allocation of GST exemption to a testamentary direct skip, an affirmative election to opt out must be made on Form 706 or Form 8939. The GST had been repealed for 2010, but under the Tax Relief Act, the GST exemption for gifts made to grandchildren in 2010 and onwards has been made equal to the applicable exclusion amount for estate tax purposes. Thus, the GST exemption amount is \$5 million with a GST rate of zero for GSTs made in 2010. ■

## EXTENSION OF TWO-YEAR LIMIT ON INNOCENT SPOUSE RELIEF

The Internal Revenue Service (IRS) announced in July 2011 that it will "extend help to more innocent spouses" who were unaware that their husband or wife understated or underpaid taxes on their jointly filed returns by eliminating the two-year time limit that had previously applied to equitable

relief requests under section 6015(f) of the tax code. To date, the IRS receives about 50,000 innocent spouse relief requests annually. Innocent spouse relief is designed to help married or divorced taxpayers who did not know that their spouse understated or underpaid an income tax liability on the couple's joint

return. Those taxpayers who qualify for the relief are freed from the responsibility of paying tax, interest, and penalties for the actions of their spouse. The equitable relief provision is a category available to taxpayers who fail to meet the stricter requirements of other provisions of the innocent spouse law.

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bipartisan National Commission on Fiscal Responsibility and Reform, known as the White House Deficit Commission, which released a plan in December 2010 for lowering the deficit by nearly \$4 trillion by 2020 through a combination of spending cuts and tax increases.

The tax provisions the JSC is expected to consider include the following:

### **Extension of the Bush-era income tax rates past 2012 for some or all taxpayers, or an overhaul of the current income tax rate schedule.**

Under current law, the lower individual income tax rates enacted under President George W. Bush are due to expire at the end of 2012. The Obama administration has called for these rates (10%, 15%, 25%, 28%, 33%, and 35%) to be extended beyond 2012 only for taxpayers with incomes under \$200,000 for individuals and \$250,000 for families. Although support has been shown for the Bush-era rates to be made permanent for taxpayers of all income levels, the Gang of Six has proposed replacing the current income tax rate schedule with three new tax brackets: 8%–12%, 14%–22%, and 23%–29%. The White House Deficit Commission suggested a similar three-tier structure with a low top rate.

### **Extension of the Bush-era tax breaks for capital gains and dividends, or the elimination of separate capital gains rates.**

Unless further legislative action is taken, the current 0% and 15% rates on long-term capital gains and qualified dividends are set to expire after 2012. In 2013, the top rate will revert to 20% for long-term capital gains, and dividends will be taxed as ordinary income. The White House Deficit Commission has recommended that both capital gains and dividends be taxed as ordinary income, together with a lowering of the top income tax rates.

**Elimination of the AMT.** In recent years, Congress has regularly increased the exemption amounts for the Alternative Minimum Tax (AMT) to prevent middle-income families with large

numbers of deductions from being pulled into this parallel tax system. Both the White House Deficit Commission and the Gang of Six have proposed abolishing the AMT, offsetting its disappearance with adjustments in regular income tax rates and the reform, reduction, or elimination of certain deductions and credits.

### **Reform of deductions and credits for individual taxpayers.**

Under the proposals by the Gang of Six, certain deductions and credits may be up for review, including the home mortgage interest deduction, the medical expenses deduction, and deductions for charitable contributions. In addition, the earned income tax credit and the child tax credit could be reduced or eliminated altogether. The White House Deficit Commission would eliminate all miscellaneous itemized deductions, provide a 12% non-refundable tax credit for charitable giving for amounts over 2% of adjusted gross income, repeal state and local tax deductions for individuals, replace the mortgage interest deduction with a 12% tax credit and cap eligible mortgages at \$500,000, as well as cap the income tax exclusion for employer-sponsored health plans.

### **Changes to tax-deductible retirement plans.**

The White House Deficit Commission proposes consolidating 401(k) plans, IRAs, and other tax-advantaged plans into a single retirement plan. The panel further recommends limiting annual contributions to \$20,000 or 20% of income, whichever is lower.

**Reform of inflation adjustments.** To raise revenues, the Gang of Six proposes that provisions of the current tax code adjusted to inflation be tied to the chained Consumer Price Index, which generally shows a lower rate of inflation than the calculation currently used by the Federal government. This change could affect annual adjustments, such as

those to tax brackets, standard deductions, personal exemptions, some itemized deduction phase-outs, and IRA contribution limits and deduction amounts.

**Changes to corporate taxes.** The Gang of Six recommends replacing the current eight-rate corporate tax structure, which tops out at 35%, with a single, lower corporate rate of between 23% to 29%. This lowering of the rate would be accompanied by eliminating or reducing some of the deductions,



credits, and subsidies that have helped companies trim their tax bills in the past. These proposals would especially impact companies with international operations, as the Gang of Six calls for a shift from the current worldwide system of taxation to a territorial tax system, in which profits are taxed in the country where they are earned. The White House panel further recommends eliminating the domestic production activities deduction, the last-in, first-out (LIFO) inventory accounting method, and oil and gas production incentives.

### **Changes to the health care reform legislation.**

The Gang of Six suggests repealing the provision of the Patient Protection and Affordable Care Act (PPACA) of 2010 known as the Community Living Assistance Services and Supports Act (CLASS Act), which would create a voluntary long term care and disability program. ■

## IRS Revokes Tax-Exempt Status of Many Nonprofits

On June 8, 2011, the Internal Revenue Service (IRS) announced that approximately 275,000 nonprofit organizations automatically lost their tax-exempt status because they did not file legally required annual reports for three consecutive years. While agency officials said they believe that the vast majority of tax-exempt organizations are in compliance with the new filing requirements, and that most of the organizations that failed to comply are defunct, the IRS is providing further assistance to existing organizations with applying for reinstatement of their tax-exempt status.

Under the Pension Protection Act (PPA) of 2006, most organizations that have been granted tax-exempt status are required to file an annual information return or notice with the IRS using Forms 990, 990-EZ, 990-PF, or 990-N. The law imposed a filing requirement for the first time in 2007 for very small

organizations (with annual gross receipts of \$25,000 or less through 2009, or \$50,000 or less starting in 2011), but these groups are permitted to file using the 990-N “e-postcard.” The law automatically revokes the tax-exempt status of any organization that does not file required returns or notices for three consecutive years.

The IRS has issued guidance on how organizations can apply for reinstatement of their tax-exempt status, including retroactive reinstatement, and offered transition relief for tax-exempt organizations with annual gross receipts of \$50,000 or less for 2010. To receive retroactive reinstatement, a nonprofit must re-file Form 1023 or 1024, and demonstrate reasonable cause for failure to file an annual return. These reinstatement procedures are not available to organizations that lost their exempt status as a result of an IRS examination.

The list of organizations whose tax-exempt status has been revoked is available on the IRS website. The IRS said it will update the list monthly to include additional organizations that lose their tax-exempt status. Publication 78, *Cumulative List of Organizations*, is also being updated to reflect the changes.

The listing should have little or no impact on donors who previously made deductible contributions to organizations whose tax-exempt status has been automatically revoked because donations made prior to the list’s publication remain tax-deductible. However, organizations that are on the list and are not reinstated are no longer eligible to receive tax-deductible contributions, and the income they receive may be taxable. An organization that loses its tax-exempt status could be subject to corporate income taxes at the Federal level, as well as state and local taxes. ■

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## EXTENSION OF TWO-YEAR LIMIT ON INNOCENT SPOUSE RELIEF

Under regulations adopted in 2002, innocent spouse requests seeking equitable relief had to be filed within two years after the IRS first takes collection action against the requesting spouse. This time limit was designed to encourage prompt resolution while evidence remained available. However, taxpayers filing these claims have frequently argued that they were unable to seek relief within two years because they were either unaware of the collection notices or feared taking action due to a threatening or abusive spouse.

Under the new rule, a taxpayer whose equitable relief request was previously denied solely due to the two-year limit may reapply using IRS Form 8857, Request for Innocent Spouse Relief, provided the collection statute of

limitations for the tax years involved has not expired. However, taxpayers with cases currently held in suspense will be automatically afforded the new rule, and should not reapply. Additionally, the two-year limit will not be applied in any pending litigation involving equitable relief, and collection action may be suspended under certain circumstances even in cases where litigation is final.

Although the IRS plans to issue regulations formally removing this time limit, the two-year election period for seeking innocent spouse relief under the other provisions of section 6015 of the tax code continues to apply. The normal refund statute of limitations also continues to apply to tax years covered by any innocent spouse request.

The announcement effectively reverses multiple appellate court decisions that found in favor of the IRS’s position. The IRS had argued that, while there is no statutory time limit in section 6015(f), two-year limitation periods that appear in sections 6015(b) and (c) also apply to (f). While the appellate courts have upheld this rule, the Tax Court has declared the limit invalid on several occasions. It was generally expected that the issue would produce divided rulings in the appeals courts, and might have been ultimately decided by the Supreme Court. This change in the position of the IRS settles the issue. For more information about innocent spouse relief, contact one of our qualified tax professionals. ■