2nd Quarter 2011 Tax Developments

July 19th, 2011

The following is a summary of the most important tax developments that have occurred in the past three months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

Standard mileage rates increase for last half of 2011. The IRS has announced that the optional mileage allowance for owned or leased autos (including vans, pickups or panel trucks) is increased 4.5¢ from 51¢ to 55.5¢ per mile for business travel from July 1, 2011 to Dec. 31, 2011 to better reflect the real cost of operating an auto in this period of rapidly rising gas prices. This rate can also be used by employers to reimburse tax-free under an accountable plan employees who supply their own autos for business use, and to value personal use of certain low-cost employer-provided vehicles. The rate for using a car to get medical care or in connection with a move that qualifies for the moving expense also increases 4.5¢ for the last half of 2011 from 19¢ to 23.5¢ per mile.

FUTA surtax is no longer in effect. Beginning July 1, 2011, the 0.2% federal unemployment tax (FUTA) surtax is no longer in effect. Thus, the FUTA tax rate, before consideration of state unemployment tax credits, is now 6.0%. Employers need to separately track FUTA taxable wages paid before July 1, 2011, and FUTA taxable wages paid after June 30, 2011, since the FUTA tax rates are different during those two periods. Employers whose FUTA tax is more than $500 for the calendar year need to make quarterly FUTA deposits. The next quarterly payment is due on Aug. 1, 2011, but that payment is based on taxable wages paid through June 30, 2011, so it will be computed using the 6.2% FUTA tax rate. However, the payment after that is due on Oct. 31, 2011, and it will be computed using the 6.0% FUTA tax rate if legislation is not enacted to retroactively reinstate the FUTA surtax beginning July 1, 2011.

Two bonus depreciation deductions for one expenditure. Under IRS regulations, businesses that trade in machinery or equipment for which they claimed bonus depreciation may qualify for another bonus depreciation deduction on the remaining depreciable basis if they swap for like-kind property that also is eligible for bonus depreciation. In effect, the business gets two bonus depreciation deductions for its expenditure on the traded-in property.

Real estate professionals allowed late election to aggregate rental real estate interests. The IRS has provided guidance that allows certain real estate professionals to make a late election under the regulations to treat all interests in rental real estate as a single rental real estate activity for purposes of the passive activity loss (PAL) rules. This election can make it easier to currently deduct losses from real estate activities. As a general rule, the election is made by filing a statement with the taxpayer's original income tax return for the tax year. However, under new guidance, a taxpayer meeting certain conditions can make a late election on an amended return.

More courts treating basis overstatements as triggering 6-year limitations period. Late last year, the IRS issued final regulations under which an understated amount of gross income reported on a return resulting from an overstatement of unrecovered cost or other basis is an omission of gross income for purposes of the 6-year period for assessing tax and the minimum period for assessment of tax attributable to partnership items. The 6-year limitations period applies when a taxpayer omits from gross income an amount that's greater than 25% of the amount of gross income stated in the return. Several courts had held that a basis overstatement is not an omission of gross income for this purpose. In response to these decisions, the IRS issued the new regulations to clarify that an omission can arise in that fashion. Recently, two Courts of Appeals (the Tenth Circuit and the District of Columbia Circuit) have upheld the regulations. While the momentum clearly is in favor of the IRS on this issue, others courts have rejected the regulations. Ultimately, the Supreme Court will have to resolve the dispute.

Regulations would toughen tax rules for owners of bankrupt disregarded entities. A taxpayer whose debts are forgiven generally has cancellation of debt (COD) income subject to exceptions including one for bankruptcy and one for insolvency. Some taxpayers have taken the position that the bankruptcy exception is available if a grantor trust (trust used in family or business planning) or disregarded entity (e.g., a single-member limited liability company taxed directly to owner) is under the jurisdiction of a bankruptcy court, even if its owner is not. Similarly, some taxpayers have contended that the insolvency exception is available to the extent a grantor trust or disregarded entity is insolvent, even if its owner is not. The IRS has issued proposed regulations that would clarify that the bankruptcy exception is available only if the owner of the grantor trust or disregarded entity is subject to the bankruptcy court's jurisdiction, and the insolvency exception is available only to the extent the owner is insolvent. They would apply to COD income occurring on or after the date they are published as final regulations.

Trust's investment advice fees. The Supreme Court has held that investment advisory fees paid by a trust were deductible only to the extent that they exceeded 2% of the trust's adjusted gross income (AGI). Thus, such expenses didn't qualify for the exception to the 2% of AGI limit in the tax law for costs paid or incurred in connection with the administration of a trust or estate that wouldn't have been incurred if the property weren't held in the trust or estate. However, for the sake of administrative convenience, the IRS has provided that, until final regulations are issued, nongrantor trusts and estates will not have to “unbundle” a fiduciary fee (i.e., separate the fee into components that are subject to the deduction limit and those that aren't). As a result, until the regulations are issued, affected taxpayers can deduct the full amount of a bundled fiduciary fee without regard to the 2% floor.

IRA trustees weren't liable for Madoff losses. A district court has dismissed all claims brought by holders of self-directed individual retirement accounts (IRAs) against the IRA trustees for losses incurred by the IRAs for investments with Bernard Madoff's firm. A number of individuals owned self-directed IRAs with IRA agreements that clearly stated that they were solely responsible for making investment decisions in connection with the funds in their IRAs, and that the IRA trustees would not provide any investment advice. Pursuant to instructions given by these IRA owners, the IRA trustees sent IRA funds to Bernard Madoff's brokerage firm, Bernard L. Madoff Investment Securities LLC, for investment in securities. These funds were ultimately lost in Madoff's ponzi scheme. The IRA owners sought to hold the IRA trustees responsible for their role in the losses that the IRAs sustained. The action asserted claims under federal common law based on Internal Revenue Code sections governing IRAs, and state law negligence, contract, and unjust enrichment claims. However, the court rejected all such claims.

Another Appeals Court upholds IRS's time limit on spousal relief requests. Married joint return filers are jointly and severally liable for the tax arising from their returns. Innocent spouses may request relief from this liability in certain circumstances. An IRS regulation states that a request for equitable innocent spouse relief must be no later than two years from the first collection activity against the spouse. The Tax Court had found this regulation invalidly imposed a time limit. However, the Court of Appeals for the Fourth Circuit has reversed the Tax Court and upheld the regulation (as have the Courts of Appeals for the Third and Seventh Circuits).

Nonspouse real estate transfers under scrutiny. A recent court case reveals that the IRS has discovered a pattern of taxpayers failing to file gift tax returns for real property transfers between nonspouse related parties. As a result, it launched a compliance initiative to capture data from states and counties regarding real property transfers taking place between nonspouse family members for little or no consideration during the period of Jan. 1, 2005, through Dec. 31, 2010. While the IRS has faced hurdles in attempting to force California to release the data, a number of states have voluntarily done so. These include Connecticut, Florida, Hawaii, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Tennessee, Texas, Virginia, Washington, and Wisconsin. Thus, individuals who transferred real property to nonspouse family members should make sure that required gift tax returns were filed and file amended returns if they weren't.