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## INSIDE THIS ISSUE:

Get the Latest on IRS Audit Activity 1-3

Corporations: Good Time for Tax-Wise Transactions 4-6

IRS Takes Another Step Toward Implementing Controversial New Information Reporting 6

Hall, Kistler Client Portal on our website 7

HK Notes 8

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- Tax Alerts
- 2010 Healthcare Reform Act
- And all the information you need to make smart financial decisions.
- HK clients can now access all their information via our website on the Client Portal.



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## Get the Latest on IRS Audit Activity

Many clients ask: "How can I avoid being audited by the IRS?" Of course, there's no 100 percent guarantee that a taxpayer won't be picked because some returns are chosen randomly. However, completing tax returns in a timely, orderly, and accurate fashion with a trusted tax adviser certainly works in a taxpayer's favor. It also helps to know the red flags that catch the attention of the IRS.

The overall percentage of taxpayers who are audited is historically around 1 percent, although it varies from year to year. However, certain groups of people and organizations are audited at much higher rates.

We'll tell you about some of the new and recurring audit targets, but first, here are some of the latest collection statistics from the *IRS Data Book* for the fiscal year ending September 30, 2009.

**Individual Returns:** The IRS audited about 1 percent of the 138.8 million individual returns filed. Nearly 23 percent of individual audits were conducted by IRS personnel. The rest were correspondence audits.

Auditors focused heavily on high income taxpayers. For example, 6.4 percent of returns with total positive income of more than \$1 million were audited, a jump from 5.6 percent the year before.

**Corporate Returns:** The tax agency audited 1.3 percent of returns from corporations. Specifically:

- For corporations with assets from \$1 million to \$5 million, audits edged down to 1.8 percent of returns from 2 percent.
- For corporations with assets between \$5 million and \$10 million, audits fell to 2.7 percent from 3.1 percent.
- Audits for corporations with \$10 million or more in assets dropped to 14.5 percent from 15.3 percent.
- The audit percentage for S corporations and partnerships remained unchanged at 0.4 percent of returns.



So, what's next? Here are some new and recurring areas that are likely to raise red flags:

**Homebuyer Tax Credit** - In a new report from the Treasury Inspector General, the IRS was found to have paid more than \$27 million in fraudulent homebuyer tax credit claims on 2008 returns. Incredibly, approximately 1,300 prison inmates (some serving life sentences) received \$9 million for homes they could not have possibly bought while behind bars.



Continued on page 2

## Get the Latest on IRS Audit Activity (continued from page 1)

In response, the IRS plans to scrutinize the returns of taxpayers claiming the homebuyer credit, as well as attempt to recoup money paid erroneously on past claims. There are now special filing requirements that include sending sale-related documents with a tax return claiming the homebuyer credit.



**Online Income** - Starting in 2011, the IRS will be taking a closer look at transactions by sellers on eBay and other online auction sites. This is the result of a new law that requires any bank or other payment settlement company that processes credit cards, debit cards, and electronic payments such as PayPal to report to the IRS what merchants receive. Not all online sales are taxable, as many sell used items at a loss.

**Investment Income** - The IRS often discovers unreported taxable income when its computers compare the income reported on tax returns with the information obtained from financial institutions about dividends and interest.

Right now, the IRS is informed about how much investors sell securities for, but the tax agency relies on investors to provide the purchase prices.

Beginning with specified securities purchased in 2011, brokers will be required to calculate gains and losses and classify them as short-term or long-term. This information will be reported to customers and the IRS.

The expanded requirements were implemented in response to tax officials' suspicion that many people overstate the tax basis when they sell securities in order to pay less tax.



**Changes Ahead:** Be aware that the IRS will soon receive more information about investors' activities.

**Self-Employment Income** – The tax system makes it easier for self-employed individuals (rather than employees) to underreport income and fabricate or overstate deductions. The IRS traditionally expends extra effort to ensure self-employed taxpayers filing Schedule C remain compliant. But there is a new focus after a recent report from the Treasury Inspector General found that even when the IRS audited self employed taxpayers; it failed to address significant potential misreporting of income.



**Automobile Expenses** – Traditionally, this is a high-risk area for business taxpayers. Auditors are suspicious of claims that a personal car is mostly or exclusively used for business. Clients should maintain a daily log of business mileage with odometer readings, dates, locations and purposes of meetings, as well as the names of people they meet with.

**High Itemized Deductions** – If taxpayers' itemized tax deductions exceed IRS ranges for their income group, the odds of an audit jump significantly.

**Home Office Tax Deductions** – As a general rule, the office must be a taxpayer's principal place of business or a place where he or she regularly meets with clients or patients.

**Alimony** – These payments have become an audit target after years of perceived abuses. The IRS matches deductions taken by one former spouse with the taxable alimony income reported by the other.



**Losses from an Activity the IRS Considers a Hobby** – This is another ongoing favorite IRS target and includes activities such as horse breeding and photography. However, taxpayers have effectively fought the IRS by keeping accurate records, following industry practices, and operating at a profit in three out of five consecutive years (two out of seven for horse businesses).

Continued on page 3

## Get the Latest on IRS Audit Activity (continued from page 2)

### IRS Scrutinizing 401(k) Plan Compliance

The IRS has begun checking compliance with 401(k) plan regulations by asking a random sample of 1,200 plan sponsors to fill out an online questionnaire.

If a company is chosen, failing to accurately complete the document and return it within the 90-day deadline could generate an audit. In announcing the project, the IRS noted that although 401(k)s are the preferred retirement plan for most employers, they are the most non-compliant.

The questions cover the following categories related to 2006, 2007, and 2008:

- Demographics relating to plan features and participation by employees, age, and service restrictions.
- Other plans an organization sponsors.
- Types of employer and employee contributions (such as matching, non-elective, and deferral).
- Non-discrimination testing to determine if a plan is "top heavy" (a majority of assets attributed to key employees).
- Rules for loans and hardship withdrawals.
- Features such as employer stock, foreign investments, and in-kind distributions.
- Types of automatic contribution arrangements and qualified default investment alternatives.
- Designated Roth features, such as rollovers, and the number of participants.
- Voluntary compliance and correction programs.
- Procedures for administering and amending the plan.



### [Liens and Levies Hurt Revenue Collection?](#)

When the IRS automatically files liens and levies against delinquent taxpayers, it actually hurts the Federal government's ability to collect revenue owed. That statement was made in a report to Congress on July 7.

"The conventional wisdom seems to be that more hard-core enforcement actions like liens and levies mean more revenue," Taxpayer Advocate Nina Olson stated. "But the data don't bear that out." Since fiscal year 1999, the IRS has increased lien filings by about 475 percent and levies by about 600 percent. However, inflation-adjusted revenue raised from such efforts has actually declined by about seven percent over that period.

Olson explained that lien filings badly damage a taxpayer's financial viability because they cause the person's credit score to drop about 100 points, and typically remain on a credit record for at least seven years. Employers, mortgage companies, landlords, car dealers, and credit card issuers use credit reports, so a lien can adversely affect a person's ability to obtain and retain a job, purchase or rent a home, and obtain credit. Accordingly, it can reduce a taxpayer's income or increase expenses, which impairs his or her ability to pay taxes in the future.

## Corporations: Good Time for Tax-Wise Transactions

As you know, the 2010 Federal income tax rate structure is quite favorable for shareholders of closely-held C corporations for these reasons:

- If a company pays a taxable dividend this year, the maximum Federal income tax rate is only 15 percent; and
- That same 15 percent maximum rate applies to 2010 corporate payouts or stock sales that generate long-term capital gains.

### **DIVIDEND AND CAPITAL GAINS TAXES ARE ALMOST CERTAIN TO GO UP**

With the passage of the massive healthcare bill, odds are the current taxpayer-friendly picture will only last through the end of this year. Unless Congress takes action to extend the status quo, higher taxes on dividends and long-term gains will kick in on January 1, 2011, when the "Bush tax cuts" are scheduled to expire.

Even if the Republicans take back Congress in November, they might not be able to change the tax outlook anytime soon. Through 2012, the President has stated he would likely veto any tax cuts as the revenue will be needed to help pay for government health-care.



### **HERE ARE THE SPECIFICS ABOUT WHAT IS LIKELY COMING DOWN THE PIKE:**

#### ***DIVIDEND TAXES***

The maximum Federal rate on dividends is scheduled to increase from the current 15 percent to 39.6 percent on January 1. Although the President has promised more than once to limit the maximum rate to 20 percent, that pledge has changed.

Beginning in 2013, the new healthcare legislation will impose an additional 3.8 percent Medicare tax on a high-income individual's net investment income, which is defined to include dividends. That raises the maximum dividend tax rate to at least 23.8 percent for 2013 and beyond. For affected individuals, that's at least a 58.7 percent increase in Federal taxes on dividends (23.8 percent is 158.7 percent of 15 percent).

For this purpose, a high-income individual has an adjusted gross income of \$250,000 if married and filing jointly or \$200,000 for single filers.

#### ***TAXES ON LONG-TERM GAINS***

Starting January 1, 2011, the maximum rate on most long-term capital gains is scheduled to increase from the current 15 percent to 20 percent. And in 2013, the new healthcare legislation will impose an additional 3.8 percent Medicare tax on a high-income individual's net investment income, which is defined to include long-term gains. As with dividends, that means a maximum Federal tax rate of at least 23.8 percent for 2013 and beyond. For affected individuals, that amounts to at least a 58.7 percent increase in Federal taxes on long-term gains.

Depending on where your clients live, state income tax rate on dividends and long-term gains may be headed higher, too.

## Corporations: Good Time for Tax-Wise Transactions (continued from page 4)

### WHAT CAN YOU DO?

Although next year and beyond look grim from a tax perspective, you still have some time to take advantage of this year's historically favorable rates. Here are three strategies to consider before the end of 2010:

#### STRATEGY 1: Take Dividends This Year

Let's say a profitable C corporation has a healthy amount of earnings and profits (E&P). The concept of E&P is somewhat similar to the more-familiar financial accounting concept of retained earnings. While lots of E&P indicates a financially successful company, it also creates two unfavorable tax side effects:

1. To the extent the corporation has current or accumulated E&P, corporate distributions to shareholders (including owners and executives) count as taxable dividends. Since the 2010 Federal tax rate on dividends cannot exceed 15 percent, dividends received before the end of this year will be taxed lightly compared to what is likely to happen in 2011 and beyond. Therefore, shareholders should weigh the possibility of triggering a manageable current tax bill by taking dividends in 2010 against the possibility of absorbing a much bigger (but deferred) tax hit on dividends they would otherwise plan to take in future years.
2. When a C corporation retains a significant amount of earnings, there's a risk that the IRS will assess the accumulated earnings tax (AET). This tax can potentially be assessed once a corporation's accumulated earnings exceed \$250,000 (or \$150,000 for a personal service corporation). When the AET is assessed, the tax rate is the same as the maximum Federal rate on dividends received by individuals. Therefore, the AET rate is also scheduled to jump from the current 15 to 20 percent, starting in 2011 (*assuming the President's pledge to keep it at 20 percent rather than 39.6 percent goes through*).

Dividends paid in 2010 will be taxed lightly, and they will also reduce a company's accumulated earnings. So they will also reduce or eliminate the company's AET exposure in future years, when the AET rate will probably be at least 20 percent.

#### STRATEGY 2: Arrange a Low-Taxed Stock Redemption This Year

Another way to convert theoretical C corporation wealth into cash is with a stock redemption transaction in which a client sells back some or all of his or her shares to the company. (When there are several shareholders, this is a common technique to cash out one or more selected shareholders while the others continue to hold their stakes.)

To the extent of the corporation's current or accumulated E&P, any stock redemption payment is generally treated as a taxable dividend. However, the Internal Revenue Code provides several exceptions to this rule. If one of these exceptions applies, the redemption payment will be treated as proceeds from selling the redeemed shares. In other words, regular stock sale treatment applies.

The distinction between dividend and stock sale treatment may or may not be important to your clients. That's because when dividend treatment applies, the client receives no offset for his or her tax basis in the redeemed shares. In that case, the entire redemption payment may count as taxable dividend income.

## Corporations: Good Time for Tax-Wise Transactions (continued from page 5)

In contrast, when stock sale treatment applies, the client has capital gain (probably long-term) only to the extent the redemption payment exceeds his or her basis in the redeemed shares. So only part of the redemption payment is taxed. In addition, the client can offset capital gain from a redemption treated as a stock sale with capital losses from other transactions (including capital loss carryovers the client may have left over from the 2008 stock market meltdown).

If a client doesn't have significant basis in the redeemed shares or significant capital losses, there's usually only a minor distinction between dividend treatment and stock sale treatment under today's Federal income tax system. For 2010, both dividends and long-term capital gains are taxed at the same rates, with a maximum rate of only 15 percent.

However, as explained earlier, both dividends and long-term gains will almost certainly be taxed at higher rates in 2011 and beyond. Therefore, a stock redemption that is completed in 2010 could result in a much lower tax bill than a redemption that's put off until 2011 or later.

### STRATEGY 3: Sell Stock This Year

Speaking strictly from a Federal income tax rate perspective, selling shares this year and paying no more than 15 percent on the resulting gains (assuming the taxpayer has held the shares for more than a year) sure beats paying 23.8 percent (or maybe more) on gains from sales in later years.

**Exception:** A taxpayer might want to defer capital gains until the following year because of a reasonable expectation that he or she will be experiencing capital losses at that time that could offset the gains.

Clients should consider the possible advantages of taking dividend payments, transacting stock redemptions, or selling shares in a closely-held corporation under today's favorable Federal income tax structure. Waiting until next year or later could prove costly.



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## IRS Takes Another Step Toward Implementing Controversial New Information Reporting

The IRS has taken another step forward in final implementation of sweeping information return requirements. As required by law, it has formally asked for comments from the public on how to best write the final rules with the least amount of trouble for businesses and other "reporting" entities. "Good luck in minimizing trouble," many taxpayers are already complaining.

New non-health related reporting requirements imposed by the Patient Protection and Affordable Care Act of 2010 (PPACA) will go into full force in 2012. They expanded existing information reporting requirements to apply to payments made to corporations and generally to include payments of "gross proceeds" for property and services, and all "amounts [paid] in consideration for property."

The expansion of information reporting was anticipated for corporations, but not for "property transactions" and "gross proceeds." Many tax practitioners are already complaining loudly that businesses need guidance on what are gross proceeds and what property transactions are covered. Others predict that the new requirements will give rise to an expensive compliance burden for businesses, with as much as a tenfold increase in reporting on Form 1099-MISC.

After comments are received next month, the IRS likely will release preliminary rules on the new information requirement either at year end or by early 2011.

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## Hall, Kistler Client Portal on our website—[www.hallkistler.com](http://www.hallkistler.com)

We have great news to share with you! In our continued effort to be efficient and secure with your tax information we have implemented a Hall, Kistler Client Portal on our website. You can find it at [www.hallkistler.com](http://www.hallkistler.com).

### What is a Portal and why should I use it?

- 1) Portals allow the secure transfer of information.
- 2) Portal interfaces are designed to be very intuitive and are as simple to use as other web services like web browsers, Google and on-line banking.
- 3) Portals allow for the quick transfer of information to and from the client bypassing mail, unsecured email and fax.

### Is the HK Portal secure?

Portals are actually more secure than other forms of communication like mail, email, and fax services. Portal technology leverages strong encryption technology\* that complies with privacy regulations and protects the transfer of data so that hackers cannot intercept this data.

To get started, just send us an email at [help@hallkistler.com](mailto:help@hallkistler.com) letting us know that you would like to use the Client Portal to access your account information. Please notify us with the exact email address you would like to use for the transmission of your data.

For more information on how to get started, please refer to the FAQ (Frequently Asked Questions) below the Client Portal tab on our website.

\* *Encryption Technology- Encryption Technologies encode data into non-readable formats to ensure privacy of data during communications between the data centers and client transactions. We use the highest level of encryption to prevent hackers from intercepting your data.*

The screenshot shows a web browser window displaying the Hall, Kistler & Company LLP website. The browser title is "Hall Kistler - Windows Internet Explorer provided by Hall, Kistler & Company". The address bar shows "http://www.hallkistler.com/index.php". The website features a navigation menu with the following items: HK, Services, Industries, News / Events, Tools, Fun at HK, Contact Us, Client Portal, and Client Portal FAQ. The "Client Portal" and "Client Portal FAQ" items are circled in red. Below the navigation menu, there is a red banner that reads "New law extends homebuyer credit closing deadline to September 30...". The main content area includes a "Hall Kistler" logo, a "Login to our CLIENT PORTAL" link (circled in red), and a description of the firm's services: "The Hall, Kistler team of professionals advise businesses, individuals and non-profit organizations on ways to optimize cash flow, minimize tax liability, comply with fiscal and regulatory requirements, assist owners in acquisitions, dispositions and succession planning." There is also a photograph of a building and a list of recent news items on the right side of the page, including "Client Tax Organizer...", "Tax Flash - New Hire Ac...", "Health Care Reform...", "Tax Flash - Ohio Sales & Use Tax", and "Tax Flash - Repeal of the Federal...". The footer of the page shows the URL "http://www.hallkistler.com/client-portal-faq" and the "HK" logo.



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## HK Notes

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### What is BKR International and Why Is HK A Member?

BKR International is a leading global association of independent accounting and business advisory firms representing the expertise of more than 135 member firms with over 300 offices in over 70 countries around the world. Hall, Kistler has become a global company through our association with BKR allowing us exposure that has led to new clients throughout the United States and in China, England and Canada. On a national level, BKR has also provided nationwide leadership opportunities in the areas of Business Valuations, Tax and Manufacturing for several of our partners. Because of our membership with BKR we can offer our clients the best of both worlds: personalized local service and the financial expertise of a global association.



**S. Franklin Arner, CPA**  
Partner

Congratulations to S. Franklin Arner, CPA, Partner, who was selected to participate in the Leadership Stark County 24th Signature Class 2010-2011 and senior accountant, Kelly Kimble who was selected to participate in the 2010 Spotlight Stark County program.



**Kelly Kimble**  
Senior Accountant

We are always looking for ways to improve how our clients, referrals and the community receive our information and welcome your comments and suggestions at [info@hallkistler.com](mailto:info@hallkistler.com).

