Lally & Co.
CPAs and Business Advisors

The EVERGREEN

Quarterly Journal for Clients & Friends

Winter 2012 – **Volume I**

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Dear Clients and Friends,

For nearly 30 years, Lally & Co. has been creating simple solutions for our clients' financial needs. And now, to offer our customers greater accessibility, knowledge, and service, we have created *The Evergreen*. This quarterly newsletter serves as a tool to provide our clients with the latest news and updates on accounting, tax, and business issues.

Why a leaf-bearing tree? For *The Evergreen* we've chosen the image of a live oak tree to represent the strength, stability, and resourcefulness of our clients. Remaining green throughout the year in most climates, the live oak has been a living symbol of strength and durability for centuries. At Lally & Co. we strive to offer solid solutions that ensure our clients' financial strength and protection. We are always looking for ways to better serve you.

We hope you enjoy this and future issues of *The Evergreen.*

Alternative Minimum Tax for Individuals

The alternative minimum tax (AMT) is trapping more middle income taxpayers. If government forecasts are correct, about one-fifth of all taxpayers will be affected by the AMT in 2011, many of them middle income taxpayers. At a tax rate of at least 26 percent imposed on AMT items, in addition to your regular tax bill, your AMT could be substantial. In view of the serious risk of AMT exposure, careful planning to reduce your overall tax bill is critical.

Although the AMT is a significant concern, tax planning should not focus solely on eliminating AMT liability. Due to the complexity of the interrelationship of the AMT and regular tax systems, concentration on lowering minimum tax liability alone could easily result in an unwanted increase in your regular income tax liability.

In general, the best way to handle AMT liability is careful planning involving coordination of future regular income tax and AMT, using accurate projections of income, expenses, and deductions over multiple years with several alternative scenarios. An overall plan must then be devised to manage your AMT liability without raising regular tax liability.

Did you know?

- Pennsylvania employers must begin to withhold the local earned income tax from employees beginning on January 1, 2012.
- You can find helpful financial tools on our website. www.lallycpas.com/financial-calculator/
- This and future issues of The Evergreen are available on our website. www.lallycpas.com/newsletter

Contact our office or visit our website for more information.

412.367.8190
www.lallycpas.com

Firm Announcements

Lindsey Burchell joined our Tax Department in January 2011 as a Staff Accountant

Diane Hoak earned her Master of Science in Accounting degree in November 2011

Zachary Miles transferred to the A&A Department in August 2011

Patrick Revay became a licensed CPA in May 2011

Anna Sella joined our Tax Department in January 2012 as a Staff Accountant

Eric Wortzman became a first-time father to baby boy, Tyler Austin Wortzman, born May 26, 2011

Important Dates:

January 15, 2012 -
2011 4th Quarter Estimated Payments Due

February 28, 2012 -
2011 Form 1099 Due

March 15, 2012 -
2011 Corporate Tax Returns Due

April 17, 2012 -
2011 Partnership, Individual, Trust, and Gift Tax Returns Due and 2012 1st Quarter Estimated Payments Due

May 15, 2012 -
2011 Foundation Tax Returns Due

Inflation adjustments may generate tax savings in 2012

The IRS recently announced that inflation is increasing many dollar amounts in the Tax Code for 2012. For taxpayers, the inflation adjustments may help reduce their overall tax liability in 2012.

Many provisions in the Tax Code are required to be adjusted annually for inflation. These include various deductions, exemptions, and exclusion amounts. The tax law also requires that the individual income tax brackets be adjusted annually for inflation. Due to low inflation in 2009 and 2010, many of the provisions were not adjusted for 2010 and 2011.

This year is different. In October 2011, the IRS announced that inflation is running at just over 3.8 percent. In response, the IRS increased a number of amounts in the Tax Code for 2012.

Retirement accounts
401(k) plans. For 2012, the maximum amount an individual can contribute to a 401(k) plan increases $500 from $16,500 to $17,000. Individuals who will be at least age 50 by the end of the tax year may make an additional "catch up" contribution of $5,500.

Individual income tax brackets
Inflation also impacts the individual income tax rate brackets (which are 10, 15, 25, 28, 33, and 35 percent, respectively, for 2011 and 2012). Indexing of the income tax rate brackets effectively lowers tax bills by including more of an individual's income in lower brackets.

Standard deduction.
Taxpayers who elect not to itemize deductions will use the standard deduction amount. For married couples filing a joint tax return, the standard deduction increases by $500 (from $11,400 for 2011 to $11,900 for 2012). The standard deduction for single individuals increases from $5,700 for 2011 to $5,950 for 2012.

Personal exemption.
Taxpayers may claim a personal exemption deduction (and an exemption deduction for each person they claim as a dependent). The amount of the personal exemption and the dependency exemption increases from $3,700 for 2011 to $3,800 for 2012.

Estate tax.
The 2010 Tax Relief Act provided a $5,000,000 exclusion amount for estates of decedents dying after December 31, 2009. The $5 million amount is adjusted for inflation for tax years beginning after December 31, 2011. For 2012, the inflation-adjusted amount will be $5,120,000.

Gift Tax Exclusion.
For 2012, a taxpayer can give up to $13,000 to any person without incurring gift tax. Married couples can gift up to $26,000 tax-free to any person. There is no limit on the number of individuals to whom you can make the $13,000 ($26,000) gift. The $13,000 and $26,000 amounts are unchanged from 2011.

IRS Offshore Disclosure Initiative

Reporting requirements. United States persons who have a financial interest in or signature authority over any financial account in a foreign country, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year, must report these accounts to the IRS.

Taxpayers who do not disclose their foreign accounts risk many penalties. Depending on the taxpayer's facts and circumstances, some of the penalties include, but are not limited to, penalties for failing to file certain returns, fraud penalties, and an accuracy-related penalty on underpayment of tax. The IRS can also seek criminal sanctions against a taxpayer.

Penalty framework. In most cases, the 2011 penalty is 25 percent of the amount in the foreign bank accounts in the year with the highest aggregate account balance covering the 2003 to 2010 time period. Some taxpayers may be eligible for five or 12.5 percent penalties. The requirements for the five or 12.5 percent penalties are very tailored. Participants also must pay back-taxes and interest for up to eight years as well as paying accuracy-related and/or delinquency penalties.

The 12.5 percent penalty applies to taxpayers with smaller offshore accounts. The IRS has explained that these generally are taxpayers whose offshore accounts or assets did not surpass $75,000 in any calendar year.

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The five percent rate may apply if the taxpayer can show that the foreign account was not used to hide income and the taxpayer did not have withdrawals of more than $1,000 in any year, unless transferred to an account in the U.S. The five percent penalty may also apply in the case of a foreign resident who was unaware that he or she was a U.S. citizen. The five percent penalty may also apply to taxpayers who are foreign residents and who met all of their tax requirements in that foreign country.

The penalty is intended to apply to all of the taxpayer's offshore holdings that are related in any way to noncompliance with U.S. tax laws. The penalty applies regardless of the form of the taxpayer's ownership or the character of the asset. If the assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer's interest in the entity or to the taxpayer. The IRS has also emphasized that its agents and managers have no discretion or authority to negotiate a different penalty for taxpayers who request to participate in the initiative.

Reporting. The IRS will soon have more tools to discover funds in foreign accounts and other assets outside the U.S. In 2010, Congress passed legislation (the Hiring Incentives to Restore Employment (HIRE) Act) requiring taxpayers to attach a disclosure statement to their income tax return if the aggregate value of all specified foreign financial assets exceeds $50,000. Taxpayers will make these disclosures with their 2011 tax returns filed in 2012. The HIRE Act also imposes new disclosure and reporting requirements on foreign banks and financial institutions.

Does sick pay get any special tax treatment?

The term "sick pay" can refer to a variety of payments. Some of these payments are nontaxable, while others are treated as taxable income. Some of the taxable payments are treated as compensation, subject to income tax withholding and employment taxes; others are exempt from some employment taxes.

Amounts received for personal injury or sickness through an accident or health plan are taxable income if the employer paid for the plan. If the coverage is provided through a cafeteria plan, the employer, not the employee, is considered to have paid the premiums; thus, the benefits are included in income. If, on the other hand, the employee paid the entire cost of the premiums (or included the premiums in income), any amounts paid under the plan for personal injury or sickness are not included in income.

An employee who is injured on the job may receive workers' compensation under a workers' compensation act. These amounts are fully exempt from income and employment taxes. However, the exemption does not apply to retirement plan benefits that are based on age, length of service, or prior contributions, even if retirement was triggered by occupational sickness or injury. The exemption also does not apply to amounts that exceed the amount provided in the worker's compensation act. There is no exemption under these plans for amounts received as compensation for a nonoccupational injury or sickness.

Compensatory damages paid for physical injury or physical sickness are not taxable, whether paid in a lump sum or as periodic payments. This applies to amounts received through prosecution of a legal suit or action or through a settlement agreement in lieu of prosecution. Other nontaxable benefits include disability benefits paid for loss of income or earning capacity as a result of injuries under a no-fault automobile insurance policy.

Payments for permanent injury or loss of a bodily function under an

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employer-financed accident or health plan are excludible. The payments must be based on the nature of the injury rather than on the length of time the employee is absent from work.

Disability income plans are employer plans that provide full or partial income replacement for employees who become disabled. Employer-provided disability income benefits generally are taxable to employees. Similarly, sick pay that is a continuation of some or all of an employee's compensation is subject to income tax withholding if paid by the employer. The first six months of payments for sickness or disability, when the employee is off work, are subject to employment taxes, but payments made after the expiration of six months are not subject to FICA (Social Security) and FUTA (unemployment) taxes.

Reimbursements from an employer's plan for medical expenses are not includible in income and are not subject to income tax withholding. If the employer has no plan or system and pays medical expenses for sickness or disability, the payments are subject to FICA and FUTA for the first six months. Of course, reimbursements of amounts deducted in a prior year must be included in income. Medical reimbursements provided under a self-insured employer plan are not subject to income tax withholding, even if the amounts are included in income.

Payments for sick leave or accumulated sick leave are taxable compensation.

Independent Contractor vs. Employee

The likelihood of your business being involved in a worker classification or employment tax audit is increased. The IRS is aggressively attempting to reduce the "tax gap," which is the annual shortfall between taxes owed and taxes paid. Employment tax noncompliance is estimated by the IRS to account for approximately $54 billion of the tax gap. Under-reporting of FICA makes up $14 billion; under-reporting of self-employment tax accounts for $39 billion; and under-reporting of unemployment tax accounts for $1 billion in lost revenue.

As a result of the Questionable Employment Tax Practice (QETP) initiative in 2007, the IRS entered into agreements with workforce agencies in 29 states to share the results of employment tax examinations. These agreements provide a centralized, uniform means for the IRS and state employment officials to encourage compliance with federal and state employment tax requirements. In addition, for the 2008 through 2010 tax years, the IRS plans to examine 6,000 randomly selected employers' Forms 941, Employer's Quarterly Federal Tax Return, as part of the National Research Program (NRP).

Because the existing worker classification rules are complex and ambiguous, much uncertainty surrounds their interpretation and application. The lack of a single, definitive test for classifying workers as either employees or independent contractors contributes significantly to the worker classification problem.

Therefore, understanding the difference between an employee and an independent contractor is very important. If you are an employer, you are required to withhold and contribute a matching amount of FICA and Medicare taxes from your employee's income. However, if your workers are independent contractors, you are only required to report payments of $600 or more on a Form 1099-MISC (Miscellaneous Income). Failing to make the right classification could cost you money.

If you have workers who make substantial financial investments in tools, equipment, or a place to work, or undertake some entrepreneurial risks, they are probably independent contractors. However, when you control and direct the workers who perform services for you as to the end result and how it will be accomplished, you are probably involved in an employer-employee relationship.

Unless there is a reasonable basis for treating your employees as independent contractors, failing to withhold income and employment taxes from their wages can result in severe penalties and interest, in addition to the back taxes owed. Of course, penalties for intentional worker misclassifications are harsher than they are for inadvertent mistakes.

Your benefit plan may also be in jeopardy if any eligible employees have been misclassified as independent contractors. Since these employees have been excluded from plan participation, your retirement plan may lose its tax-favored status. The problem is compounded when excluded employees seek restitution for lost benefits not only due to their exclusion from the benefit plan, but also for health coverage and other employee benefits.

Sophisticated Charitable Giving

Significant tax savings can be achieved through a properly planned program of gifts to charity. Although a contribution may be motivated by humanitarian reasons, it is nevertheless wise to take the tax considerations into account when making a contribution. Charitable giving can be divided into two general categories. First, there are donations

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that are made on a regular basis and involve relatively small amounts. Second, there is the large extraordinary donation often associated with estate planning. Different planning concepts govern each type of donation.

Individuals who make charitable contributions should take into consideration a number of factors when making the decision as to when and how much to contribute, including the deduction-limitation rules. Generally, the amount that you may deduct in a tax year cannot exceed 50% of your adjusted gross income. However, lower percentages apply when donations are made to certain donees, when the contribution consists of capital gain property, and when contributions are made “for the use of” a donee rather than “to” a donee.

The IRS requires that contributions of $250 or more must be substantiated in order to be deductible. The burden is placed on you, as the donor, to request written substantiation because a canceled check may not be sufficient to support a deduction. The amount of the contribution is fully deductible whether it is paid by cash, check or credit card. However, a charitable deduction cannot be based on a mere pledge to pay. The pledge must actually be paid before the end of the year in which the deduction is claimed.

A charitable deduction is not allowed to the extent that you receive a benefit for the contribution, such as admission to a charity ball, banquet, show, or sporting event. In such cases, payments qualify for the deduction only to the extent they exceed the fair market value of the privileges or other benefits received. In addition, no charitable deduction may be claimed for travel expenses, including meals and lodging, if there is a significant element of personal pleasure, recreation or vacation present in the travel.

A deduction is not allowed for the value of services contributed to the charitable organization. However, if you are active in such organizations, you should be aware that out-of-pocket expenses incurred while performing volunteer services are deductible as a charitable contribution. If you use your auto, you may also be able to deduct the standard mileage allowance of 14 cents per mile.

Noncash contributions present a unique set of planning opportunities. There are special rules for the donation of cars, boats, and planes if the claimed value exceeds $500. If you have appreciated assets, you may want to consider donating the asset rather than selling and donating the proceeds. Using this approach allows you to avoid the capital gains tax that results from selling the asset. In addition, the deduction amount is for the fair market value of the asset at the time of the donation, regardless of your basis. There are additional limitations and elections that must be considered when donating assets instead of cash, including the need for an appraisal.

Large contributions require special tax-planning considerations. First, you must determine whether or not it is advisable to make a contribution during your lifetime or at death. Thus, your income and prospective estate tax brackets must be considered. You should take into consideration the income tax deduction limitations mentioned above, and the fact that there are no limitations for estate tax charitable contribution deductions. Second, you should consider whether you can afford the gift, not only in the current year, but in future years as well. This requires an analysis of the financial needs of you and your family, which may indicate that some form of deferred charitable giving is appropriate.

When can I deduct job-hunting expenses?

Job-hunting expenses are generally deductible when you are searching for a job in the same field. This can be useful in a tough job market. It does not matter whether your job hunt is successful, or whether you are employed or unemployed when you are looking.

The expenses are deductible as a miscellaneous itemized deduction. You can deduct job-hunting expenses if the amount of all your miscellaneous itemized deductions exceeds two percent of your adjusted gross income. However, if you claim the standard deduction, you cannot deduct job-hunting expenses. Therefore, as a practical matter for many job seekers, job-hunting expenses do not produce a tax deduction.

For those who are able to use job seeking expenses as a deduction, it can be difficult to determine what a new field is. Taking a temporary job while searching for permanent employment in your current field will not be considered a job change that disqualifies your job-hunting expenses.

Persons entering the job market for the first time, such as college students, and persons who have been out of the job market for a long period of time, such as parents of young children, cannot deduct their job-hunting expenses. However, a college student who worked in a particular field while in school may be able to deduct job-hunting expenses.

It is important to keep records of your expenses. While your individual expenses may not be substantial, your total expenses can add up to a significant amount.