Lally&Co.
CPAs and Business Advisors

The Evergreen
Quarterly Journal for Clients & Friends

Spring 2012 – Volume II

This Issue:

The Evergreen. Always Growing.

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

Contact our office or visit our website for more information.

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Dear Clients and Friends,

Spring has arrived and with that comes the end of another "busy" season. We would like to extend our sincere gratitude for the trust you have invested in us. Whether you are a client of the Firm or a referral source, we thank you for making this tax season one of our busiest and most successful. It would not have happened without each of you.

We continue to service our clients throughout the calendar year. As you read through *The Evergreen*, please do not hesitate to contact us at any time. We would be happy to hear from you! This and past issues of *The Evergreen* are available on our website at http://lallycpas.com/newsletters/.

What is a disregarded entity?

A disregarded entity refers to a business entity with one owner that is not recognized for tax purposes as an entity separate from its owner. A single-member LLC ("SMLLC"), for example, is considered to be a disregarded entity. For federal and state tax purposes, the sole member of a SMLLC disregards the separate legal status of the SMLLC otherwise in force under state law.

As the result of being "disregarded," the SMLLC does not file a separate tax return. Rather, its income and loss is reported on the tax return filed by the single member.

If the sole owner of the SMLLC is an individual, the SMLLC's income and loss is reported on his or her Form 1040, U.S. Individual Income Tax Return. This method is similar to a sole proprietorship.

If the sole owner of the SMLLC is a corporation, the SMLLC's income or loss is reported on the corporation's Form 1120, U.S. Corporation Income Tax Return (or on Form 1120S in the case of an S Corporation). A SMLLC is not the only entity treated as a disregarded entity. Two corporate forms are also disregarded: a qualified subchapter S subsidiary and a qualified REIT subsidiary. However, SMLLCs are by far the most common disregarded entity currently in use.

For federal tax purposes, the SMLLC does not exist. All its assets and liabilities are treated as owned by the acquiring corporation.

Even though a disregarded entity's tax status is transparent for federal tax purposes, it is not transparent for state law purposes. For example, an owner of an SMLLC is not personally liable for the debts and obligations of the entity.

Did you know?

- Lally & Co. has been providing accounting and tax services to clients since 1983.
- You can find helpful financial tools on our website. www.lallycpas.com/financial-calculator/
- This and past issues of *The Evergreen* are available on our website. www.lallycpas.com/newsletter

Firm Announcements

Jim Norris successfully completed the IRS exam to become a Registered Tax Return Preparer in March 2012

Tristin Simmons successfully completed the Uniform CPA Exam in February 2012

Important Dates:

May 15, 2012 -
2011 Foundation Tax Returns Due

June 15, 2012 -
2012 2nd Quarter Estimated Payments Due

June 30, 2012 -
Form 90-22.1, Report of Foreign Bank and Financial Accounts Due

Private Company Financial Reporting Initiatives

Diversity is a key element of American society. This concept is also true in business. Large publicly-owned companies (i.e., Fortune 100's) and small, privately-owned companies are very diverse in how they operate. However, as diverse as they are, all businesses have similar financial reporting and disclosure requirements under U.S. generally accepted accounting principles (GAAP).

The burden of complying with extensive GAAP presentation and disclosure requirements has been the subject of considerable debate. As this issue has become more urgent and growing, there have been a number of attempts to address it.

One of the first attempts came in 2004 when the Financial Accounting Standards Board (FASB) created a Small Business Advisory Committee (SBAC). This SBAC was formed to generate more active involvement by the small business community in the development of financial accounting and reporting standards. The committee also provided additional and ongoing input on issues before the FASB.

The next attempt was in 2005 when the American Institute of Certified Public Accountants (AICPA) created the Private Company Financial Reporting Task Force. This task force studied private company accounting and issued a report known as the "Castellano Report". This report concluded that private company financial statement users have different needs than public company financial statement users.

As a result of the Castellano Report, the FASB created the Private Company Financial Reporting Committee (PCFRC). This committee provided recommendations to the FASB about differences in prospective and existing GAAP accounting standards related to private companies based on user needs and cost/benefit considerations.

Not withstanding the interim efforts, the issue remained unresolved. In 2009, the AICPA, the Financial Accounting Foundation (FAF) and the National Association of State Boards of Accountancy (NASBA) created a Blue-Ribbon Panel, which addressed the needs of users of U.S. private company financial statements. In its report issued in January 2011, the Blue-Ribbon Panel made two key recommendations:

GAAP for private companies should be based on existing U.S. GAAP, with exceptions and modifications that would result in financial statements that meet the objectives of financial reporting for the users of private company financial statements in a cost effective manner.

A "private company accounting standards board" under the oversight of the FAF, which would be independent of FASB, should have standard-setting authority to determine, and set exceptions and modifications in U.S. GAAP for privately-held companies.

However, the Blue-Ribbon Panel's recommendations were not adopted by the FAF. Rather, upon receipt of the Blue-Ribbon Panel's report in 2011, the FAF created a Private Company Standards Improvement Council (PCSIC), which replaced the PCFRC. The Private Company Review Committee (PCRC) was also created to oversee the activities of the PCSIC and its transactions with the FASB. After a planned three year transition period, the PCRC is to be disbanded, and its responsibilities are to be assumed by the Standard-setting Process Oversight Committee of the FAF.

The process of creating standards suited for private companies in the U.S. is a work in process. As it continues to unfold, we will keep you informed of the changes and how they may affect your business.

Payroll tax holiday extended for all of 2012

On February 22, President Obama signed the Middle Class Tax Relief and Job Creation Act of 2012. The new law extends the employee-side payroll tax holiday, giving wage earners and self-employed individuals 12 months of reduced payroll taxes in 2012.

2011 payroll tax holiday
Until 2011, the Old-Age, Survivors and Disability Insurance (OASDI) tax rate for employees was 6.2 percent (12.4 percent for self-employed individuals who pay both the employee-share and the employer-share). These taxes help to fund Social Security.

In 2011, a payroll tax holiday took effect. The payroll tax holiday reduced the employee-share of OASDI taxes from 6.2 percent to 4.2 percent for calendar year 2011 up to the Social Security wage base of $106,800. The payroll tax holiday also gave a similar percentage reduction to self-employed individuals for calendar year 2011.

Two-month extension
The 2011 payroll tax holiday was originally enacted as a one-year tax break. It was scheduled to expire after December 31, 2011.

In December 2011, Congress approved a two-month extension of the payroll tax holiday for January and February 2012.

Tough negotiations
In early 2012, lawmakers began negotiations over extending the two-month payroll tax holiday for the remainder of the year. The 2011 payroll tax holiday had not been offset; that is, the lost revenue had not been made up elsewhere. Several offsets were proposed and rejected, including a surtax on individuals with incomes over $1 million and repeal of certain business tax preferences. In the end, lawmakers could not agree on any offsets and decided to extend the payroll tax holiday without paying for it.

The House and the Senate passed the Middle Class Tax Relief and Job Creation Act on February 17, 2012. President Obama signed the bill on February 22, 2012.

2012 payroll tax holiday
The 2012 payroll tax holiday is essentially an extension of the 2011 payroll tax holiday. This means that wage earners pay OASDI taxes at a rate of 4.2 percent for calendar year 2012 up to the Social Security wage base ($110,100 for 2012). Self-employed individuals also benefit from a two-percentage point reduction in OASDI taxes for calendar year 2012. The OASDI tax rate for employers, however, is not reduced and remains at 6.2 percent for calendar year 2012.

According to the White House, an "average" taxpayer should expect to see about $1,000 in savings in 2012. An individual who makes at or above the Social Security wage base for 2012 ($110,100) will see a $2,202 benefit.

No recapture rule
The Middle Class Tax Relief and Job Creation Act repeals a recapture rule Congress had imposed on the two-month extension. The recapture rule was intended to prevent higher income individuals from enjoying too great a benefit from the payroll tax cut if it was not extended for all of 2012. Because the payroll tax cut has been extended through the end of 2012, the recapture rule is expressly removed in the new law.

Coming soon: Additional Retirement Payment options

Retired employees often start taking benefits by age 65 and, under the minimum distribution rules, must begin taking distributions from their retirement plans when they reach age 70 ½. According to Treasury, a 65-year old female has an even chance of living past age 86, while a 65-year old male has an even chance of living past age 84. The government has become concerned that taxpayers who normally retire at age 65 or even age 70 will outlive their retirement benefits.

The government has found that most employees want at least a partial lump sum payment at retirement, so that some cash is currently available for living expenses. However, under current rules, most employer plans do not offer a partial lump sum coupled with a partial annuity. Employees often are faced with an "all or nothing" decision, where they would have to take their entire retirement benefit either as a lump sum payment when they retire, or as an annuity that does not make available any immediate lump-sum cash cushion. For retirees who live longer, it becomes difficult to stretch their lump sum benefits.

Longevity solution
To address this dilemma, the government is proposing new retirement plan rules to allow plans to make available a partial lump sum payment while allowing participants to take an annuity with the other portion of their benefits. Furthermore, to address the problem of employees outliving their benefits, the government would also encourage plans to offer "longevity" annuities. These annuities would not begin

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paying benefits until ages 80 or 85. They would provide you a larger annual payment for the same funds than would an annuity starting at age 70 ½. Of course, one reason for the better buy-in price is that you or your heirs would receive nothing if you die before the age 80 or 85 starting date. But many experts believe that it is worth the cost to have the security of knowing that this will help prevent you from "outliving your money."

To streamline the calculation of partial annuities, the government would allow employees receiving lump-sum payouts from their 401(k) plans to transfer assets into the employer's existing defined benefit (DB) plan and to purchase an annuity through the DB plan. This would give employees access to the DB plans low-cost annuity purchase rates.

According to the government, the required minimum distribution (RMD) rules are a deterrent to longevity annuities. Because of the minimum distribution rules, plan benefits that could otherwise be deferred until ages 80 or 85 have to start being distributed to a retired employee at age 70 ½. These rules can affect distributions from 401(k) plans, 403(b) tax-sheltered annuities, individual retirement accounts under Code Sec. 408, and eligible governmental deferred compensation plans under Code Sec. 457.

Tentative limitations

The IRS proposes to modify the RMD rules to allow a portion of a participant's retirement account to be set aside to fund the purchase of a deferred annuity. Participants would be able to exclude the value of this qualified longevity annuity contract (QLAC) from the account balance used to calculate RMDs. Under this approach, up to 25 percent of the account balance could be excluded. The amount is limited to 25 percent to deter the use of longevity annuities as an estate planning device to pass on assets to descendants.

Coming soon

Many of these changes are in proposed regulations and would not take effect until the government issues final regulations. The changes would apply to distributions with annuity starting dates in plan years beginning after final regulations are published, which could be before the end of 2012. Our office will continue to monitor the progress of this important development.

Contemporaneous tax records: Are you keeping up?

Everybody knows that tax deductions aren't allowed without proof in the form of documentation. What records are needed to "prove it" to the IRS vary depending upon the type of deduction that you may want to claim. Some documentation cannot be collected "after the fact," whether it takes place a few months after an expense is incurred or later, when you are audited by the IRS. This article reviews some of those deductions for which the IRS requires you to generate certain records either contemporaneously as the expense is being incurred, or at least no later than when you file your return. We also highlight several deductions for which contemporaneous documentation, although not strictly required, is extremely helpful in making your case before the IRS on an audit.

Charitable contributions. For cash contributions (including checks and other monetary gifts), the donor must retain a bank record or a written acknowledgment from the charitable organization. A cash contribution of $250 or more must be substantiated with a contemporaneous written acknowledgment from the donee. "Contemporaneous" for this purpose is defined as obtaining an acknowledgment before you file your return. So save those letters from the charity, especially for your larger donations.

Tip records. A taxpayer receiving tips must keep an accurate and contemporaneous record of the tip income. Employees receiving tips must also report the correct amount to their employers. The necessary record can be in the form of a diary, log, or worksheet and should be made at or near the time the income is received.

Wagering losses. Gamblers need to substantiate their losses. The IRS usually accepts a regularly maintained diary or similar record (such as summary records and loss schedules) as adequate substantiation, provided it is supplemented by verifiable documentation. The diary should identify the gambling establishment and the date and type of wager, as well as amounts won and lost. Verifiable documentation can include wagering tickets, canceled checks, credit card records, and withdrawal slips from banks.

Vehicle mileage log. A taxpayer can deduct a standard mileage rate for business, charitable, or medical use of a vehicle. If the car is also used for personal purposes, the taxpayer should keep a contemporaneous mileage log, especially for business use. If the taxpayer wants to deduct actual expenses for business use of a car also used for personal purposes, the taxpayer has to allocate costs between the business and personal use, based on miles driven for each.

Material participation in business activity. Taxpayers that materially participate in a business generally can deduct business losses against other income. Otherwise, they can only deduct losses against passive income. An individual's participation in an

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activity may be established by any reasonable means. Contemporaneous time reports, logs, or similar documents are not required but can be particularly helpful to document material participation. To identify services performed and the hours spent on the services, records may be established using appointment books, calendars, or narrative summaries.

Hobby loss. Taxpayers who do not conduct an activity with a sufficient profit motive may be considered to engage in a hobby and will not be able to deduct losses from the activity against other income. Maintaining accurate books and records can itself be an indication of a profit motive. Moreover, the time and activities devoted to a particular business can be essential to demonstrate that the business has a profit motive. Contemporaneous records can be an important indicator.

Travel and entertainment. Expenses for travel and entertainment are subject to strict substantiation requirements. Taxpayers should maintain records of the amount spent, the time and place of the activity, its business purpose, and the business relationship of the person being entertained. Contemporaneous records are particularly helpful.

Internal Control, Revisited

As a business owner, how often do you think about the effectiveness of the internal control in your organization? Are controls adequate and effective? Do they accomplish the objectives for which they have been designed?

Internal control is an extremely important part of your business, specifically in helping to assure the accomplishment of your organization's objectives. Good internal control is about achieving financial and organizational objectives in a cost-effective way.

Since 1992, the Internal Control framework developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, has been a mainstay for developing and evaluating an internal control system for businesses both small and large. Recently, COSO has proposed an update to this framework, not to change but to modernize the system to accommodate our ever-evolving business environment.

What remains unchanged in the framework is the basic definition of internal control and the five essential components of good internal control.

- Establishing a strong control environment
- Identifying and evaluating risks
- Selecting proper control activities to lessen risks
- Developing strong information and communication systems throughout the organization
- Providing a framework for management to effectively monitor controls

Although the framework has been updated, it does not change the fundamental components of the framework; rather it integrates 17 new principles throughout the five original components. The principles allow for ease of application and evaluation of current internal control.

Each of the 17 principles elaborates on one specific component of the framework, eliminating the guesswork about whether something needs to be present in the framework. It's now explicit as to what the internal control principles are.

Determining the proper internal controls for your organization and evaluating whether they are suitable to achieve your plans may seem overwhelming to the untrained eye. We are here to help. If you would like us to review or assist in developing proper controls for your organization, please don't hesitate to contact us.

Latest IRS Data Book Shows Jump in Higher-Income/Small Business Audit Rates

The just-released 2011 IRS Data Book provides statistical information on IRS examinations, collections, and other activities for the most recent fiscal year ended in 2011. The 2011 Data Book statistics, when compared to the 2010 version, shows, among other things, a notable increase in the odds of being audited within several high-income categories.

Individual taxpayers collectively were audited at a 1.1% rate over the FY 2011 period, based on 1,564,690 audited returns out of the 140,837,499 returns that were filed. While this rate is about the same as in 2010, variations occurred within the income ranges. An uptick was particularly noticeable in the upper brackets.

Both correspondence and field audits were counted within the statistics. Correspondence audits accounted for 75% of all audits for FY 2011 (down from 77.1% in FY 2010), while audits conducted face-to-face by revenue agents were only 25% of the total, albeit representing an increase from the 21.7% level in FY 2010. Business returns and higher-income individuals are more likely to experience an audit by a revenue agent; while correspondence audits are generally single-issue audits, a revenue agent is likely to explore other issues while he or she is there.

The tables on the next page provide a distribution of 2011 and 2010 audit rates for individuals and corporations.

Individual Returns Without Business Income

AGI Level	FY 2011	FY 2010
No AGI	3.42%	3.19%
Under $25k	1.22%	1.18%
$25k-$50k	0.73%	0.73%
$50k-$75k	0.83%	0.78%
$75k-$100k	0.82%	0.64%
$100k-$200k	1.00%	0.71%
$200k-$500k	2.66%	1.92%
$500k-$1M	5.38%	3.37%
$1M-$5M	11.80%	6.67%
$5M-$10M	20.75%	11.55%
$10M and over	29.93%	18.38%

Individual Returns With Business Income

Business Income	FY 2011	FY 2010
Under $25k	1.30%	1.20%
$25k-$100k	2.90%	2.50%
$100k-$200k	4.30%	4.70%
Over $200k	3.80%	3.30%

*Returns with total positive income of at least $200k and under $1M provide further evidence of the IRS's tendency toward auditing business returns: 3.6% for returns with business income versus 3.2% without business income in FY 2011 (2.9% versus 2.5% in FY 2010).

Corporations

Total Assets	FY 2011	FY 2010
$250k-$1M	1.60%	1.40%
$1M-$5M	1.90%	1.70%
$5M-$10M	2.60%	3.00%
$10M-$50M	13.30%	13.40%
$5B-$20B	50.50%	45.30%

*The overall audit rate was 0.4% (same as in 2010) for S Corporations and Partnerships, in contrast to an overall 1.5% rate for C Corporations (1.4% in 2010).