

Tax Season

Everything you need to navigate through the busy season.

TOOLKIT



As the holiday season turns into tax season, bringing the promise of constant, adrenaline-fueled deadlines, CPAs can be excused for turning a sentimental eye to winter. But never fear! CalCPA's annual Tax Season Toolkit is here to help.

As you meet with clients, research what's new in the tax codes and update your software to provide the best service you can, spring ahead and confidently meet the only season that's never late or early—tax season.

California Tax Tips

No Conformity Bill Means More CA Differences

Some of the new non-conforming items as a result of the lack of a conformity bill this year include:

1. Charitable contributions fail to conform, but this is virtually immaterial because the Federal requirements set the higher standard. Federal law requires receipts or cancelled checks for all charitable contributions for 2007; California only requires taxpayers to meet the pre-2007 law.
2. California doesn't allow a deduction for mortgage insurance premiums as a mortgage interest expense.
3. HSA, FSA and IRAs. California doesn't allow tax free rollovers of HSA or FSA accounts into IRAs, creating taxable income and possibly an early withdrawal penalty. Indeed, California doesn't conform to health savings accounts at all.
4. California doesn't conform to the indexing of AGI requirements for IRAs (*Spidell's CA Taxletter*, Page 147, October 2007). Consequently, the taxpayer may have a different deductible amount for Federal income tax purposes than for California income tax purposes. However, this isn't new. There were different upper limits in the early days of IRAs and Keoghs.
5. Kiddie tax differences. The Internal Revenue Code applies the kiddie tax under age 18 for 2007, and under age 24 for students in 2008. California's limit remains at age 14.
6. California still doesn't permit the unlimited deduction of rental losses of real estate professionals.

Other Tax Legislation Enacted, A Partial List

SB 87: California has repealed the Teacher Retention Tax Credit

AB 897: This act eliminates the requirements for certain federally tax-exempt entities to apply for California income tax exemption by allowing 501c(3) organizations to submit a copy of the IRS tax exemption notice to the FTB to establish California income tax exemption. 501c(3) organizations would no longer be required to file an exemption application with FTB or submit a \$25 filing fee.

Filing individual taxpayers as married filing separately

There's generally no advantage to filing married individuals as married-filing-separately because of the community income, deductions and credits that must be reported on each separate return.

However, there has been an added impetus to computing the taxes both ways because of the 1 percent surtax (called the Mental Health Services Tax) on taxable incomes of more than \$1 million because a taxable income of, for example \$1.6 million on a joint return turns into only \$800,000 on each of MFS returns.

Oftentimes, though, since whatever filing status is used on the Federal Form 1040 must also be used on the California Form 540, with few exceptions, the additional taxes paid on the Federal return exceed the savings from filing MFS for California.

The only way to know for sure it do the return both ways. Computer programs are capable of doing that if the input is coded correctly.

Reminders of Protective Claims/Amended returns to be filed

1. Tax practitioners have been filing protective claims requesting refunds of the gross receipts LLC "fee" (but not the \$800 annual tax), pending the outcomes of the *Yentas* and *Northwest* cases in the California courts. The California Legislature is attempting to circumvent these claims via AB 198, which would not allow full refunds if the current LLC fee provision is ruled unconstitutional. As of press time, the fate of AB 198 is unknown.

2. The other matter necessitating protective claims is the California provision that otherwise tax-free state and municipal bond interest is taxable to California residents when the source of the interest is a non-California instrument. This matter is on appeal to the U.S. Supreme Court in the case of *Commonwealth of KY vs. George W. Davis et aux*.

3. Protective claims for both matters for the year 2003 must be filed by April 15, 2008.

Federal Tax Tips

2007 SMALL BUSINESS & WORK OPPORTUNITIES TAX ACT Preparer Penalties Expanded and Increased

The definition of "preparer" is broadened to include preparers of gift, estate, employment, excise and exempt organization returns.

This Act also alters the standards of conduct that must be met to avoid penalties for preparing a return which has a tax understatement. The realistic possibility standard for undisclosed positions is replaced with a requirement that there be a "reasonable belief" that the tax treatment of the position was more likely than not the proper treatment.

The “not-frivolous” standard, accompanied by disclosure, is replaced with the requirement that there must be a “reasonable basis” for the position’s tax treatment accompanied by disclosure.

In addition, the first-tier penalty is increased from \$250 to the greater of \$1,000 or 50 percent of the income derived, or to be derived, by the preparer from preparing the return or claim with respect to which the penalty is imposed.

The second-tier penalty also is increased from \$1,000 to the greater of \$5,000 or 50 percent of the income derived, or to be derived, by the preparer.

These new rules are effective for tax returns prepared after May 25, 2007. However, IRS Notice 2007-54 (IRB-2007, 7/2/07) relaxes this effective date for:

1. All returns, amended returns and refund claims due (with extensions) before 2008;
2. 2007 estimated tax returns (vouchers) due by Jan. 15, 2008; and
3. 2007 employment and excise tax returns due by Jan. 31, 2008.

The U.S. Treasury proposed regulations (REG-138637-07), Sept. 25, 2007, to conform the professional standards in Circular 230, Section 10.34 with these new preparer penalties. These regulations are proposed to be effective for returns filed or advice provided on or after the date that final regulations are published in the *Federal Register*, but not earlier than Jan. 1, 2008.

Erroneous Refund Claims

A new penalty is imposed on any taxpayer filing an erroneous claim for refund or credit. This penalty is 20 percent of the disallowed portion of the claim if there is no reasonable basis for the claimed tax treatment.

The penalty does not apply to the earned income credit (which has its own compliance rules). It also does not apply to any part of the disallowed portion of the claim that is subject to accuracy-related or fraud penalties.

Effective Date: Claims filed after May 25, 2007.

Kiddie Tax

The kiddie tax is expanded to apply to children who are 18 years old or who are full-time students over age 18, but under age 24. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support.

Effective Date: Tax years beginning after May 25, 2007 (e.g., calendar year 2008).

Increased and Extended Sec. 179 Deduction

Old Law: Generally, the maximum amount that a taxpayer may elect to expense for tax years 2003-09 was \$100,000 of the cost of qualifying property placed in service during the tax year.

Qualifying property was generally defined as new or used depreciable tangible personal property purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in tax years beginning before 2010 was treated as qualifying property.

The \$100,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeded \$400,000.

The \$100,000 and \$400,000 amounts were indexed for inflation for tax years beginning after 2003 and before 2010. For tax years beginning in 2007, the inflation adjusted amounts were \$112,000 and \$450,000, respectively.

Taxpayers could make or revoke Sec. 179 expense deduction elections on amended returns without IRS consent for tax years beginning after 2002 and before 2010. Any such revocation was irrevocable.

New Law: The \$100,000 and \$400,000 amounts are increased to \$125,000 and \$500,000, respectively, for tax years 2007-2010. These amounts will be indexed for inflation in tax years beginning after 2007 and before 2011.

In addition, the new law extends for one year the increased amount that a taxpayer may deduct and the other Sec. 179 rules applicable in tax years beginning before 2010. Thus, these rules continue in effect for tax years beginning after 2009 and before 2011.

Effective Date: Tax years beginning after 2006.

S Corporation’s Capital Gains No Longer Passive Investment Income

Old Law: An S corporation was subject to corporate level tax, at the highest corporate tax rate, on its excess net passive income if the corporation had:

- Accumulated earnings and profits (AE&P) at the end of the tax year; and
- Gross receipts more than 25 percent of which were passive investment income.

Also, an S election was terminated if the corporation had AE&P at the close of each of three consecutive tax years and had gross receipts for each of those years, more than 25 percent of which were passive investment income.

Excess net passive income was the net passive income for a tax year multiplied by the following fraction: Passive investment income exceeding 25 percent of gross receipts divided by total passive investment income for the year.

Tax

SOFTWARE SUPPORT

Every major provider offers call-in, e-mail and online support. Here’s a guide to tax software support:

BNA Tax Management

(800) 372-1033
www.bna.com/tm/support.htm
 e-mail: tm@bna.com

Creative Solutions Ultra Tax

(800) 968-0600
www.cc.thomson.com/support/
 e-mail: www.creativesolutions.thomson.com/support/customer/

Drake Software

(828) 524-8020
<http://support.drakesoftware.com>
 e-mail: support@drakesoftware.com

Lacerte

(800) 933-9999
www.lacertesoftware.com/support/
 e-mail: www.lacertesoftware.com/myaccount/emailsupport/AddEmail.aspx

GoSystem Tax RS

(800) 327-8829
<https://support.riahome.com>
 e-mail: RIA.TechSupport@Thomson.com

ProSystemFX

(800) PFX-9998
<http://prosystemfxsupport.tax.cchgroup.com/>
 e-mail: http://tax.cchgroup.com/CustomerSupport/CCH/csinq/default

TaxWise

(866) 641-WISE
<http://taxwise.com/>
 e-mail: customer.support@taxwise.com

TAX TIP

Recent changes in California tax law give registered domestic partners the same tax filing status as married couples. Under current state and federal law, domestic partners use the single or head of household filing status.

The law, SB 1827, provides for registered domestic partners to file their state tax returns using either the “married filing jointly” status or “married filing separate.” The new law takes effect for tax year 2007, which taxpayers will begin filing in January 2008, and does not impact federal tax law.

The FTB has formed an implementation team to review the various processes, forms and system changes needed for implementation by Jan. 1, 2008.

Find more information at <http://www.ftb.ca.gov/forms/RegDomPrtnr/RegDomPrtnr.shtml>.

Net passive income was passive investment income reduced by allowable deductions directly connected with producing that income.

Passive investment income generally included gain from sales or exchanges of stock or securities.

New Law: Gains from sales or exchanges of stock or securities are eliminated as items of passive investment income.

Effective Date: Tax years beginning after May 25, 2007.

PRACTITIONER PENALTIES

IRS Notice 2007-39 (IRB 2007-20, 5/14/07) provides guidance to practitioners, employers and firms that may be subject to monetary penalties under 31 USC Section 330.

Generally, Section 330 authorizes the Secretary of the Treasury to regulate CPAs, attorneys, enrolled agents, actuaries and others practicing before the IRS. Regulations under Section 330 are reprinted as Treasury Circular 230.

The 2004 Jobs Act amended Section 330 to provide monetary penalties for certain prohibited conduct (defined in Circular 230, Section 10.52) after Oct. 22, 2004. As amended, Section 330 authorizes sanctions, including monetary penalties, against a practitioner who is incompetent or disreputable, fails to comply with Section 330's regulations or, with intent to defraud, willfully and knowingly misleads or threatens a client or potential client.

Monetary penalties also are authorized against an employer or firm if the practitioner was acting on its behalf in connection with the prohibited conduct giving rise to the penalties and the employer or firm knew, or reasonably should have known, of this conduct.

The aggregate penalties cannot exceed the gross income derived, or to be derived, from the prohibited conduct.

Penalties may be imposed for a single act or for a pattern of misconduct. They may be imposed in addition to, or in lieu of, any suspension, disbarment or censure.

However, these penalties are not a "bargaining point" that a practitioner may offer to avoid suspension, disbarment or censure if those sanctions are otherwise appropriate.

Notice 2007-39 contains detailed requirements for imposing these penalties, covering the penalty's amount and determining a separate penalty on an employer or firm.

The Treasury published final regulations (T.D. 9359) Sept. 26, 2007 on practice before the IRS covering contingent fees, conflicting interests, sanctions, disciplinary proceedings and procedural matters. In particular, the regulations adopt amendments under Circular 230, Section 10.50 authorizing these monetary penalties in accordance with the Jobs Act.

The **TaxTalk listserve** is an online community for posing and answering tax questions and passing on tax information. For details, visit www.calcpa.org/Content/listserve/taxtalk.aspx.

The regulation's preamble states that Notice 2007-39 provides guidance regarding such penalties. These rules, concerning sanctions, apply to prohibited conduct occurring after Oct. 22, 2004.

See *California CPA*, June 2007, Page 32 for an example of this provision.

2006 TAX RELIEF & HEALTH CARE ACT

Research Credit

This credit is extended for amounts paid or incurred after 2005 and before 2008. This law also modifies the research credit for tax years ending after 2006 by increasing the rates of the alternative incremental credit and providing a new alternative simplified credit.

Refundable Credit for Unused AMT Credit

For tax years beginning after Dec. 20, 2006, an individual's minimum tax credit that is allowable for any tax year beginning before 2013 cannot be less than the "AMT refundable credit amount," which is the *greater of*:

1. The *lesser of* \$5,000 or the long-term unused minimum tax credit; *or*
2. 20 percent of the long-term unused minimum tax credit.

For further details, see *California CPA*, March/April 2007, Page 28.

PATENTED TAX PLANNING METHODS

On Sept. 26, 2007, regulations were proposed (REG-129916-07) that would add patented transactions to the categories of reportable transactions. A patented transaction is a transaction for which a taxpayer pays a fee to a patent holder or the holder's agent for the legal right to use a tax planning method that the taxpayer knows, or has reason to know, is the subject of a patent.

Proposed Effective Date: Upon publication of these proposals as final regulations, these regulations would apply to transactions entered into after Sept. 25, 2007.

2008 PENSION PLAN LIMITATIONS

The IRS has unveiled cost-of-living adjustments applicable to dollar limitations for pension plans and other items for tax year 2008. Many of the pension plan limitations will change for 2008.

For most of the limitations, the increase in the cost-of-living index met the statutory thresholds that trigger their adjustment. However, the limitation under Sec. 402(g)(1) on the exclusion for elective deferrals described in Sec. 402(g)(3) remains unchanged at \$15,500 for 2008. This limitation also affects elective deferrals to Sec. 401(k) plans and to the Federal Government's Thrift Savings Plan, among other plans.

For more, visit www.irs.gov/newsroom/article/0,,id=163616,00.html.

2008 INFLATION ADJUSTMENTS

The value of each personal and dependency exemption will be \$3,500, a \$100 increase from 2007. The new standard deduction will be:

	2008	2007
Married filing jointly	\$10,900	\$10,700
Single or married filing separately	5,450	5,350
Head of household	8,000	7,850

The contribution amount allowed for Roth IRAs will begin to phase out for joint filers with modified adjusted gross income exceeding \$159,000 (up from \$156,000) and \$101,000 (up from \$99,000) for single and head of household filers.

Other adjustments for more than approximately 36 other tax benefits are set forth in Rev. Proc. 2007-66 (IRB 2007-45, 11/5/07). **CPA**

TAX TIP

Raise Your Hand: Find a CPA

As tax season begins, don't forget to register or update your information with CalCPA.org's Find a CPA.

Find a CPA is among the most popular pages on the website, receiving thousands of hits each month. The feature has matched scores of taxpayers with the local CPAs who best suit their needs.

Your listing specifies not only where you practice, but how you practice. Listings include services provided, industries served and languages spoken. Add your name to the directory—or update your profile if you're already listed—at www.calcpa.org.