

# 2012 TAX YEAR-IN-REVIEW

January 10, 2013

Special Report

## HIGHLIGHTS

- American Taxpayer Relief Act Passes Congress
- Supreme Court Upholds Affordable Care Act
- IRS Issues Guidance On Many Health Care Tax Measures
- Retirement Incentives Take On New Importance
- IRS Expands Voluntary Compliance Settlement Program
- Treasury Releases FATCA Model Agreements
- IRS Focuses On Domestic And International Compliance

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## 2012 Resolves Many Uncertainties, Creates Others; Sets Stage For Future Tax Reform

Uncertainty during 2012 over what tax laws would govern in 2013 and beyond because of the expiring Bush-era tax cuts clearly was the most significant development of the year. Now that Congress and President Obama — through the American Taxpayer Relief Act of 2012 (ATRA) — have provided a degree of certainty over tax rates into at least the immediate future, taxpayers need to adjust their tax plans accordingly. Individuals and businesses should immediately recalibrate strategies in light of ATRA. 2012 was also a significant year for important tax developments from the Treasury Department, the IRS and the courts. These developments demand the attention of individual and business taxpayers not only to caution what is no longer allowed under the tax laws but also to shape what steps can be taken in 2013 and beyond to maximize tax savings. *With that forward-looking perspective, this Tax Briefing reviews key federal tax developments that took place during 2012.*

### LEGISLATION/TAX POLICY

Months of uncertainty during 2012 over the fate of the Bush-era tax cuts were resolved by passage of ATRA on New Year's Day 2013. Unfinished, however, was legislation to find more revenue and spending cuts, which all but guarantees further debate and likely legislation on taxes in 2013. Moreover, Congressional hearings during 2012 on tax reform, combined with several Administration proposals on corporate and international tax reform, point to a growing possibility of comprehensive tax reform legislation taking shape in 2013.

**American Taxpayer Relief Act.** The fate of the Bush-era tax cuts missed being resolved in 2012 literally by minutes. The Senate approved ATRA in the early hours of New Year's Day, followed by the House's approval later that same day. President Obama signed ATRA into law on January 2, 2013. ATRA extends permanently many of the Bush-era tax cuts for lower and moderate income individuals. However, higher-income taxpayers will pay more in taxes in 2013 and beyond. ATRA imposes a maximum 39.6 percent tax rate on income and a maximum 20 percent tax rate on capital gains and dividends on individuals with taxable income over \$400,000 and families with income over \$450,000. ATRA also makes permanent the \$1,000 child tax credit and permanently "patches" the alternative minimum tax (AMT) among other changes.

**IMPACT.** *During his re-election campaign, President Obama promised to allow the Bush-era tax cuts to expire for individuals with incomes over \$200,000 and families with incomes over \$250,000. The \$400,000/\$450,000 thresholds in ATRA reflect a compromise between the President and the GOP.*

**Payroll tax holiday.** Congress passed the Middle Class Tax Relief and Job Creation Act of 2012 to provide for an employee-side payroll tax holiday for calendar year 2012. Individuals ordinarily would have paid Old Age, Survivors and Disability Insurance (OASDI) taxes of 6.2 percent of their wages, up to the annual cap, which was \$110,100 for 2012. The payroll tax holiday reduced the rate to 4.2 percent. Self-employed indi-

viduals received a comparable benefit. The American Taxpayer Relief Act did not extend the payroll tax holiday into 2013.

**IMPACT.** *The average taxpayer saw approximately \$1,000 more in take-home pay in 2012. The maximum benefit was \$2,202, which was two percent of the Social Security wage cap for 2012. Because the payroll tax holiday was not renewed for 2013, take-home pay for all wage earners has been decreased in 2013.*

**Administration's tax proposals.** President Obama unveiled several tax proposals during his State of the Union address in January 2012. The President's proposals focused on economic stimulus and international tax reform. The proposals, further elaborated in February by the Treasury Department's "Green Book," included making permanent the research credit, extending 100 percent bonus depreciation, imposing a new minimum tax on overseas profits, and preventing companies from shifting profits overseas using intangible property.

**IMPACT.** *Many of these likely will be re-proposed by President Obama in 2013. The difference this time around, however, is that any "fine-tuning" of the current tax system may be eclipsed by tax reform measures that trade many current deductions and credits in exchange for lower rates, especially for business taxpayers.*

**IMPACT.** *In discussions surrounding how to raise tax revenues to avoid the fiscal cliff, various proposals to reduce or eliminate certain itemized deductions were raised for taxpayers in all income groups. In addition to a cap on all itemized deductions geared either to a dollar amount or rate level, these preliminary discussions touch upon some "hot buttons" for many interest groups, especially proposals that would limit mortgage interest and charitable deductions.*

**Business tax reform.** The Obama administration released its Framework for Business Tax Reform (February 2012), proposing a top corporate tax rate of 28 percent (25 percent for

manufacturers). The Framework also proposed to eliminate certain tax expenditures, such as the last-in, first-out method of accounting, tax preferences for oil and gas, and special depreciation rules for corporate aircraft. Additionally, the Framework proposed to tax carried interest as ordinary income and to reform insurance industry taxation.

**IMPACT.** *The Framework proposed some international tax reforms, such as a minimum tax on overseas profits, a tax on excess profits from shifting intangibles, and the delay of interest expense deductions until the related income is taxed in the U.S. There would be tax credits for moving operations back to the U.S., and elimination of deductions for moving production overseas.*

"Months of uncertainty during 2012 over the fate of the Bush-era tax cuts were resolved by passage of the American Taxpayer Relief Act on New Year's Day 2013"

## HEALTH CARE REFORM

2012 settled two major challenges to the Patient Protection and Affordable Care Act (PPACA) and its companion law, the Health Care and Education Reconciliation Act (HCERA). The U.S. Supreme Court's validation of the health care legislation in *National Federation of Independent Business (NFIB) v. Sebelius*, 2012-2 USTC ¶50,573, followed by the re-election of President Obama ended any reasonable conclusion that the major PPACA provisions coming into force in 2013 and 2014 could be ignored any longer.

The IRS for its part did not wait until the Supreme Court and Election Day to provide guidance on many PPACA provisions.

The IRS issued a steady stream of guidance throughout 2012 to explain and implement key PPACA provisions. Expectations are that the IRS will continue issuing significant explanatory guidance during 2013 even as it also turns to enforcing those provisions that are coming into force in 2013 and 2014.

**IMPACT.** *Employers immediately need to take steps to comply with requirements in the health care reform law that go into effect in 2013. Employers also need to use 2013 to prepare for major requirements that go into effect starting in 2014, including steps to comply with the so-called employer mandate, as well as coordination of the individual mandate with existing health plans.*

**IMPACT.** *Some estimates forecast an increase of more than 20 percent in the IRS's administrative budget within the next several years to enforce compliance with the many PPACA provisions that are enforced or funded through surtaxes, excise taxes, fees and penalties.*

**COMMENT.** *Two important Medicare surtaxes, the 3.8 percent Net Investment Income surtax and the 0.9 percent Additional Medicare Tax, both created under the PPACA and effective January 1, 2013, are covered under a separate heading in this Tax Briefing, below, because of their significance. Higher income investors, wage earners and self-employed individuals, as well as certain trusts and estates, are impacted by these new Medicare surtaxes.*

**Supreme Court upholds PPACA.** On June 28, 2012, the U.S. Supreme Court upheld the PPACA in a 5-4 decision (*National Federation of Independent Business (NFIB) v. Sebelius*, 2012-2 USTC ¶50,573). Writing for the majority, Chief Justice John Roberts found that the individual shared responsibility provision in Code Sec. 5000A, as added by the PPACA, is a valid exercise of Congress' taxing authority. Code Sec. 5000A generally requires qualified individuals to carry minimum essential health insurance

coverage or pay a shared responsibility penalty, starting in 2014.

**IMPACT.** *Because the Supreme Court upheld the PPACA and its companion bill, HCERA, the tax provisions in both laws survived, including the 3.8 percent Net Investment Income surtax, 0.9 percent Additional Medicare Tax, Code Sec. 45R small employer health care credit, excise tax on medical devices, and many more.*

#### **Salary reduction limit for Health FSAs.**

The IRS issued guidance in May 2012 (Notice 2012-40) clarifying the effective date of the \$2,500 limit on salary reduction contributions to health flexible spending arrangements (health FSAs) under the PPACA. The guidance provides among other rules, that:

- The \$2,500 limit does not apply for plan years that begin before 2013;
- Plans may do the paperwork to adopt the required amendments to reflect the \$2,500 limit at any time through the end of calendar year 2014; and
- For plans providing a grace period up to two months and 15 days into the next tax year, unused salary-reduction contributions for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the \$2,500 limit for the subsequent plan year; and
- Taxpayers may rely on the guidance, pending issuance of proposed regs.

**W-2 reporting of health benefits.** Beginning with the 2012 tax year (for 2012 Forms W-2 issued in 2013), the PPACA requires large employers to report on an employee's Form W-2 the cost of coverage they provided to that individual under an employer-sponsored group health plan. The IRS previously made reporting optional for 2011 for all employers. During 2012, the IRS also provided further relief by exempting small employers (employers that filed fewer than 250 Forms W-2 in the previous calendar year) from W-2 reporting for 2012 and later years, until further guidance is issued (Notice 2012-9).

**IMPACT.** *The amounts are provided for informational purposes only.*

In May 2012, the IRS updated its online frequently asked questions (FAQs) and posted a chart illustrating the types of health care coverage that employers must report. Some types of coverage must be reported on Forms W-2; others are optional. Major medical coverage, health flexible spending arrangement value for the plan year that is in excess of employee's cafeteria plan salary reductions for all qualified benefits, and domestic partner coverage included in gross income are examples of items that must be reported.

**Summary of benefits and coverage.** The IRS issued final regs requiring that insurers, employers and other providers of health care plans provide a summary of benefits and coverage (SBC) to plan participants and other affected individuals (TD 9575, NPRM REG-140038-10 (February 2012)). The provision is for the benefit of individuals enrolling in group health coverage and individuals and dependents enrolling in individual health care plans. The rules generally apply on or after September 23, 2012. There are 12 required elements for an SBC, which cannot exceed four double-sided pages.

**IMPACT.** *The SBC requirement essentially applies to all health plans, including grandfathered plans, large plans, and self-insured plans.*

**Code Sec. 36B premium assistance tax credit.** Treasury and the IRS issued final regs on the Code Sec. 36B health insurance premium assistance tax credit, created under the PPACA. The tax credit is available to eligible individuals who receive health insurance coverage through an exchange and who do not otherwise have access to affordable health coverage that offers minimum essential health coverage (TDNR-1587, TD 9590 (May 2012)). It will be directly paid to insurance providers to offset premiums. Taxpayers may apply for the credit through a health insurance exchange, beginning in 2014. The final regs apply to tax years beginning after December 31, 2013.

**Employer mandate.** Under the PPACA, an applicable large employer is subject to a shared responsibility payment (an assessable payment) if any full-time employee is certified to receive an applicable premium tax credit or cost-sharing reduction payment and the employer does not offer to its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan (Code Sec. 4980H(a)); or the employer offers its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that either is unaffordable relative to an employee's household income or does not provide minimum value (Code Sec. 4980H(b)). During 2012, the IRS issued a number of Notices (Notice 2012-31, Notice 2012-33, Notice 2012-58, Notice 2012-59) on various aspects of the employer mandate.

**COMMENT.** *The IRS issued proposed reliance regs on the PPACA's employer mandate in January 2013 (NPRM REG-138006-12).*

**Medical loss ratio rebates.** In 2012, some taxpayers received the first round of medical loss ratio (MLR) rebates payable under the PPACA. The PPACA requires the rebates to encourage health insurance companies to spend a certain percentage of premiums directly on health care. Insurers that do not meet the requirements must rebate a portion of the premiums to customers.

**IMPACT.** *The IRS posted frequently asked questions (FAQs) on its website about MLR rebates. Generally, if a tax benefit was previously gained on the premiums being refunded, the rebate would be taxable; otherwise, the premiums would be tax free to the recipient.*

**Wellness programs.** The IRS issued proposed regs on wellness programs in group health coverage under the PPACA (NPRM REG-122707-12 (November 2012)). The proposed regs are designed to encourage employer-sponsored wellness programs.

**IMPACT.** *The proposed wellness regs apply to both grandfathered and non-grandfathered plans and group health insurance coverage for plan years beginning on or after January 1, 2014.*

**COMMENT.** *Wellness programs must be reasonably designed to promote health or prevent disease. Examples include programs that encourage increased levels of physical activity; improve nutrition, decrease obesity, and eliminate tobacco use. Programs must have a reasonable chance of improving health or preventing disease and not be overly burdensome for individuals. The proposed regs continue to divide wellness programs into two categories: participatory wellness programs and health-contingent wellness programs.*

**Contraceptive exemption safe harbor created.** The IRS issued final regs providing a temporary safe harbor that would exempt certain religious-sponsored group health plans and coverage from the requirement to cover certain preventative health services, including contraception, education and sterilization procedures (TD 9578 (February 2012)). The regs require insurance issuers to offer religious employers insurance without contraceptive coverage, while offering contraceptive coverage directly to the employer's plan participants and beneficiaries, with no cost-sharing by the religious employer.

**IMPACT.** *The Obama administration faced strong objections from religious groups claiming that the preventative services requirements violated their religious freedom. The guidance is part of the effort to accommodate all parties by providing the services to plan participants without involving religious employers.*

**Preventive health services changes.** The IRS in March 2012 announced proposed changes to the regs on providing preventive health care services (ANPRM RIN-1210-AB44). Prior regs had exempted group health plans of certain religious employers from having to provide contraceptive services.

**Excise tax on medical devices.** The PPACA imposes an excise tax on the total revenues of a company that manufactures certain medical devices, generally at a 2.3 percent rate, starting in 2013. In December 2012, the IRS finalized proposed regs describing a taxable medical device (NPRM REG-113770-10). The final regs use the Food and Drug Administration definition of medical device. The final regs make several clarifications regarding what devices are taxable, how the exemption for devices purchased at retail is applied, how "convenience kits" should be taxed, and other issues.

**IMPACT.** *The final regs also contain broad safe harbors that specifically exempt categories of devices, such as eyeglasses and contact lenses sold at retail.*

**Funding fees for patient-centered research institute.** The IRS issued final regs describing certain fees imposed under the PPACA on issuers of specified health insurance policies and sponsors of applicable self-insured health plans (TD 9602 (December 2012)). The fees are meant to partly fund the Patient-Centered Outcomes Research Institute Trust Fund. The final regs clarify an exclusion from the definition of "specified health insurance policy" for employee assistance programs (EAPs), disease management programs, and wellness programs.

## NEW MEDICARE TAXES

Effective January 1, 2013, the PPACA imposes two new Medicare taxes on qualified taxpayers: a 3.8 percent net investment income (NII) surtax and a 0.9 percent Additional Medicare Tax. Despite questions almost immediately after passage regarding the operation of both of these new taxes, and despite forecasts by some at the IRS as early as last February that guidance would be forthcoming "shortly," guidance was not issued until just over a month before these taxes came into effect. The IRS issued proposed reliance regs on the NII surtax and the Additional Medicare Tax in November 2012.

**IMPACT.** *The proposed reliance regs are effective for tax years beginning after calendar year 2013. However, taxpayers may rely on these proposed regs immediately until hearings are held, public comments are considered, and final regs are issued. The IRS intends to finalize the regs before 2014.*

**NII Surtax.** The NII surtax generally applies at a rate of 3.8 percent to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts. The statutory threshold amounts are based on filing status: \$200,000 in the case of a single taxpayer, head of household (with qualifying person); \$250,000 in the case of married couples filing jointly and qualifying widow(er) with dependent child; and \$125,000 in the case of married couples filing separately. These thresholds are imposed independent of the \$450,000 and \$400,000 thresholds under the American Taxpayer Relief Act of 2012 that set the starting points for a maximum 20 percent capital gains tax starting in 2013.

**IMPACT.** *The PPACA's definition of net investment income for purposes of the new surtax encompasses many types of income, such as interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer under Code Sec. 469. The coordination set up by Congress between Code Sec. 469 and the NII tax under Code Sec. 1411, however, is not identical in all respects.*

**COMMENT.** *Taxpayers must report and pay over any NII surtax on their individual tax returns. Because the NII surtax starts in 2013, the first returns reflecting the new tax will be filed in 2014. For estates and trusts, which have a threshold amount considerably lower than for individuals (\$11,950 projected for 2013), the NII surtax will be reported on, and paid with, Form 1041.*

**Additional Medicare Tax.** Qualified taxpayers with compensation (including self-employment compensation) received after December 31, 2012 and above certain threshold amounts are liable for Additional Medicare Tax. The threshold amount is \$200,000 in the case of a single individual, head of household (with qualifying person) and qualifying widow(er) with dependent child. The threshold amount is \$250,000 in the case of a married couple filing jointly and \$125,000 in the case of a married couple filing separately.

**IMPACT.** *The PPACA requires employers to withhold Additional Medicare Tax from wages paid to individuals in excess of \$200,000 in a calendar year, without regard to the individual's filing status or wages paid by another employer. In particular, the proposed reliance regs clarify that it is not the employer's responsibility to determine whether an employee and his or her spouse may reach the \$250,000 threshold for joint filers. As long as the employee's wages are more than \$200,000, additional 0.9 percent withholding is required by the employer.*

**COMMENT.** *Taxpayers cannot request withholding for Additional Medicare Tax. However, taxpayers can request that their employer withhold an additional amount of income tax withholding on Form W-4, which would be applied against taxes shown on their Form 1040, including any Additional Medicare Tax liability. A taxpayer may also choose to pay the 0.9 percent tax as part of quarterly estimated income tax payments.*

## INDIVIDUAL INCOME/ EXPENSES

Individual income tax issues cover a wide variety of circumstances. Notable 2012 developments in this area are representative of that diversity, covering issues that do not fall under a single theme but are significant to those taxpayers who may be touched by their reach.

**Equitable innocent spouse relief expanded.** The IRS revised in 2012 the threshold

requirements for equitable innocent spouse relief under Code Sec. 6015(f) (IR-2012-3, Notice 2012-8). It clarified the application of equitable factors, taking into account abuse and financial control by the non-requesting spouse, and also changed the evaluation of economic hardship. The IRS also provided for streamlined determinations.

**IMPACT.** *The IRS came under heavy criticism for its rejection of applications for equitable innocent spouse relief. The IRS previously eliminated the two-year statute of limitations on equitable relief. The new measures will make equitable relief more accessible to innocent spouses who do not qualify for other types of relief under Code Sections 6015(b) and 6015(c).*

**Final regs govern exclusion for personal injury/sickness payments.** The IRS issued final regs in 2012 (TD 9573) on the exclusion from gross income for amounts received on account of personal physical injury or physical sickness. The regs reflect a 1995 Supreme Court decision and the Small Business Jobs Protection Act of 1996 that require a direct link between the personal injury and the recovery. The regs eliminate a "tort test" that had based the exclusion on tort causes of action and remedies.

**IMPACT.** *Although the regs apply to damages received after January 23, 2012, taxpayers may apply the final regs to amounts*

*received after August 20, 1996, if the statute of limitations has not expired.*

**Income exclusion for restitution payments.** The Trafficking Victims Protection Act of 2000 requires courts to order defendants to pay restitution to victims for offenses such as kidnapping with intent to sell a person into slavery. The IRS explained that the restitution payments are not included in the victim's gross income (Notice 2012-12, January 2012).

**IMPACT.** *The full amount of any restitution payments may be excluded, including medical costs, transportation, temporary housing, child care, lost income, the value of services, and other cost related costs.*

**Interest deduction on co-owned personal residence limited.** The Tax Court concluded that two unmarried co-owners who owned two residences could not each deduct interest on \$1.1 million of personal residence debt (*Sophy*, 138 TC No. 8). Both taxpayers could only deduct interest incurred on a total of \$1.1 million of debt—\$1 million of acquisition debt and \$100,000 of home equity debt. The taxpayers had argued that they could deduct interest on \$2.2 million of debt because they were unmarried. The court rejected the argument that the debt limits applied per taxpayer, concluding that the limits applied with respect to any qualified residence of the taxpayer.

## TOP 10 TAX DEVELOPMENTS FOR 2012

The start of a New Year presents a time to reflect on the past 12 months and, based on that history, predict what may happen next. Here is a list of the top 10 developments from 2012 that may prove particularly important as we move forward into the New Year.

- Year-End Fiscal Cliff Legislation
- Supreme Court Upholds Affordable Care Act
- Repair and Capitalization Reg Deadlines
- Net Investment Income (NII) and Additional Medicare Tax Regs
- FATCA and FBAR
- Supreme Court's Tax Basis Limitation Decision
- Enhanced IRS Fresh Start Initiative
- Enhanced IRS Worker Classification Compliance Program
- IRS Whistleblower Awards and Regs
- IRS Return Preparer Oversight

**IMPACT.** *The decision may impact domestic couples and partners who jointly own property.*

**Dependency exemptions.** In *Carlebach*, 139 TC No. 1, the Tax Court upheld the IRS's determination that married taxpayers residing in Israel were not entitled to dependency exemption deductions because their children were not U.S. citizens. The couple claimed six dependency exemptions, which the IRS disallowed because the none of the children met the definition of qualifying child under Code Sec. 152 and its regs. The court found that Reg. §1.152-2(a)(1), which requires that the subject child be a U.S. citizen at some time during the relevant tax year, was valid.

**Casualty losses.** In a case of first impression, the Court of Federal Claims held that a taxpayer's failure to provide timely proof of loss to his insurance company did not prevent him from deducting the loss under Code Sec. 165(h)(5)(E) (*Ambrose*, 2012-2 USTC ¶50,518). The IRS had disallowed the loss because the taxpayer did not timely file an insurance claim. The court found that the statute did not define "files a timely insurance claim" and the statute merely requires a basic demand for compensation.

**COMMENT.** *The Claims Court announced its decision before Hurricane Sandy hit the east coast of the United States. The IRS is anticipating a large number of casualty losses from the catastrophe.*

## RETIREMENT

With people living longer, an increased emphasis is being placed upon retirement savings strategies to better provide a longer retirement. A number of developments in 2012 fostered that goal in different ways.

**Deferred retirement payout options recommended.** The Treasury Department and the IRS proposed a comprehensive package of guidance to increase the number of available retirement payout options (NPRM

REG-115809, NPRM REG-110980, Rev. Rul. 2012-3, Rev. Rul. 2012-4 (February 2012)). Proposed regs would encourage defined benefit plans to allow participants to take a partial lump sum and a partial annuity, instead of having to make a cash or annuity decision upon retirement. Other regs would promote deferred longevity annuities for people age 80 or even older, modifying the required minimum distribution rules to facilitate a purchase of a deferred annuity and to help participants hedge the risk of drawing down their benefits too quickly and outliving their retirement savings in the process. Revenue rulings clarified how the spousal protection rules would apply to longevity annuities and how defined benefit plan participants can purchase annuities.

**2013 COLA Limits.** The IRS announced the 2013 cost-of-living adjustments (COLAs) for qualified plans in October (IR-2012-77). Many retirement plan contribution and benefit limits will increase slightly in 2013.

**COMMENT.** *The limitation for defined contribution (DC) plans increases from \$50,000 for 2012 to \$51,000 for 2013. The annual benefit limit under a Code Sec. 415(b)(1)(A) defined benefit (DB) plan increases from \$200,000 for 2012 to \$205,500 for 2013. The limits on elective deferrals for employees who participate in 401(k), 403(b), certain 457*

*plans, and the federal government's Thrift Savings Plan, increase from \$17,000 for 2012 to \$17,500 for 2013.*

**Normal retirement age—governmental plans.** The IRS announced in 2012 plans for future guidance on the applicability of the normal retirement age (NRA) rules under Code Secs. 401(a) and 411(a)(8) to governmental plans (Notice 2012-29). The IRS intends to clarify that a governmental pension plan does not need a definition of "normal retirement age" to make in-service distributions to certain employees and would also provide a lower normal retirement age for plans whose participants were substantially all qualified public safety employees.

**IMPACT.** *The IRS explained that proposed regs would provide that a governmental pension plan does not need a definition of NRA to make distributions to employees who have reached retirement or age 62 but have not yet left employment. Proposed regs would also allow an NRA of 50 under a governmental plan in which substantially all of the participants are qualified public safety employees, whether or not the employees are covered by a separate plan.*

**Form 8955-SSA/automatic extension.** The IRS issued proposed reliance regs for automatic extensions of time to file Form 8955-

### 2012 AND 2013 DOLLAR LIMITS

IRAs	2012	2013
IRA Contribution Limit	\$5,000	\$5,500
IRA Catch-Up Contributions	1,000	1,000
<b>Traditional IRA AGI Deduction Phase-out Starting at</b>		
Joint Return	92,000	95,000
Single or Head of Household	58,000	59,000
<b>401(k), 403(b), Profit-Sharing Plans, etc.</b>		
Annual Compensation - 401(a)(17)/404(l)	250,000	255,000
Elective Deferrals - 402(g)(1)	17,000	17,500
Defined Contribution Limits - 415(c)(1)(A)	50,000	51,000
Social Security Taxable Wage Base	110,100	113,700

SSA, Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits (NPRM REG-153627-08, June 2012). Under Code Sec. 6057(a), plan administrators of a plan subject to the vesting standards of ERISA that file a registration statement must submit the reporting information on Form 8955-SSA.

**IMPACT.** *The proposed regs would apply the same rules to a request for an extension of time to file Form 8955-SSA that apply to a similar request for filing the Form 5500 series. In other words, a signature from a plan administrator, employer, plan sponsor, or any other individual or authorized representative would not be required to request an extension of time to file either a Form 5500 series or Form 8955-SSA.*

**IRA exempt from bankruptcy estate.** The Fifth Circuit Court of Appeals affirmed a federal district court and concluded that an inherited individual retirement account was exempt from a bankruptcy estate (*Chilton, CA-5*, 2012-1 USRC ¶150,250). A bankruptcy court had found that the funds were retirement funds to the creator of the IRA but not to the party that inherits the IRA. The couple that inherited the IRA did not contribute any additional assets to the IRA. The district court reversed the bankruptcy court, and the Fifth Circuit court affirmed. The Fifth Circuit cited several decisions concluding that an inherited IRA retained its status as retirement funds under the Bankruptcy Code.

**IMPACT.** *The decision protects an inherited IRA from the creditors of the bankrupt individual.*

## ESTATE PLANNING

*Estate planning has been in a state of flux for several years as the ultimate fate of the estate and gift tax was uncertain. In 2012, the lifetime estate and gift tax exclusion was at an all time high. This prompted many gift-giving strategies. The American Taxpayer Relief Act has set a permanent estate and gift tax unified*

*exclusion (and generation-skipping transfer tax (GST) exemption) at \$5 million, adjusted annually for inflation, and a permanent rate of 40 percent on any excess for 2013 and beyond. The American Taxpayer Relief Act also made permanent the concept of portability, which allows the estate of a decedent who is survived by a spouse to make a portability election to permit the spouse to apply the decedent's unused exclusion to the spouse's own transfers during life and at death.*

“Employers immediately need to take steps to comply with requirements in the health care reform law that go into effect in 2013. Employers also need to use 2013 to prepare for major requirements that go into effect starting in 2014.”

**Election.** The IRS issued temporary and proposed regs on the portability election (TD 9593, NPRM REG-141832-11 (June 2012)). The regs generally require the portability election to be made on a timely filed Form 706, whether or not estate tax is due.

**IMPACT.** *Unlike the estate tax marital deduction, which effectively defers tax on the death of the first spouse, portability provides a permanent benefit for married couples. Moreover, the surviving spouse can claim the unused exclusion against transfers during life and death.*

**Trust and estate donations.** The IRS issued final regs that, in order to be recognized for federal tax purposes, an ordering provision in a trust, will, or provision of local law for payments to charitable beneficiaries must have economic effect independent of income tax consequences (TD 9582 (April 2012)).

**IMPACT.** *The final regs reiterate the IRS's view that a specific provision in a governing instrument or in local law that identifies the source(s) of the amounts to be paid, permanently set aside, or used for a purpose specified in Code Sec. 642(c), must have economic effect independent of income tax consequences for the specific provision in the governing instrument or in local law to be respected for federal tax purposes. The IRS set out this view in the proposed regs and declined to abandon it in the final regs.*

## BUSINESS ENTITIES

The IRS was busy during 2012 providing guidance for business entities. Cancellation of indebtedness income within the partnership structure, as well as earnings and profit allocations and loss deferrals in controlled groups, were among the issues targeted by the IRS in 2012 guidance.

**Partnership nonrecourse debt.** The IRS determined that for purposes of measuring a partner's insolvency under Code Sec. 108(d)(3), each partner treats as a liability an amount of the partnership's discharged excess nonrecourse debt that is based upon the allocation of cancellation of indebtedness (COD) income to the partner under Code Sec. 704(b) (Rev. Rul. 2012-14 (May 2012)). This guidance extended the general rules of COD in Rev. Rul. 92-53 into the partnership arena using Code Sec. 704(b) allocation principles.

**COMMENT.** *The use of allocation strategies by partnerships is a trend that began to increase only recently. As such, the IRS has not updated its initial COD guidance in Rev. Rul. 92-53. The economic downturn, which precipitated many underwater assets, particularly in investment-structured partnerships, also accelerated the need for further guidance. Notably, the IRS avoided direct mention of Code Sec. 752 debt allocations in Rev. Rul. 2012-14, even though it was the principal alternative allocation regime that was available for IRS approval. Such*

*an allocation method would generally be less favorable for most partners.*

**Publicly traded partnerships.** The IRS issued a revenue procedure outlining a safe harbor under which it will not challenge a determination by a publicly traded partnership (PTP) that income from discharge of indebtedness (COD income) is qualifying income (passive-type income) under Code Sec. 7704(d) (Rev. Proc. 2012-28 (June 2012)). To benefit from the safe harbor, the COD income must result from debt incurred in activities that produce qualifying income. The safe harbor applies to PTPs that use the qualifying income exception in Code Sec. 7704(c) to avoid corporate treatment under Code Sec. 7704(a).

**IMPACT.** *If COD income is attributable to debt incurred in direct connection with activities of the PTP that generate qualifying income (qualifying activities), the IRS will not challenge a PTP's determination that COD income is qualifying income for purposes of Code Sec. 7704(d). A PTP may show that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities by any reasonable method. The IRS announced that it will consider a request for a private letter ruling on whether a method is reasonable. Rev. Proc. 2012-28 is effective for COD income of a publicly traded partnership to debt discharged on or after June 15, 2012.*

**Earnings and profits in tax-free reorgs.** The IRS issued proposed regs (NPRM REG-141268-11 (April 2012)) that would prevent the shifting of earnings and profits (E&P) from one corporation to another in certain tax-free reorganizations. The proposed regs clarify that unless Code Sec. 381(a) applies (allowing carryovers of attributes in certain corporation acquisitions), or regs under Code Sec. 312 apply (regarding divisive reorganizations), no E&P would be allocated on a transfer of property.

**Deferral of losses for controlled groups.** In April 2012, the IRS issued final regs (TD 9583) that require the deferral of losses on

a sale or exchange of property (including stock) between members of a controlled group. The regs generally allow the loss to be recognized when the seller and the buyer are no longer members of the same controlled group.

**COMMENT.** *While Code Sec. 267(a)(1) denies losses on the sale of property between related persons, Code Sec. 267(f)(2) contains an exception that provides for the deferral of the loss if the sale is between members of a controlled group. The primary issue is when the deferred loss can be recognized. The IRS rejected a comment that proposed applying arm's-length principles and accelerating the recognition of the loss, as provided in the transfer pricing regs.*

**Banks were not partners.** The Second Circuit Court of Appeals reversed a federal district court and concluded that foreign investors in a U.S. partnership were lenders, not partners (*TIFD III-E, Inc.*, 2012-1 USTC ¶50,167). The foreign investors had a guaranteed return, no real risk of loss, and no interest in profits from partnership assets. The partnership was designed to allocate partnership economic income to its U.S. partners, while allocating taxable income to the foreign investors, who were exempt from U.S. taxes, the Second Circuit found.

**IMPACT.** *The Second Circuit applied a totality-of-the-circumstances test to conclude that the banks held debt, not equity. As a result, the partnership's taxable income that was allocated to the investors had to be reallocated to the partnership's U.S. partners and was subject to U.S. taxes.*

## EMPLOYER/EMPLOYEE RELATIONSHIPS

Tax issues arising from the employer/employee relationship carve out a special niche for many business operations. Among these, worker misclassification, severance payments, and deferred compensation issues were important in 2012.

**Employment tax classification settlement.** The IRS revised and temporarily expanded its Voluntary Classification Settlement Program (VCSP) that enables employers to rectify past misclassification of employees as independent contractors at a reduced cost (Ann. 2012-45, 46 (December 2012)). The temporary expansion of the VCSP allows an additional group of employers until June 30, 2013 to take advantage of VCSP benefits.

**IMPACT.** *The expanded VCSP program gives many more employers that have incorrectly treated workers as independent contractors a chance to get a fresh start with the IRS at a reduced cost. As long as the employer is not currently being audited by the IRS on an employment tax issue, the employer can qualify. The employer must then file Forms 1099 for the past three years, pay a penalty, pay 25 percent of employer-based employment taxes on wages from the most recent year, and then prospectively treat the workers as employees.*

**Worker classification—farm workers.** In *Twin Rivers Farm*, TC Memo. 2012-184, CCH Dec. 59,107(M), the Tax Court found that farm workers were employees of an S corp and not independent contractors. The workers lived on the farm, groomed horses and performed other duties. The Tax Court found that the S corp owner exercised control over the activities of the workers, and that the workers used equipment provided by the S corp. All these factors indicated that the farm workers were employees and not independent contractors, the Tax Court held.

**Worker classification—masonry workers.** In *Atlantic Coast Masonry, Inc.*, TC Memo. 2012-233, CCH Dec. 59,160(M), the Tax Court found that workers performing masonry for an S corp were employees and not independent contractors. The S corp controlled the masons' work, could discharge the masons, and could set the hours and rates of pay. All these factors indicated that the masons were employees and not independent contractors, the Tax Court concluded.

**Worker classification—bank trustee.** The Tax Court found that an individual who served on the board of trustees of a community bank was an independent contractor and not an employee of the bank *Blodgett, Jr.*, *TC Memo. 2012-298*, CCH Dec. 59,234(M). Although the trustee technically reported to a higher governing body, that group exercised almost no control over the work of the trustee and indeed had never removed a trustee, the Tax Court held.

**Severance payments.** The Sixth Circuit Court of Appeals found that supplemental unemployment benefit (SUB) payments were not wages for FICA purposes (*In re Quality Stores, Inc.*, 2012-2 USTC ¶50,551). According to the Sixth Circuit, prior IRS rulings were inconsistent with the statute. The Sixth Circuit and the Federal Circuit have reached different conclusions. In *CSX v. U.S.*, 2008-1 USTC ¶50,218, the Federal Circuit followed the IRS's approach in Rev. Rul. 90-72 where the IRS determined that SUB payments would generally be subject to FICA taxes.

**IMPACT.** *The decision potentially opens the door to significant refund claims. The issue may ultimately be decided by the U.S. Supreme Court.*

**Substantial risk of forfeiture rules.** Proposed regs would tighten the definition of a substantial risk of forfeiture (SRF) that applies to compensatory transfers of property in connection with the performance of services under Code Sec. 83 (NPRM REG-141075-09 (June 2012)). As a result, fewer restrictions would qualify as a SRF.

**IMPACT.** *Employers with deferred compensation plans and executives who benefit from them should keep on eye on these proposed regs. The proposed changes would narrow the circumstances in which income could be deferred under Code Sec. 83. The proposed regs would eliminate an exclusive "facts and circumstances" test to determine whether a substantial risk of forfeiture exists.*

**Tips and service wages.** The IRS clarified and updated guidance in 2012 for its examiners on how to differentiate between

employee tips, which can make an employer eligible for a tax credit for taxes paid under the Federal Insurance Contribution Act (FICA), and service charges, which are treated as wages subject to payroll taxes (Ann. 2012-25, Rev. Rul. 2012-18).

**IMPACT.** *The IRS instructed its examiners to apply the four-factor test listed in Rev. Rul. 2012-18 (the same test as in Rev. Rul. 59-252) to determine if payments are tips or service charges.*

**COMMENT.** *In Ann. 2012-50, the IRS extended until on or after January 1, 2014 the time for taxpayers to comply with the proper treatment of service charges under Rev. Rul. 2012-18. The relief is intended to give businesses not currently in compliance additional time to amend their business practices.*

## TRAVEL & ENTERTAINMENT EXPENSES

Business transportation and meal expenses, because of the strict requirements imposed under the Tax Code for their deductibility, generally can be counted on to generate more than their share of tax developments each year. 2012 was no exception. Not only were the usual, annual mileage and depreciation limits set in 2012, but proposed new rules were issued for local lodging expenses and meal and travel reimbursement arrangements. Final regs were also released on the extent to which an employer may deduct the entertainment use of aircraft by certain employees.

**Standard mileage rates.** The optional business standard mileage rate for 2013 is 56.5 cents per mile, the IRS announced (IR-2012-95, Notice 2012-72 (October 2012)). This reflects a one cent increase from the 2012 business standard mileage rate. The depreciation component of the business standard mileage rate is 23 cents per mile, which reflects no change from 2012.

The IRS also announced that the medical/moving mileage rate is 24 cents per mile for

2013, which also reflects an increase of one cent over the 2012 rate.

**IMPACT.** *The IRS works with an independent contractor to establish the business, medical and moving expense standard rates. The IRS and the independent contractor take into account the fixed and variable costs of operating an automobile, such as fuel costs and maintenance expenses.*

**COMMENT.** *Taxpayers also have the option to use the actual expense method. The business standard mileage rate is designed to help simplify recordkeeping.*

**COMMENT.** *The charitable mileage rate is set by statute and not by the IRS. The charitable rate for 2013 is 14 cents per mile, which is unchanged from 2012. Several bills have been introduced in Congress to increase the charitable rate but have not passed.*

**2012 vehicle depreciation limits.** The IRS issued limitations on depreciation deductions for owners of passenger automobiles, light trucks, and vans first placed in service during calendar year 2012 (Rev. Proc. 2012-23 (March 2012)). Generally, the limits are \$100 more than the 2011 limits.

For passenger automobiles first placed in service during the 2012 calendar year, the maximum depreciation limits under Code Sec. 280F are \$11,160 for the first tax year (\$3,160 if bonus depreciation is not taken); \$5,100 for the second tax year; \$3,050 for the third tax year; and \$1,875 for each tax year thereafter.

For trucks and vans first placed in service during the 2012 calendar year, the maximum depreciation limits are \$11,360 for the first tax year (\$3,360 if bonus depreciation is not taken); \$5,300 for the second tax year; \$3,150 for the third tax year; and \$1,875 for each year thereafter.

**Per diem rates.** The IRS announced that the high-low per diems for 2013 would remain unchanged. The per diem for high-cost localities is \$242 and \$163 for all other localities (Notice 2012-63).

**COMMENT.** *The IRS-approved per diem rates are generally in line with the federal per diem rates approved by the General Services Administration (GSA) for travel within the continental United States by federal government employees on official business. GSA has frozen the 2013 rates in response to a White House directive that federal agencies spend at least 30 percent less on travel expenses.*

**Local lodging expenses deduction.** The IRS issued proposed reliance regs (NPRM REG-137589-07 (April 2012)) allowing an employee to treat local lodging expenses as working condition fringe benefits or accountable plan reimbursements. Current regs generally disallow deductions for local lodging expenses, calling them personal rather than business expenses. The proposed reliance regs provide a new safe harbor for local lodging expenses that would otherwise be considered ordinary and necessary business expenses under Code Sec. 162(a).

**IMPACT.** *Since the regs may be relied upon immediately, businesses should consider revising their travel policies. The IRS explained that the proposed reliance regs state that certain local lodging expenses would be deductible, for example, where an employer required its employees to stay at a local hotel for the bona fide purpose of facilitating training or team building that was directly connected with the employer's trade or business. Under such circumstances, the cost of the lodging would be considered primarily for the employers' business purposes.*

**COMMENT.** *The cost of the lodging would be deductible by an employee under Code Sec. 162 if the employee paid the cost directly. Thus the value of the lodging could be excluded from the employee's gross income as a working condition fringe if other requirements are satisfied. Similarly, a payment from the employer reimbursing the employee for the cost of the lodging may be excluded from the employee's gross income as a payment under an accountable plan, if all the requirements of an accountable plan are met.*

**Meal and travel expense reimbursement arrangements.** The IRS issued proposed reliance regs intended to clarify application of the general rule that limits a deduction for most meal and entertainment expenses to 50-percent of an otherwise allowable amount (NPRM REG-101812-07 (August 2012)). The proposed reliance regs specify who is subject to the 50-percent limit under the Tax Code in situations involving the exception to the 50-percent limit under Code Sec. 274(e)(3) for amounts paid or incurred under reimbursement or expense allowance arrangement. The IRS explained that taxpayers may apply the regs for tax years beginning before the date the regs are finalized for which the period of limitations under Code Sec. 6511 has not expired.

**COMMENT.** *The proposed reliance regs, among the many issues they address, reflect the Eighth Circuit's decision in *Transport Labor Contract/Leasing, Inc.*, 2006-2 USTC ¶150,478. In that case, which involved a corporation in the business of leasing drivers to trucking companies, the Tax Court applied the Code Sec. 274(n) limitation to the taxpayer as the drivers' common law employer. The Eighth Circuit reversed the Tax Court and found that the taxpayer's reimbursement arrangement with its clients enabled it to claim a reimbursement arrangement exception under Code Sec. 274(e).*

**Aircraft.** The IRS finalized regs (TD 9597 (August 2012)) on the employer deduction limit for entertainment use of aircraft by specified individuals. The final regs, which generally track proposed regs issued in 2007, effectively limit the deduction in many cases.

**Meals to airline crews.** In 2012, IRS Chief Counsel concluded that only 50 percent of meals provided by an airline to its crew members working on plans are deductible by the airline, rather than 100 percent, even though the meals are totally excluded from the employees' income (CCA 201151020). Chief Counsel determined that the meals had to qualify as de minimis fringe benefits to avoid the 50 percent limitation in Code Sec. 274(n).

## OTHER BUSINESS DEDUCTIONS/CREDITS

**Bona fide shareholder loans.** The IRS issued proposed regs providing that S corp shareholders increase their basis in the S corp, for indebtedness of the S corp to the shareholder, only if the indebtedness is bona fide (NPRM REG-134042-07 (June 2012)). The proposed regs are intended to clarify the requirements for increasing basis of indebtedness and to assist S corp shareholders in determining with greater certainty whether their arrangement creates basis of indebtedness.

**New Markets Tax Credit.** The IRS issued final regs in September (TD 9600) on the New Markets Tax Credit (NMTC). The proposed regs address investment in non-real estate businesses in lower income communities.

**COMMENT.** *The American Taxpayer Relief Act extended the NMTC retroactively to 2012 and through 2013.*

**RICs/REITs transfers.** Proposed regs under Code Sec. 337(d) (NPRM REG-139991-08 (April 2012)) would generally except certain transfers of property from a C corporation to a Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT) from gain recognition. This would affect certain transfers of property by a tax-exempt entity to a RIC or REIT. The proposed regs also would except certain transfers of like-kind property or involuntary conversions that would qualify for non-recognition treatment under Code Sec. 1031 or 1033.

**COMMENT.** *The IRS cautioned that this treatment would not be extended to all exchanged basis transactions. Creating a blanket exemption, the IRS predicted, would create opportunities to avoid corporate-level tax on built-in gains.*

**Medical marijuana.** In *Olive*, 139 TC No. 2, CCH Dec. 59,146, the Tax Court found that a medical marijuana dispensary was engaged in trafficking in a controlled substance and was not entitled to deduct expenses for operating the business. The court also found

that the taxpayer could not deduct the expenses as care giving expenditures.

## ACCOUNTING/ CAPITALIZATION/ EXPENSING

Accounting issues frequently involve significant dollars. One of the most important developments in the accounting area actually occurred at the end of 2011, when the IRS issued temporary “repair” regs that were effective at the beginning of 2012. There have been a number of related developments since then, culminating with the postponement of the effective date of the 2011 repair regs until January 1, 2014. The IRS also issued important guidance under the Code Sec. 263A uniform capitalization rules.

**Repair regs.** The IRS issued much-anticipated temporary and proposed regs on the capitalization of expenditures relating to tangible property in December 2011 (TD 9564; NPRM REG-168745-03). At that time, the temporary regs were slated to be effective for tax years beginning on or after January 1, 2012.

The IRS announced in October 2012 that it would delay the application of the repair regs for two years. The final regs therefore will apply to tax years beginning on or after January 1, 2014. The agency further explained that it expects to issue final repair regs in 2013. The IRS also announced its intention to amend the temporary regs to delay their effective date until tax years beginning on or after January 1, 2014, while permitting taxpayers to apply the temporary regs or the final regs to tax years beginning on or after January 1, 2012.

**IMPACT.** *The regs are known as “repair regs,” but impact much more than repairs. The repair regs potentially impact all businesses (regardless of business form or size).*

**COMMENT.** *When the IRS issued the temporary regs in 2011, the agency also released Rev. Proc. 2012-19 and Rev. Proc. 2012-20, giving taxpayers two*

*years to file automatic consent method changes to comply with the temporary regs. Taxpayers applying the temporary regs in 2012 or 2013 may continue to obtain automatic IRS consent to change their method of accounting under Rev. Procedures. 2012-19 and 2012-20. The IRS reported that it expects to publish additional revenue procedures so that taxpayers can obtain automatic consent to apply the final regs before 2014. Rev. Proc. 2012-19 deals with the primary issue of repairs versus capitalizable costs, including de minimis costs, materials and supplies, and costs of acquiring property. Rev. Proc. 2012-20 addresses changes under the depreciation rules of Code Sections 167 and 168, including general asset account treatment.*

**Audits of capitalization issues temporarily suspended.** In 2012, the IRS’s Large Business and International Division (LB&I) issued a directive to its examiners instructing them to cease conducting examinations of issues involving capitalization of costs related to tangible property (LB&I-4-0312-004). The directive applies to both current examinations and new examinations of issues for tax years beginning before January 1, 2012, which was initially the effective date of temporary regs issued at the end of December 2011.

**IMPACT.** *The directive provides taxpayers with a two-year grace period to comply with the repair regs by adopting appro-*

*priate methods of accounting provided in Rev. Procs. 2012-19 and -20.*

**Uniform capitalization.** The IRS issued proposed regs intended to clarify the “simplified methods” for determining inventory costs under the Code Sec. 263A uniform capitalization rules (NPRM REG-126770-06 (September 2012)). The simplified methods are exceptions to allocating costs to specific items of property.

## EXEMPT ORGANIZATIONS

As the federal government continues to look for additional revenue, scrutiny of exempt organizations has increased. Along with more rigorous audits of exempt organizations to varying degrees, the Treasury Department and IRS have stepped up issuing guidance, as well as increasing litigation efforts.

**Final regs on public inspection of documents.** The IRS issued final regs providing for the public inspection of applications and supporting documents of organizations seeking tax-exempt status (TD 9581, February 2012). However, the final regs preclude from public inspection any document relating to an application for exemption before the IRS makes a determination.

**UBIT on community association’s facilities.** The Fourth Circuit Court of Appeals affirmed a Tax Court decision that a tax-

## 2012 TAX DEVELOPMENTS – BY THE NUMBERS

The number of tax developments in 2012 far exceeded those highlighted in this Tax Briefing. Developments have been selected based upon their particular impact on a broad cross-section of taxpayers. The selection is by no means comprehensive. The following chart lists the number of 2012 tax developments reported by CCH during 2012 in each of the following selected categories:

Tax Court Regular and Memo Decisions: .....	529
District and Appellate Court Decisions: .....	625
Treasury Decisions and Prop Reg Projects: .....	79
IRS Notices, Revenue Rulings and Procedures: .....	162
IRS Letter Rulings, TAMs, CCAs and E-mailed Advice: .....	1680
IRS Announcements and News Releases: .....	153

exempt homeowner's association had unrelated business taxable income (UBTI) on income from a beach club for homeowners only and from parking lots (*Ocean Pines Association, Inc.*, CA-4, 2012-2 USTR ¶50,225). The Fourth Circuit concluded that the activities were not substantially related to the association's tax-exempt purpose of promoting social welfare under Code Sec. 501(c)(4). A social welfare organization does not serve the people of the community (the general public) if it operates for the exclusive benefit of its members and denies its benefits to the general public. Because the beach facilities were only available to members of the association, the facilities did not benefit the general public.

**IMPACT.** *The decision follows a line of cases requiring that facilities with limited access do not contribute to the social welfare of the general public.*

**Program-related investments.** The IRS released proposed reliance regs that provide new examples illustrating investments that qualify as program-related investments (PRIs) under the private foundation rules (NPRM REG-144267, April 2012).

**IMPACT.** *The new examples show that a PRI may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts. The examples also demonstrate that an investment that funds activities in one or more foreign countries, including investments that alleviate the impact of a natural disaster or that fund educational programs, may further the accomplishment of charitable purposes and qualify as a PRI.*

## DOMESTIC COMPLIANCE MEASURES

*As it has done in recent years, the IRS emphasized compliance measures to enhance tax collection. The IRS made some taxpayer-friendly changes to its Fresh Start initiative, moved forward with information reporting rules and made some substantial awards to*

*tax whistleblowers. The U.S. Supreme Court also announced an important decision in the dispute over whether a basis overstatement constituted an omission of income for statute of limitations purposes.*

**Fresh Start initiative.** The IRS announced enhancements to its Fresh Start initiative, which provides relief to taxpayers hurt by the economy (IR-2012-31, March 2012). The IRS had previously modified its lien policies and expanded the availability of streamlined installment agreements. The 2012 enhancements raised the threshold from \$25,000 to \$50,000 for an agreement without having to provide a financial statement. The maximum term of streamlined installment agreements increased from 60 to 72 months.

**Penalty relief.** The IRS also provided penalty relief for 2011 returns. Qualifying taxpayers were entitled to a six-month grace period for failing to pay their taxes by the initial filing date of April 17, 2012. Taxpayers qualified if they owed \$50,000 or less for 2011, if their income did not exceed thresholds of \$100,000 for single taxpayers and \$200,000 for married taxpayers, and if they were unemployed for at least 30 consecutive days or experienced a 25-percent or greater reduction in self-employment income.

**Limitations/basis overstatement.** In 2012, the Supreme Court resolved a longstanding split among the circuit courts of appeals over whether or not an overstatement of basis resulted in an omission of income. In *Home Concrete & Supply, LLC, Sup. Ct.*, 2012-1 USTR ¶50,315, the Supreme Court concluded that an overstatement of basis does not result in an omission of income for statute of limitations (SOL) purposes. As a result, the IRS has three years, rather than six, to act against taxpayers that overstate basis.

**IMPACT.** *Essentially, the Supreme Court ruled that a decision dating from before the Treasury Department and the IRS issued regs on the issue controlled. This could affect the Treasury Department's ability to promulgate authoritative regs interpreting the Tax Code in the future.*

*In the meantime, taxpayers have gained a victory. Omission of income may occur when a taxpayer leaves out receipts or accruals of interest or other such items, but if it overstates its basis in property (thus leading to a lower portion of taxable income upon sale of that property), the IRS has far less time to take action.*

**Broker reporting/debt instruments.** The IRS delayed the effective date for cost basis reporting of debt instruments and options by brokers and others (Notice 2012-34, May 2012). Reporting will be required for debt instruments and certain options acquired on or after January 1, 2014 rather than January 1, 2013.

**IMPACT.** *Over the past several years, the IRS has expanded certain reporting requirements for brokers under Code Sec. 6045, which would have required brokers to report the cost basis of debt instruments and options to the IRS as of January 1, 2013. Brokers should note, however, that the due date has been extended until January 1, 2014 only for debt instruments and options.*

**Basis information reporting: Form 8937.** In January 2012, the IRS issued Form 8937, Report of Organizational Actions Affecting Basis of Securities, for corporations to file when reporting any organizational action (such as a stock split or merger) that affects the basis of stock. The IRS previously set a transitional deadline of January 17, 2012 for corporations to begin reporting organizational actions. Otherwise, companies must file Form 8937 within 45 days after the date of the action. Alternatively, the corporation can post the information on its primary web site by the filing date.

**Electronic Schedule K-1 procedures released.** The IRS issued procedures for partnerships to furnish Schedule K-1 electronically (IR-2012-21, Rev. Proc. 2012-17, February 2012). Recipients must affirmatively consent to receive the form electronically. The IRS provided several examples of how Schedule K-1 may be furnished electronically.

**IMPACT.** *Every partnership must complete, file and send to each partner a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. Providing the forms electronically can streamline the process and save costs for the partnership. Before the IRS issued guidance, firms that issued Schedule K-1s electronically did so under a hodge-podge of rules*

**Whistleblower regs.** The IRS issued final regs on whistleblower awards made under the Tax Relief and Health Care Act of 2006 (TD 9580, February 2012). The 2006 Tax Relief Act enhanced the program by providing for mandatory awards in certain cases.

**IMPACT.** *In 2012, the IRS paid out multimillion-dollar rewards to several high-profile whistleblowers, including a former employee of a foreign bank. This individual received \$104 million, the largest award ever made through the program.*

**IMPACT.** *The IRS and many lawmakers are taking the position that it is especially important to encourage truthful tax reporting among large corporations and financial institutions during this time of fiscal challenges. Businesses have been encouraged to set up internal programs to uncover wrongdoing and deal with it before it reaches the IRS.*

**Whistleblower program regs.** The IRS also issued comprehensive proposed regs on the whistleblower program, describing the rules for filing claims for awards along with details about whistleblower administrative proceedings (NPRM REG-141066-09, December 2012). These proposed regs also define key terms and provide guidance on the determination and payment of awards.

**Whistleblower litigation.** In a case of first impression, the Tax Court found that it could not order the IRS to reopen a whistleblower's claim where the whistleblower had alleged that the IRS did not initiate an administrative or judicial action or collect proceeds (*Cohen*, 139 TC No. 12, CCH Dec. 59,220). The IRS had determined that the

whistleblower was ineligible for a reward and the taxpayer had no remedy in the Tax Court.

**COMMENT.** *The Tax Court previously found that it could not order the IRS to commence a whistleblower action (Cooper, 135 TC 70, CCH Dec. 58,265).*

**Deportation for tax offense.** The Supreme Court upheld lower court decisions that the convictions of two married Japanese citizens under Code Sec. 7206(1) for filing a false return were aggravated felonies for which they could be deported (*Kawashima v. Holder*, S.Ct., February 21, 2012). The couple had lived and worked in the U.S. since 1984. The Tax Court rejected taxpayers' arguments that their convictions did not involve fraud or deceit, and that their conduct did not rise to the level of an aggravated felony.

**Low-income housing tax credit.** The IRS finalized regs on the low-income housing tax credit (LIHTC) to address the Code Sec. 42(h)(6)(F) provisions relating to a request from a building owner to a state low-income housing tax credit allocating agency to find a buyer for a low-income housing development (TD 9587, May 2012). The property owner might make such a request so it can exit the long extended low-income housing commitment. If no buyer materializes within a year of the request, the owner would no longer be subject to the low-income housing and rent restriction requirements. The regs apply to owner requests to state low-income housing tax credit agencies that are made on or after May 3, 2012.

**IMPACT.** *The final regs, the IRS explained, are intended to answer industry questions on the requirements of the qualified contract process centering around how state agencies and building owners should calculate the acquisition price of the property for purposes of the qualified contract.*

## FOREIGN COMPLIANCE MEASURES

IRS compliance and enforcement activities in 2012 focused on income earned abroad in

financial dealings of individuals (foreign accounts and assets) and in foreign operations of U.S. businesses. The primary focus was on foreign accounts and assets of U.S. taxpayers, involving the relatively new Foreign Account Tax Compliance Act, as well as FBARs (Report of Foreign Bank and Financial Accounts). Other significant measures involved foreign tax credits, transfer pricing, and U.S. accounts of nonresident aliens.

**Foreign Account Tax Compliance Act (FATCA).** The far-reaching FATCA statute was enacted in 2010 as part of the Hiring Incentives to Restore Employment Act. FATCA expands reporting and withholding requirements to combat noncompliance by U.S. taxpayers with foreign accounts. Because of the sweep of FATCA reporting, the law is being phased in over several years.

**Comprehensive proposed regs.** The IRS issued comprehensive proposed regs to implement the requirements of FATCA (IR-2012-15, NPRM REG-121647-10, February 2012). The proposed regs apply to foreign financial institutions (FFIs), other foreign entities, and U.S. withholding agents who must identify foreign accounts owned by U.S. taxpayers, report information to the IRS on those accounts, and withhold taxes of 30 percent on noncompliant accounts.

**IMPACT.** *The proposed regs are nearly 400 pages long. The IRS took comments from practitioners and industry groups seriously and tried to make the rules as administrable as possible. For example, the proposed regs provide a phased-in compliance schedule.*

**FATCA model agreements.** The Treasury Department released in 2012 model agreements to implement FATCA. Model Agreement I establishes a framework for reporting by FFIs of certain account information, followed by an automatic exchange of information between the governments of the U.S. and the foreign jurisdiction. Model Agreement II provides for direct reporting by FFIs to the IRS about U.S.-owned accounts, supplemented by information exchanged between foreign government and the U.S.

**IMPACT.** *Treasury reported in late 2012 that it is engaged in discussions with more than 50 foreign jurisdictions about implementing FATCA. The U.S. has signed FATCA agreements with, among other countries, United Kingdom, Denmark, Norway and Mexico. The model agreements are intended to enable FFIs to comply with FATCA without violating their own countries' privacy and nondisclosure rules.*

**FATCA due diligence.** The IRS announced new deadlines for withholding agents and foreign financial institutions (FFIs) to satisfy due diligence requirements for their accounts under FATCA (Ann. 2012-42 (October 2012)). Requirements slated to take effect in 2013 will not apply until 2014.

**FATCA foreign asset reporting (Form 8938).** FATCA requires taxpayers to report information to the IRS when the value of their foreign assets exceeds applicable filing thresholds. The IRS developed Form 8938 for this purpose. The instructions to Form 8938 (January 2012) describe specified individuals, specified foreign financial assets, filing thresholds, and exceptions to filing.

**IMPACT.** *Only individuals are required to file Form 8938, but the IRS reported that it anticipates issuing regs to require domestic entities to file the form. Form 8938 does not relieve a taxpayer from filing an FBAR if the taxpayer must file an FBAR.*

**FATCA Form W-8BEN.** In June 2012, the IRS released revised drafts of withholding forms (Form W-8BEN, Form W-8BEN-E) for foreign taxpayers and intermediaries that must disclose information about their foreign status for U.S. withholding purposes.

**FATCA Form W-8IMY.** In August 2012, the IRS released a draft of Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Withholding which generally requires foreign organizations to self-identify and self-certify their FATCA status. Form W-8IMY applies to payments of U.S.-source fixed or determin-

able annual or periodic (FDAP) payments, such as rents or royalties, made to foreign intermediaries. The draft form included FATCA certifications that must be made to avoid 30 percent withholding.

**2012 OVDP:** The IRS reopened its offshore voluntary disclosure program (OVDP) in 2012 (IR-2012-5). The revived program follows on the heels of similar initiatives for 2009 and 2011. The 2012 program generally imposes a higher penalty than the previous programs. Certain taxpayers may qualify for reduced penalties.

**IMPACT.** *The IRS reported in early 2012 that it had obtained 33,000 voluntary disclosures and collected \$4.4 billion from the 2009 and 2011 programs, with more revenues expected from future disclosures and collections.*

**Low-risk taxpayers.** The IRS implemented streamlined compliance procedures for “low risk” nonresident U.S. taxpayers who failed to file returns, including FBARs. Qualified individuals must submit three years of federal income tax returns and six years of FBARs. The IRS indicated it will provide less intensive, more expedited review of submissions from qualified low risk taxpayers.

**IMPACT.** *The IRS explained that a return with less than \$1,500 in taxes due each year would be considered “low risk.” However, the presence of certain factors, such as a refund claim or the taxpayer is under investigation, will remove the return from the low risk category.*

**FBAR failure to file.** In *Williams*, 2012-2 USTC ¶50,475, the Court of Appeals for the Fourth Circuit found that a taxpayer’s failure to file an FBAR was willful and upheld civil penalties. The Fourth Circuit found that the taxpayer had made a conscious effort to avoid learning about the FBAR filing requirements.

**COMMENT.** *The taxpayer testified that he “never paid any attention to any of the written words” on his tax return. He reported on his returns that he had no for-*

*ign accounts despite his knowledge of at least two foreign accounts.*

**Required records doctrine.** The Seventh Circuit Court of Appeals rejected a taxpayer’s attempt to quash a subpoena demanding he produce records of his foreign bank accounts, *In Re: Special February 2011-1 Grand Jury Subpoena*, 2012-2 USTC ¶50,540. The court found that when the Required Records Doctrine is satisfied, a witness cannot resist a subpoena by invoking the Fifth Amendment privilege against compelled, testimonial self-incrimination.

**IMPACT.** *The Bank Secrecy Act requires taxpayers to maintain records for financial accounts outside of the United States. The Seventh Circuit found that the records required under the Bank Secrecy Act fall within the Required Records Doctrine.*

**Bank interest reporting.** The IRS finalized regs that require U.S. commercial banks, savings institutions, credit unions, and other financial institutions to report to the IRS any interest on deposits paid to a nonresident alien (NRA) on or after January 1, 2013 (TD 9584, April 2012).

**IMPACT.** *The regs are part of the IRS’s effort to combat tax evasion. However, the imposition of reporting requirements on financial institutions that made payments made to NRAs has proved controversial. Some financial institutions have expressed concern that the information required to be reported might be shared with countries without proper safeguards to protect the confidentiality of the information or with countries that would use the information for purposes other than the enforcement of its tax laws.*

**Foreign Tax Credits.** *Foreign tax credits are another area of potential abuse by U.S. taxpayers, in this case by U.S. corporations with multinational operations. The IRS released a major package of regs in this area in 2012.*

**Foreign tax credit “splitter” regs.** In February 2012, the IRS issued three sets of regs on the foreign tax credit (TD 9576, TD

9577, NPRM REG-132736-11) to address growing abuses involving manipulation of foreign tax credits.

**Supreme Court review of foreign windfall tax.** The Supreme Court will review in 2013 if a windfall tax imposed by the United Kingdom is a creditable foreign tax for U.S. tax purposes. *PPL*, 2012-1 USTC ¶50,115, U.S. Supreme Court Order List, October 29, 2012. The circuit courts of appeal are split on the question.

**COMMENT.** *The Tax Court previously found that the U.K. windfall tax was a creditable income tax under Code Sec. 901 because its dominant character was that of an income tax in the U.S. sense. The Third Circuit Court of Appeals reversed.*

**Advance pricing agreements.** In March 2012, the IRS announced that it had officially realigned and consolidated the Advance Pricing Agreement (APA) program and certain functions of the U.S. Competent Authority into a single Advance Pricing and Mutual Agreement (APMA) program (IR-2012-38, Ann. 2012-13). The reorganized APMA will govern the mutual agreement procedures (MAP) related to transfer pricing. The APMA is organized within the Large Business and International (LB&I) Division of the IRS.

**IMPACT.** *Although the reorganization resulted in a lower-than-normal number of APA case closures for 2011, the IRS expects faster and more closures in the future. The APMA planned to streamline the APA request submissions process. In the future, APMA would increase the number of case closures by several means, including minimizing the number of questions the IRS asked.*

**Controlled foreign corporations.** New temporary and proposed regs (TD 9589, NPRM REG-107548-11, May 2012) describe the treatment of upfront “swap” payments made under certain notional principal contracts (NPCs). The IRS explained that certain obligations of U.S. persons arising from upfront payments made by controlled foreign corpo-

rations (CFCs) under contracts cleared by a derivatives clearinghouse do not constitute United States property. The temporary regs are effective for payments made after May 10, 2012 but may be applied retroactively to earlier payments.

**IMPACT.** *The IRS issued the temporary regs in response to a growing trend where CFCs enter into NPCs with U.S. shareholders or persons and make significant non-periodic payments of yield adjustment fees through a clearing house or agency. Without the regs, CFCs who make such a payment could be treated as making a loan to a U.S. person, which under Code Sec. 956 might be taxable to the U.S. shareholder.*

**Corporate Inversions — substantial business activities test.** New temporary and proposed regs on corporate inversions (TD 9592, NPRM REG-107889-12, June 2012) revise, replace, and tighten temporary regs issued in 2009 on the substantial business activities test. The regs remove the facts and circumstances test of the 2009 temporary regs and replace it with a bright-line rule describing the threshold of activities required for an expanded affiliated group (EAG) to have substantial business activities in the relevant foreign country. The regs apply to acquisitions completed on or after June 7, 2012.

**Corporate inversions — surrogate foreign corporations.** The IRS issued final regs (TD 9591, June 2012) on corporate inversions that address the stock ownership requirement that applies to surrogate foreign corporations (SFCs). The rules address the treatment of options and other transactions involving stock. The final regs apply to acquisitions completed on or after June 7, 2012.

**Gain/distributions.** In April 2012, the IRS finalized regs under Code Sec. 1248 concerning gain recognized on receipt of a distribution of property with respect to stock in a foreign corporation (TD 9585). The final regs treat certain distributions as dividends under Code Sec. 1248(a). The final regs also provide that a “sale or exchange” includes a distribution that gives rise to

gain with respect to stock under Code Sec. 302(a) or Code Sec. 331(a).

**IMPACT.** *The final regs are intended to ensure that the earnings and profits of lower-tier foreign subsidiaries, as described in Code Sec. 1248(c)(2), are taken into account when there is a gain under Code Sec. 301(c)(3). Taxpayers should consider the consequences of a deemed dividend under Code Sec. 1248, including the sourcing and potential foreign tax credit consequences of the deemed dividend.*

**Recapture of overall domestic losses.** The IRS issued final regs addressing application of the recapture rules for overall domestic losses under Code Sec. 904(g), enacted by the American Jobs Creation Act of 2004 (TD 9595, NPRM REG-134935-11, June 2012). At the same time, the IRS issued proposed regs on determining high-taxed income with capital gains adjustments and the allocation and recapture of overall foreign losses and overall domestic losses.

**IMPACT.** *Under the proposed regs, the determination of whether income is high-taxed would be made before taking into account any of the capital gains adjustments under Code Sec. 904(b) or the loss allocations and loss account recapture under Code Sec. 904(f) and Code Sec. 904(g). The IRS has explained that this method is consistent with Code Sec. 904(d)(2)(F)'s use of the highest statutory U.S. tax rate, rather than the taxpayer's pre-credit effective U.S. tax rate, to determine whether income is high-taxed.*

## TAX ADMINISTRATION

The IRS underwent a change in leadership in 2012 with the departure of Douglas Shulman as Commissioner and the appointment of an Acting Commissioner pending the nomination of a successor by President Obama. The IRS also stepped up its anti-fraud efforts, continued to implement its return preparer oversight initiative, and undertook other tax administration projects.

**IRS Commissioner.** IRS Commissioner Douglas Shulman stepped down from his post on November 9, 2012, the last day of his five-year term. Steven Miller, Deputy Commissioner for Services and Enforcement, will serve as Acting Commissioner until President Obama nominates a new Commissioner and the Senate confirms the nominee.

**COMMENT.** *Whomever President Obama nominates will have to deal with a number of large projects, including implementation of the PPACA and the possibility of tax reform in 2013 or beyond. The agency also has had to make do with less in recent years because of cuts to its operating budget.*

**Identity theft.** The IRS alerted taxpayers to the risk of identity theft involving tax records (FS-2012-7, FS-2012-8 (January 2012)). The IRS has developed a comprehensive strategy to prevent, detect and resolve identity theft cases, including providing a special Identity Protection Personal Identification Number (IP PIN) for certain taxpayers to use when filing their 2012 tax returns in 2013.

**IMPACT.** *The IRS needs to balance delivery of refunds with actions to catch fraud; some of these measures may delay refunds, agency officials have cautioned.*

**IRS audit uptick.** Audit coverage of individuals with incomes of \$1 million or more increased from 8.36 percent in FY 2010 to 12.5 percent in FY 2011. For all individuals with income of \$200,000 or higher, audit rates increased from 3.1 percent in FY 2010 to 3.9 percent in FY 2011. (IRS Fiscal Year 2011 Enforcement and Service Results, (January 2012)).

Examinations of business returns declined in FY 2011 to 9.87 million from 9.94 million in FY 2010. However, audit rates for corporations with assets of \$10 million or more increased from 16.6 percent in FY 2010 to 17.6 percent in FY 2011. Audit coverage for smaller corporations (assets under \$10 million) increased to 1.02 percent in FY 2011, up from 0.94 percent in FY 2010. The IRS also reported increases in the audit rates for partnerships and S corps.

**IMPACT.** *The IRS has been criticized for overemphasizing audits of lower and middle income taxpayers. The statistics suggest that the IRS is paying more attention to higher income taxpayers.*

**COMMENT.** *In March 2012, the IRS released the 2011 IRS Data Book, providing statistics for Fiscal Year (FY) 2011 on IRS examinations, collections and other activities (IR-2012-36).*

**Tax gap growing.** The tax gap climbed to \$450 billion in tax year (TY) 2006, according to the IRS. This represented a substantial increase from the previous IRS estimate of \$345 billion in TY 2001 (IR-2012-4, FS-2012-6). Underreporting and underpayment accounted for most of the increase and 90 percent of the overall tax gap, the IRS explained. Underreporting accounted for an estimated \$376 billion and increased 32 percent from TY 2001 to TY 2006 (January 2012).

**COMMENT.** *The net tax gap for TY 2006 was \$385 billion; enforcement and late payments accounted for the difference of \$65 billion in enforcement revenue.*

**IMPACT.** *Some lawmakers look at the enormity of the tax gap and see an argument for tax reform and less complexity in the Tax Code. Others see the need for increased funding of IRS enforcement efforts. The IRS reported that all major initiatives it had launched in recent years focused on the tax gap.*

**PTINs.** In conjunction with the third anniversary of its return preparer oversight initiative the IRS issued an announcement (IR-2012-59, June 2012) calling the preparer tax identification number (PTIN) program a success. The IRS reported in 2012 that more than 850,000 preparers have obtained or renewed PTINs.

**Registered tax return preparers.** Throughout 2012, the IRS reminded practitioners who prepare Form 1040 series returns for compensation that they must pass the Registered Tax Return Preparer examination unless they are certified public accountants

(CPAs), attorneys, enrolled agents (EAs), or certain supervised preparers, subject to some exceptions. The deadline for taking the Registered Tax Return Preparer examination is December 31, 2013.

**Disclosure/use of return information.** The IRS issued final regs on the disclosure or use of tax return information by tax return preparers (TD 9608, December 2012). The final regs also provide rules for using statistical information taken from tax returns.

**Consent to disclose/use return information.** In addition to issuing final regs on disclosure or use of return information, the IRS issued a companion revenue procedure specifically the specific language required on taxpayers' consents to disclose or use return information. (Rev. Proc. 2012-18, December 2012). Rev. Proc. 2013-14 provides requirements for electronic signatures by taxpayers providing an electronic consent to the disclosure or use of return information.

**Covered opinions.** The IRS issued proposed regs intended to simplify the rules under Circular 230 for covered opinions (NPRM REG-138367-06 (September 2012)). The IRS eliminated the covered opinion rules in Circular 230 Sec. 10.35. All written tax advice would be governed under streamlined standards in Circular 230 Sec. 10.37, the IRS explained.

**IRS Appeals.** The IRS issued final rules to govern ex parte communications between IRS Appeals and other IRS offices (IR-2012-22, Rev. Proc. 2012-18, February 2012). The rules are designed to maintain the independence of IRS Appeals and to avoid communications with other IRS offices without the taxpayer's presence.

**IMPACT.** *IRS Appeals attempts to resolve disputes between taxpayers and originating offices such as IRS Examination, Collection, and the Service Centers (Campuses), and is successful at resolving a high percentage of its cases. Taxpayers expect a fresh look from IRS Appeals and would be reluctant to use the office if it were not independent.*

**IMPACT.** *The final rules define ex parte communications as written or oral com-*

*munications between Appeals and other IRS functions, discussing the strengths and weaknesses of the taxpayer's case, without the taxpayer having a chance to participate. Some communications are generally excepted, including those with Chief Counsel, Criminal Investigations, and the Taxpayer Advocate Service.*

**DOMA.** In *Windsor*, 2012-2 USTC ¶60,654, the Second Circuit Court of Appeals found the Defense of Marriage Act (DOMA) unconstitutional. The Supreme Court agreed in December to review the decision. The Supreme Court is expected to hold oral arguments in spring 2013 and announce its decision in June 2013.

**COMMENT.** *The Obama administration previously announced that it will no longer defend DOMA. However, until the law is repealed or the Supreme Court strikes it down, the IRS is not allowed to treat same-sex couples as married for purposes of the Tax Code.*

**Fast track settlement.** The IRS announced that it had made permanent the fast track settlement (FTS) program for taxpayers in the Tax-Exempt and Government Entities (TE/GE) Division (Ann. 2012-34 (August 2012)). FTS uses alternative dispute resolution techniques to promote case or issue resolution.

**Tiered issues.** The IRS announced that it was ending its Tiered Issue Process to set examination priorities (LB&I-4-0812-010 (August 2012)). The IRS reported that it intends to work issues in specialized practice groups.

**ITINs.** In 2012, the Treasury Inspector General for Tax Administration (TIGTA) warned of abuses of individual tax identification numbers (ITINs) (TIGTA, Ref. No. 2012-42-081). The IRS created ITINs in 1996 to provide an identification number to individuals without Social Security numbers. According to TIGTA, the IRS has not established adequate controls to detect and prevent the assignment of ITINs to individuals submitting questionable applications.

**COMMENT.** *TIGTA reported that the IRS processed more than 2.9 million re-*

*turns with ITINs, resulting in refunds of \$6.8 billion, in 2011.*

**Social media.** During 2012, the IRS continued to promote its social media presence. The IRS's social media tools include a smartphone app (IRS2Go) and online videos and podcasts. IRS officials also have posted short messages about tax developments on social networking sites.

**Tax patents on tax strategies.** The Court of Appeals for the Federal Circuit affirmed a federal district court and rejected a tax patent application for a strategy involving Code Sec. 1031 like-kind exchanges (*Fort Properties Inc. v. American Master Lease LLC*, CA-FC, February 27, 2012). The Fourth Circuit held that the strategy was not eligible for a patent because it did not involve a physical process or apparatus and consisted entirely of mental processes and abstract concepts.

**COMMENT.** *The Leahy-Smith America Invents Act from 2011 effectively prohibits tax strategy patents, for any application pending on or filed after September 16, 2011.*

**Goal of real time tax system.** The IRS held its second public meeting on a real-time tax system (January 2012), a system that would verify items of information on a return when the return is filed, rather than "after-the-fact" under the current business model. Then Commissioner Douglas Shulman met with state officials, software providers, and payroll processors. The processing of Forms W-2 and various Forms 1099 could be moved to a real-time system, but some procedures might have to change, Shulman said.

**COMMENT.** *Now that Shulman has departed from the IRS, the fate of his real-time tax system project is uncertain.*

## HURRICANE SANDY RELIEF

After Hurricane Sandy hit the east coast of the U.S. in October 2012, the IRS announced a number of measures to help affected taxpayers (IR-2012-82, 83, 84, 85, 86).

**IMPACT.** *The IRS identifies taxpayers located in the federally-declared disaster areas and applies automatic filing and payment relief. The IRS instructed taxpayers who reside outside the disaster areas but whose books, records or tax professional are located in the areas affected by Hurricane Sandy and believe they may qualify for relief to contact the agency.*

**COMMENT.** *The relief available for Hurricane Sandy victims is very similar to relief provided after Hurricane Katrina in 2005. After Hurricane Katrina, however, Congress enacted several statutes to provide additional relief, such as relaxing the casualty loss rules and expanding the charitable deduction rules.*

**Extended deadlines.** In IR-2012-83, the IRS announced that affected taxpayers will have until February 1, 2013 to file most returns and pay any taxes due. Relief applies to the fourth quarter individual estimated tax payment due on January 15, 2013. The IRS also extended the October 31, 2012 and January 31, 2013 deadlines for filing payroll and excise taxes to February 1, 2013.

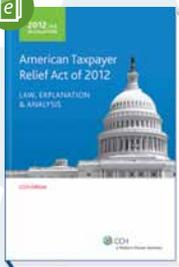
**Abatement/waiver.** The IRS will abate any interest and any late-payment or late-filing penalties that would otherwise apply. The IRS also announced that it will waive failure-to-deposit penalties for payroll and excise taxes due on or after the disaster area start date and before November 26, 2012 if the deposits are made by November 26, 2012.

**Exempt organizations.** The IRS announced that the filing relief in IR-2012-83 applies to exempt organizations required to file Form 990 series returns with an original or extended deadline within the period starting in late October 2012 through February 1, 2013.

**Loans/hardship distributions.** After Hurricane Sandy, the IRS announced it would allow expedited and expanded loan and hardship distributions from qualified employer-sponsored retirement plans. To qualify for relief, a hardship distribution must be made by February 1, 2013.

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