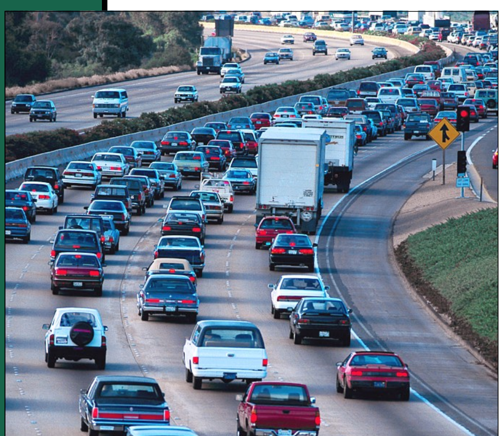
January 2012
TAX ALERTS

Internal Revenue Service (IRS) Announces 2012 Standard Miles Rates



The IRS issued the 2012 optional standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical, or moving purposes.

Beginning on January 1, 2012, the standard mileage rates for the use of a car (also vans, pickups or panel trucks) will be:

- 55.5 cents per mile for business miles driven
- 23 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

The rate for business miles driven is unchanged from the mid-year adjustment that became effective on July 1, 2011. The medical and moving rate has been reduced by 0.5 cents per mile.

The standard mileage rate for business is based on an annual study of the fixed and variable costs of operating an automobile. The rate for medical and moving purposes is based on the variable costs as determined by the same study. Independent contractor Runzheimer International conducted the study.

Taxpayers always have the option of calculating the actual cost of using their vehicles rather than using the standard mileage rates. A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System (MACRS) or after claiming a Section 179 deduction for that vehicle. In addition, the business standard mileage rate cannot be used for more than four vehicles used simultaneously. These and other requirements for a taxpayer to use a standard mileage rate to calculate the amount of a deductible business, moving, medical or charitable expense are in Revenue Procedure 2010-51. The IRS Notice 2012-01 contains the standard mileage rates, the amount a taxpayer must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that a taxpayer may use in computing the allowance under a fixed and variable rate plan.

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Payroll Tax Cut Extended Temporarily

On December 23, Congress passed, and President Obama signed into law, the "Temporary Payroll Tax Cut Continuation Act of 2011" (the TTCA, P.L. 112-78). The tax provisions of the TTCA consist of a two-month temporary extension of the payroll tax cut that is in place for 2011, plus a parallel extension of a lower Self-Employment Contributions Act (SECA) tax rate on self-employment income. In a related news release, the IRS also provided guidance to employers on how and when to implement the new rate.

Overview

The Federal Insurance Contributions Act (FICA) imposes two taxes on employers, employees, and self-employed workers—one for Old Age, Survivors and Disability Insurance (OASDI, commonly known as the Social Security tax); and the other for Hospital Insurance (HI, commonly known as the Medicare tax). Before passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act, P.L. 111-312), the FICA tax rate for employees and employers was 7.65% each—6.2% for OASDI and 1.45% for HI. Under the SECA tax, self-employment income of self-employed taxpayers was subject to a tax of 15.3%—12.4% for OASDI and 2.9% for HI. There is a maximum amount of compensation subject to the OASDI tax (the wage base), but no maximum for HI. (The wage base is $106,800 for 2011 and $110,100 for 2012.) Similar rules apply under the Railroad Retirement Tax Act (RRTA).

Under pre-2010 Tax Relief Act law, for computing the income tax of an individual, an above-the-line deduction is allowed equal to 50% of the amount of the SECA tax imposed on the individual's self-employment income for the tax year.

Under Code Sec. 1402(a)(12), a taxpayer is allowed a deduction in computing net earnings from self-employment equal to: (1) net earnings from self-employment as determined before taking the Code Sec. 1402(a)(12) deduction into account, multiplied by (2) one-half the sum of the OASDI tax rate and the HI tax rate. This deduction is allowed in computing net earnings from self-employment in lieu of the above-the-line deduction on 50% of the self-employment tax. Thus, the above-the-line deduction cannot be taken in computing self-employment tax liability. The Code Sec. 1402(a)(12) deduction is designed to put the self-employed in the same position as employees in that they don't have to pay self-employment tax on about half of the amount of the tax itself.

Temporary Tax Cut for 2011

For remuneration received during 2011, the 2010 Tax Relief Act reduced the employee OASDI tax rate under the FICA tax by two percentage points to 4.2%. Similarly, for self-employment income for tax years beginning in 2011, the Act reduced the OASDI tax rate under the SECA tax by two percentage points to 10.4%. As a result, for 2011, employees pay only 4.2% Social Security tax on wages up to $106,800 and self-employed individuals pay only 10.4% Social Security self-employment taxes on self-employment income up to $106,800. The 2010 Tax Relief Act provided rules for coordination with deductions for employment taxes, as follows:

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The 50% of SECA tax deduction allowed for tax years beginning in 2011 is computed at the rate of 59.6% of the OASDI tax paid, plus one-half of the HI tax paid. A new percentage (59.6%) replaces the rate of one-half (50%) allowed under pre-2010 Tax Relief Act law for this portion of the deduction. The new percentage is necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remains at 6.2%, while the employee portion falls to 4.2%. Thus, the employer share of total OASDI taxes is 6.2% divided by 10.4%, or 59.6% of the OASDI portion of SECA taxes. However, the two-percentage-point reduction is not taken into account in determining the Code Sec. 1402 SECA tax deduction allowed for determining the amount of the net earnings from self employment for the tax year.

New Law

Under the TTCA, the reduced employee OASDI tax rate of 4.2% under the FICA tax, and the equivalent employee portion of the RRTA tax, are extended to apply to covered wages paid in the first two months of 2012. The TTCA also provides for a recapture of any benefit a taxpayer may have received from the reduction in the OASDI tax rate, and the equivalent employee portion of the RRTA tax, for remuneration received during the first two months of 2012 in excess of $18,350 (i.e., two-twelfths of the 2012 wage base of $110,100). The recapture is accomplished by a tax equal to 2% of the amount of wages (and railroad compensation) received during the first two months of 2012 that exceed $18,350.

For tax years beginning in 2012, the TTCA provides that the OASDI rate for a self-employed individual remains at 10.4%, for self-employment income of up to $18,350 (reduced by wages subject to the lower OASDI rate for 2012). Related rules for 2011 concerning coordination of a self-employed individual's deductions in determining net earnings from self-employment and income tax also apply for 2012, except that the income tax deduction allowed for the OASDI portion of SECA tax paid for tax years beginning in 2012 is computed at the rate of 59.6% of the OASDI tax paid on self-employment income of up to $18,350. For self-employment income in excess of this amount, the deduction is equal to half of the OASDI portion of the SECA tax paid. The Joint Committee on Taxation's explanation of the TTCA says that the 59.6% used for the first $18,350 of self-employment income is necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remains at 6.2%, while the employee portion falls to a 4.2% rate for the first $18,350 of self-employment income. Thus, the employer share of total OASDI taxes is 6.2% divided by 10.4%, or 59.6% of the OASDI portion of SECA taxes, for the first $18,350 of self-employment income.

Guidance to Employers

The IRS instructed employers to implement the new payroll tax rate as soon as possible in 2012, but not later than January 31, 2012. If there is any Social Security tax over-withheld during January, employers should make an offsetting adjustment in workers' pay as soon as possible, but not later than March 31, 2012. Further guidance will be issued by the IRS as necessary to implement the provisions of the two-month extension, including the issuance of revised employment tax forms and instructions and information for employees who may be subject to the new recapture provision. For most employers, the quarterly employment tax return for the quarter ending March 31, 2012 is due April 30, 2012.

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Plan Now to Get Full Benefit of Saver's Tax Credit

Low- and moderate-income workers can take steps now to save for retirement and earn a special tax credit in 2011 and the years ahead, according to the Internal Revenue Service (IRS).

The saver's credit helps offset part of the first $2,000 workers voluntarily contribute to IRAs and to 401(k) plans and similar workplace retirement programs. Also known as the retirement savings contributions credit, the saver's credit is available in addition to any other tax savings that apply. Eligible workers still have time to make qualifying retirement contributions and get the saver's credit on their 2011 tax returns. People have until April 17, 2012 to set up a new individual retirement arrangement or add money to an existing IRA and still get credit for 2011. However, elective deferrals must be made by the end of the year to a 401(k) plan or similar workplace program, such as a 403(b) plan for employees of public schools and certain tax-exempt organizations, a governmental 457 plan for state or local government employees, and the Thrift Savings Plan for federal employees. Employees who are unable to set aside money for this year may want to schedule their 2012 contributions soon so their employers can begin withholding them in January.

The saver's credit can be claimed by:

- Married couples filing jointly with incomes up to $56,500 in 2011 or $57,500 in 2012;
- Heads of Household with incomes up to $42,375 in 2011 or $43,125 in 2012; and
- Married individuals filing separately and singles with incomes up to $28,250 in 2011 or $28,750 in 2012.

Like other tax credits, the saver's credit can increase a taxpayer's refund or reduce the tax owed. Though the maximum saver's credit is $1,000, $2,000 for married couples, the IRS cautioned that it is often much less and, due in part to the impact of other deductions and credits, may, in fact, be zero for some taxpayers.

A taxpayer's credit amount is based on his or her filing status, adjusted gross income, tax liability and amount contributed to qualifying retirement programs. Form 8880 is used to claim the saver's credit, and its instructions have details on figuring the credit correctly. In tax year 2009, the most recent year for which complete figures are available, saver's credits totaling just over $1 billion were claimed on just over 6.25 million individual income tax returns. Saver's credits claimed on these returns averaged $202 for joint filers, $159 for heads of household, and $121 for single filers.

The saver's credit supplements other tax benefits available to people who set money aside for retirement. For example, most workers may deduct their contributions to a traditional IRA. Though Roth IRA contributions are not deductible, qualifying withdrawals, usually after retirement, are tax-free. Normally, contributions to 401(k) and similar workplace plans are not taxed until withdrawn.

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Other special rules that apply to the saver's credit include the following:

- Eligible taxpayers must be at least 18 years of age.
- Anyone claimed as a dependent on someone else's return cannot take the credit.
- A student cannot take the credit. A person enrolled as a full-time student during any part of 5 calendar months during the year is considered a student.
- Certain retirement plan distributions reduce the contribution amount used to figure the credit. For 2011, this rule applies to distributions received after 2008 and before the due date, including extensions, of the 2011 return. Form 8880 and its instructions have details on making this computation.
- Begun in 2002 as a temporary provision, the saver's credit was made a permanent part of the tax code in legislation enacted in 2006. To help preserve the value of the credit, income limits are now adjusted annually to keep pace with inflation. More information about the credit is on IRS.gov.

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New for 2012 - Tax Changes Effective This Year

There are many important tax changes taking effect in 2012, as well as some that took effect late last year and thus are "new." They are the result of tax legislation enacted in prior years, or are triggered by effective dates in regulations, rulings and other guidance, or will occur by default in 2012 absent Congressional action.

Business and retirement plan changes taking effect in 2012 and late 2011

- ***New guidance on deduction vs. capitalization of tangible property costs.*** The Internal Revenue Service (IRS) has issued temporary regulations, generally effective in tax years beginning after 2011, on the application of Code Sec. 162(a) and Code Sec. 263(a) to amounts paid to acquire, produce, or improve tangible property. Among other things, these new regulations clarify and expand the standards in the current regulations; provide certain new bright-line tests for applying these standards; provide guidance under Code Sec. 168 regarding the accounting for, and dispositions of, property subject to that section; and amend the general asset account regulations.

- ***Basis reporting requirements.*** The complex stock basis and character reporting rules under Code Sec. 6045(g) apply to shares in a regulated investment company (RIC, i.e., a mutual fund), or stock acquired in connection with a dividend reinvestment plan (DRP), if acquired after 2011.

- ***Estimated taxes for large corporations.*** For a corporation with assets of at least $1,000,000,000 (determined as of the end of the previous tax year), the amount of any required installment of corporate estimated tax that is otherwise due in July, August, or September of 2012 is 100.5% of that amount, and the amount of the next required installment after the installment due in July, August, or September of 2012 is appropriately reduced to reflect the amount of the 0.5% increase.

- ***Use of smartcards or other electronic media to provide qualified transportation fringes.*** Beginning in 2012, after numerous postponements, the rules under which employers can provide their employees with qualified mass transit fringe benefits through the use of employer-provided credit cards, debit cards, smartcards, or other electronic media officially go into effect (although employers could rely on the guidance before 2012).

- ***Lump-sum payouts from defined benefit plans.*** Some defined benefit plans offer participants the option of receiving a lump-sum distribution (e.g., at age 65) instead of an annuity. For plan years beginning after 2007, the Pension Protection Act of 2006 (PPA, P.L. 109-280) amended Code Sec. 417(e)(3) to require defined benefit plans to compute the minimum lump-sum value of an annuity using blended corporate bond rates instead of 30-year Treasury bond rates, which were the benchmark under prior law. Because corporate bond rates generally are higher than long-term Treasury bond rates, the change had the overall effect of reducing lump-sum distributions. Under Code Sec. 417(e)(3), this new rule was phased in over 2008 through 2011 and will be fully in effect for plan years beginning after 2011.

- ***Hybrid defined benefit plan regs.*** Regulations that set forth the exclusive list of interest crediting rates and combinations of interest crediting rates that satisfy the market rate of return requirement for hybrid plans apply to plan years that begin on or after January 1, 2012. For plan years that begin before January 1, 2012, statutory hybrid plans could use a rate that is permissible under the final regs, or the 2010 proposed regulations.

- ***"Readily tradable" employer securities.*** For purposes of meeting Code Sec. 401(a)(35)'s diversification requirements for defined benefit contribution plans, generally effective for plan years beginning on or after January 1, 2012, employer securities that are "readily tradable on an established securities market" and "readily tradable on an established market" mean employer securities that are readily tradable on an established securities market under Reg. § 1.401(a)(35)-1(f)(5).

- ***Community health needs assessment mandatory.*** To qualify as tax-exempt, for tax years after March 23, 2012, under Code Sec. 501(r)(3), charitable hospital organizations will need to (i) conduct a community health needs assessment during the tax year or in either of the two tax years immediately preceding the tax year, and (ii) adopt an implementation strategy to meet the community health needs identified therein.

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- ***Work opportunity tax credit (WOTC) not available except for hiring qualified veterans.*** The WOTC under Code Sec. 51 generally can't be claimed for an individual who begins work for the employer after December 31, 2011. However, the WOTC continues to be available for employers that hire qualified veterans who began work for the employer before January 1, 2013.

- ***Disregarded entities included in rules for conduit financing arrangements.*** Effective for payments made after December 8, 2011, transactions that a disregarded entity enters into are taken into account in determining whether a financing arrangement exists and should be recharacterized under Code Sec. 7701(l) and Reg. § 1.881-3.

- ***Longer write-off period for certain property.*** For specialized realty assets (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) placed in service after 2011, a 39-year (up from 15-year) write-off period generally applies.

- ***Reduced bonus depreciation allowance for qualified property.*** For qualified property acquired and placed in service after 2011 and before 2013 (after 2012 and before 2014 for aircraft and certain long-production period property), a 50% (down from 100%) bonus first-year depreciation allowance applies under Code Sec. 168(k).

- ***Reduced expensing.*** For a tax year beginning in 2012, the Code Sec. 179 expensing election is reduced to $139,000, with a $560,000 investment-based ceiling (down from $500,000/$2 million). For tax years beginning after 2012, it will be further reduced to $25,000 with a $200,000 investment-based ceiling. Additionally, for a tax year beginning after 2011, expensing can no longer be claimed for qualified real property.

Individual changes taking effect in 2012

- ***Reduced alternative minimum tax (AMT) exemption amounts.*** Absent another AMT "patch," the AMT exemption amounts for tax years beginning after 2011 revert to the significantly lower "permanent" amounts of $33,750 for unmarried taxpayers, $45,000 for joint filers, and $22,500 for married filing separately.

- ***Reduced adoption credit.*** For 2012, the total expenses that may be taken as a credit for all tax years with respect to the adoption of a child by the taxpayer will be limited to $12,650 (down from $13,360 for 2011), and the credit for the adoption of a special-needs child will also be $12,650 (down from $13,360 for 2011). Furthermore, the adoption credit will no longer be refundable.

- ***No parity for exclusion from income for employer-provided mass transit and parking benefits.*** For 2012, unless Congress changes the rules, the exclusion for qualified parking rises from $230 to $240 due to an inflation adjustment, but falls from $230 to $125 for employer-provided transit and vanpooling benefits.

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- ***Protective claims for estate tax refunds.*** For estates of decedents dying after 2011, a Code Sec. 2053 protective claim for refund of estate tax must be filed by either: (i) attaching one or more completed Schedules PC to the estate's Form 706 at the time the return is filed; or (ii) filing a Form 843 with the IRS office where the Form 706 for the decedent's estate was previously filed, with the notation "Protective Claim for Refund under Section 2053" entered across the top of page 1 of the Form 843.

- ***Reporting foreign assets.*** Beginning in 2012, U.S. taxpayers who have an interest in certain specified foreign financial assets with an aggregate value exceeding $50,000 must report those assets to the IRS on Form 8938, Statement of Specified Foreign Financial Assets, with their tax returns.

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Internal Revenue Service (IRS) Extends Tax Return Filing Deadline to April 17, 2012

The IRS announced that taxpayers will have until Tuesday, April 17 to file their 2011 tax returns and pay any tax due, because April 15 falls on Sunday and Emancipation Day, a holiday observed in the District of Columbia, falls on Monday, April 16, this year. According to federal law, District of Columbia holidays affect tax deadlines in the same way that federal holidays give all taxpayers two extra days to file this year. Taxpayers who request an extension to file will have until October 15, 2012 to file their 2011 individual income tax returns. The IRS will start accepting e-file and free-file returns on January 17, 2012. The IRS said it expects to receive more than 144 million individual income tax returns this year, with most of those being filed by the April 17 deadline.

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New Penalties for Independent Contractor Misclassification

In October 2011, Governor Brown signed Senate Bill 459 (Ch. 11-706) into law that makes the "willful misclassification" of employees as independent contractors "unlawful" and provides for severe penalties. The difference is these higher penalties are not just for the employer; they also apply to the employer's paid accountant, enrolled agent, CPA, or any paid person who advised him. The law exempts attorneys and employees of the business from being penalized.

Who Assesses the Penalty?

The new law provides agencies in the California Labor Workforce Development Agency, specifically the Labor Commissioner or a court, with the authority to assess a civil penalty of $5,000 to $15,000 for each violation (a single misclassified individual). If the Labor Commissioner, or a court, determines there is a "pattern and practice" of these violations, a civil penalty of $10,000 to $25,000 for each violation may be imposed. These fines are in addition to any other assessments, penalties, or fines permitted by law. There are also fines for requiring "willfully misclassified" independent contractors to pay their own expenses.

The statute also authorizes these penalties, against both the employer and the paid advisor, if the employer charges a worker who has been "willfully misclassified" as an independent contractor a "*fee or makes any deductions from their compensation, for any purpose, including goods, materials, space rental, services, government licenses, repairs, equipment maintenance, or fines arising from the individual's employment*." This means if the taxpayer treats consultants as independent contractors and requires them to pay their own business expenses, and the Labor Commissioner determines these consultants were willfully misclassified, the above penalties will apply. If the paid advisor has advised the taxpayer to handle these workers as independent contractors, then the advisor may also be assessed these same penalties, even though the taxpayer was also charged. This rule also includes the higher dollar penalty for a "pattern and practice of the violations" ($10,000 to $25,000 for each violation).

Willfully Misclassifying

Willful misclassification is defined in the new law as "…avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor."

Some courts have defined "knowingly" in this context as including *constructive knowledge,* which can mean what a professional purportedly *should have known*. This interpretation could open up a very loose definition for "willful misclassification" and could expose both employers and their accountants to severe penalties for what was once considered an honest mistake derived from the complex common law rules for employee and independent contractor.

Pattern or Practice?

The definition of a "pattern or practice," which will kick in the higher-level penalties, was not defined in the law, and is therefore even more daunting. The dollar amounts for the higher penalties are so severe that we can expect to see a case, where a "pattern or practice" was determined, appealed to establish new case law precedent.

Attorneys are Exempt

The law reads: "SEC. 2. Section 2753 is added to the Labor Code, to read:

a) A person who, except an attorney who provides legal advice in the course of the practice of law, for money or other valuable consideration, knowingly advises an employer to treat an individual as an independent contractor to avoid employee status for that individual shall be jointly and severally liable with the employer if the individual is found not to be an independent contractor.

b) This section does not apply to the following persons:
   1) A person who provides advice to his or her employer.
   2) An attorney authorized to practice law in California or another United States jurisdiction who provides legal advice in the course of the practice of law.

Other Consequences

The new law also requires the labor agency to notify the Contractors' State License Board of a licensed contractor who is determined to willfully misclassify workers, and then requires the registrar of the Contractors' State License Board to "initiate disciplinary action against a licensee within 30 days of receiving a certified copy of an agency of court order."

Public Letter

The new law also requires employers who are determined to have "willfully misclassified" workers:

"…prominently for one year on its Internal Web site, in an area accessible to all employees and the general public, or, in the absence of an Internal Web site, to display in an area that is accessible to all employees and the general public at each location where a violation occurred, a notice signed by an officer that contains all the following:

1) That the Labor and Workforce Development Agency or a court, as applicable, has found that the person or employer has committed a serious violation of the law by engaging in the willful misclassification of employees.

2) That the person or employer has changed its business practices in order to avoid committing further violations of this section.

3) That any employee who believes that he or she is being misclassified as an independent contractor may contact the Labor and Workforce Development Agency. (The notice must include the mailing address, e-mail address, and telephone number of the Agency.)

4) That the notice is being posted pursuant to a state order."

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Reduce the Cost of Employee Versus Independent Contractor Audits

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As the economy remains stagnant, businesses are hiring independent contractors to do employee work. This saves money in the short term but often will result in a bigger bill when the terminated independent contractor files for unemployment.

Obstructed Claim

Many Employment Development Department (EDD) audits happen when there is an obstructed claim. An obstructed claim happens when an individual applies for unemployment and the EDD shows no wages reported by an employer. The most common situation is where the worker was treated as an independent contractor but, when the job is over, tries to collect unemployment. Often, the result Is a payroll tax audit of the employer. If, as a result of the audit, the auditor reclassifies independent contractors as employees, the EDD will assess:

- Personal income tax (PIT) withholding at a 6% rate;
- State Disability Insurance;
- Unemployment Insurance;
- Employment Training Tax; and
- Penalties and interest.

Worker Paid the Tax

An employer may reduce the liability if Forms 1099 were filed and/or the worker reported the income on his California tax return. To reduce the assessment:

- If the business filed Forms 1099 for the workers, the EDD will grant automatic abatement of the PIT by providing Form DE 6028P, Declaration, to the auditor;
- If no 1099s were filed, or for payments made during the current year prior to filing Forms 1099, prepare Form 938P, claim for Adjustment or Refund of Personal Income Tax, and give it to the auditor. The PIT withholding assessment will be withdrawn for each worker who signs Form 938P, attesting to the fact that they reported the income.
- The PIT withholding assessment may be reduced. The auditor will assess the PIT based on a flat rate for all workers. The amount may be adjusted using one of these methods:
  - If the employee had provided a Form W-4 or DE 4, use the filing status and exemptions on that form.
  - If no W-4 or DE 4 was provided, use the EDD withholding tables and the single rate zero exemption; or
  - If there was a large number of employees in the assessment, the employer may use a reasonable sample.

See Form DE 231W, Personal Income Tax Adjustment Process, for more information. This form must be mailed to the local office address provided.

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Unclaimed Property: Find and Report It

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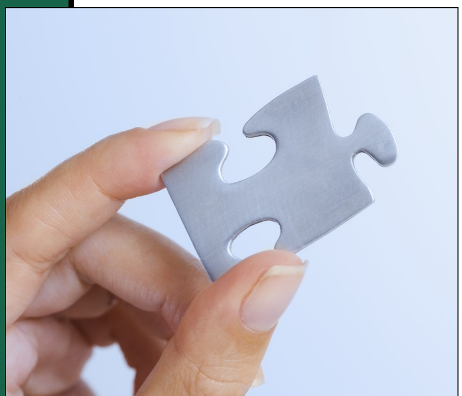
The California State Controller's Office (SCO) is currently in possession of more than $6.1 billion in unclaimed property belonging to approximately 17.6 million individuals and organizations. The SCO acquires unclaimed property from "holders" (general businesses), which are required to annually turn over any unclaimed property to the state under California's Unclaimed Property Law. Failure to adhere to the law can result in substantial penalties to noncompliant businesses. On a sunnier note, Californians can claim their property conveniently and at no cost.

Responsibilities of Businesses

California businesses must review their records each year to determine whether they hold any funds, securities, or other property belonging to others that has been unclaimed for the required "dormancy period." The dormancy period varies depending on the type of business (bank, securities firm, etc.) and the type of property (wages, retirement accounts, etc.), but is generally three years.

Property must be reported and remitted to the SCO if:



- The last known address of the owner is in California; or
- The owner's address is unknown and the holder is domiciled in California; or
- The last known address of the owner is in a foreign country or in a state that does not provide by law for escheat (turning unclaimed property over to the state) of such property and the holder is domiciled in California; or
- If the property does not meet the California address requirements, escheat may be required by another state.

If the holder pays or delivers escheated property to the SCO, the State Controller will defend the holder against claim and indemnify the holder against any future liability arising from the claim.

How to Recognize Unclaimed Property

Unclaimed property for businesses usually consists of uncashed payroll checks, customer deposits or refunds, and pension distributions. A potential unclaimed property liability may be recognized in a taxpayer's books when:

- Stale outstanding checks - These checks represent an attempt to pay an obligation. If the check remains uncashed, then the liability remains unpaid. After the designated period has expired (see "When and how to report" below), the check amount is considered unclaimed and is reportable to the state;
- Liabilities written off to an income account or reversed in the expense account;
- Customer deposit liability account that has not been reconciled in some time;
- Overpayments;
- Credit balances in accounts receivable;
- Unidentified receipts;
- Dividends payable or dividend checks that were never cashed; and
- Unrecorded liabilities - The most common example is an obligation for goods or services that were received but never booked because the invoice was never received.

NOTE: Companies in industries prone to holding unclaimed property often have employees who specialize in unclaimed property or hire outside specialists. Moreover, there are special rules pertaining to safe deposit boxes, insurance proceeds, real estate, and many other items.

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When and how to report

Wages escheat to the state when they remain unclaimed by the employee for more than one year. Most other property is escheated when it remains unclaimed by the owner for more than three years. All businesses must either determine unclaimed property each year as of June 30 or base it upon their previous fiscal year-ends. If the "as of" date falls between January 1 and June 30, the report is due October 31 of the same year. If the "as of' date falls between July 1 and December 31, the report is due October 31 of the following year. Businesses undergoing dissolution or liquidation must report all unclaimed property within six months of the date of final liquidation.

California is a "report and remit" state, which means escheated property specified in a report must be paid or delivered to the SCO seven months after the final date for filing. The only exception is property that the State Controller determines is not in the interest of the state to take custody of does not have to be remitted. Also, starting in 2012, the length of time the controller must maintain escheated property that has no apparent commercial value was extended to seven years from 18 months.

Holders must make an attempt to notify owners before escheating the property to the state. A notice must be mailed to the owner's last known address not less than six months or more than 12 months before submitting the property to the state. There are very specific requirements regarding the contents of the notice.

Reports and forms vary depending on the amount and type of property being submitted. Forms are available on the State Controller's Web site at www.sco.ca.gov. Owners can also call California's Unclaimed Property Call Center at (800) 992-4647.

What must be submitted?

Most businesses holding ordinary items (uncashed payroll or refund checks or unreimbursed deposits) will remit the original amount owed. The holder does not have to add interest and cannot deduct any charges for the time and cost of reporting and remitting the property. However, the holder can deduct any amount owed under a valid, enforceable contract. The holder must attach a copy of the contract to the report when withholding such an amount.

Penalties for violations

Willful violation may be punished by a fine of $100 per day for each day that a required duty is not performed, not to exceed $10,000. Anyone who willfully refuses to pay or deliver escheated property to the State Controller may be punished by a fine of not less than $5,000 and not more than $50,000.

Hunting for treasure

For owners, the SCO's Bureau of Unclaimed Property has a searchable index at its website. There are also convenient links to other states' unclaimed property database at www.naupa.org.

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Collecting the loot

Once a person finds something in a state's database, he or she must be able to prove the validity of the claim to the SCO by filing the following forms (available on the SCO's Web site, listed above);

- The claim form;
- The signed Affirmation Form; and
- The required documentation as determined by "Instructions for filing a Claim."

NOTE: Required forms may be different in other states.

The third requirement can be a difficult one. If the unclaimed property is tied to an address from, for example, 10 or more years ago, it can be difficult to track down an official document (utility bill, tax form, etc.) with the claimant's name and address on it. If the property is under a claimant's maiden name, a copy of the marriage certificate is necessary.

In the case of a deceased claimant, heirs to unclaimed assets must provide a certified copy of the owner's death certificate and a certified copy of the will or final decree of distribution. Because the SCO receives hundreds of claims each month, processing can take up to 180 days.

Other unclaimed property Web sites are listed below:

- U.S. Department of the Treasury, Bureau of the Public Debt: www.treasurydirect.gov/indiv/tools/tools_treasuryhunt.htm
- National Association of Unclaimed Property Administrators, at www.naupa.org
- www.oldstockresearch.com
- Research company histories at the U.S. Securities and Exchange Commission site: www.sec.gov
- International Bond and Share Society - Old stock certificates that have no cash-in value may be worth something as a collectible: www.scripophily.org

Example: Alexander is a CPA who has a signed engagement letter from Genghis to do accounting work. The engagement calls for fees at $125 per hour and a $2,000 advance. When Alexander has completed four hours of work, he discovers he needs more information and attempts to contact Genghis. Eventually, through mutual business associates, he learns that Genghis has returned to Mongolia and cannot be found. After three years, Alexander escheats $1,500 to the State Controller's Office, keeping the fees that he earned for four hours of work. He attaches a copy of the engagement letter to his report.

For more information about this article, please contact us at taxalerts@windes.com or any of our tax professionals at (562) 435-1191, (949) 271-2600, (310) 316-8130, or (213) 239-9745.

Don't Overlook California's New Jobs Credit for Small Businesses

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Although there has been an increase in new jobs in California in the past year, very few taxpayers are taking advantage of the New Jobs Credit. This may be because the computation of the credit can be tedious. However, once the taxpayers understand how the credit works, they may be able to find a goldmine of tax savings for their businesses. And the smaller the business, the easier it is to compute the credit.

The credit is available to new businesses for all employees and to businesses who hire a new seasonal employee who works full-time for a portion of the year.

Example: Jake was laid off from his job in 2010, and he started his own business in 2011. Jake did not have any employees in 2010, and the new business has two employees in 2011. Jake qualifies for the credit for both employees.

Here are some examples:

- An employee is laid off and starts a Schedule C business, hiring one employee;
- A person left his job and formed an S corporation, and the shareholder is the only employee. 100% of the credit passes through to the shareholder and the S corporation gets 1/3 of the credit;
- A CPA is sole proprietor who hires two full-time seasonal workers for four months and receives 1/3 of the credit for each employee; and
- A business hires a new full-time employee in October and receives 25% of the credit in 2010. That employee continues to work the entire year of 2011. The business is entitled to a credit of 75% of $3,000 for 2011.

Who is a qualified employee?

A qualified full-time employee is:

- One who was paid wages, subject to withholding under the California Unemployment Insurance Code, for services of not less than an average of 35 hours per week; or
- A salaried employee who was paid compensation during the taxable year for full-time employment.

None of these employees is qualified for purposes of the credit:

- An employee certified as a qualified employee in an economic development area (Enterprise Zone, Manufacturing Enhancement Area, Targeted Tax Area, or LAMBRA); or
- An employee whose wages are included in calculating any other credit.

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Computing the credit

California's New Jobs Credit provides a credit of up to $3,000 for each net increase in qualified full-time employees hired during the taxable year for qualified small businesses. For purposes of the credit, a small business is one that had 20 or fewer employees on the last day of the previous taxable year.

The net increase in qualified full-time employees is determined based on an annual full-time equivalent basis. This means that the taxpayer can get a partial credit for an employee who worked full-time but only for part of the year. To make it simple, make a list of each full-time employee and the percentage of the year each worked. Do this for 2010 and 2011, and subtract the 2010 number from the 2011 total.

To determine whether an employer has a net increase in qualified full-time employees, subtract:

- The total number of qualified full-time employees employed in the preceding taxable year by the taxpayer, and by any trade or business acquired by the taxpayer during the current taxable year; from
- The total number of full-time employees employed in the current taxable year by the taxpayer, and by any trade or business acquired during the current taxable year.

The credit is available for taxable years beginning on or after January 1, 2009 and does not reduce any other deduction for qualified wages. It must be claimed on a timely filed original return. Therefore, the taxpayer cannot amend a prior year return but may get a credit multiple years as long as employment increases.

For 2011, the credit is based on an increase in the 2011 employment over the 2010 employment, and employers with fewer than 20 employees on December 31, 2010 (for calendar-year taxpayers) will qualify to compute the credit.

Formula for net increase in full-time employee

Number of full-time employee equivalent in 2011	_________
- Number of full-time employee equivalent in 2010	(_________)
= Net increase in qualified full-time employees	_________

Multiply net increase by $3,000 *

- The net increase in employees can be partial number.

What is an annual full-time employee equivalent?

"Annual full-time equivalent" means either of the following:

- In the case of a full-time employee who is paid hourly, it is the total number of hours worked for the taxpayer (not to exceed 2,000 hours per employee) divided by 2,000; or
- In the case of a salaried full-time employee, it is the total number of weeks worked for the taxpayer divided by 52.

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Example: Harold is a Schedule C filer and owns Harold's Tax Service. In 2010, he had Tom working full-time from January 1, 2010, through June 30, 2010. In 2011, Harold hired a clerical employee in addition to Tom who worked full-time from January 1, 2011 through June 30, 2011. Therefore, Harold had an increase of 0.5 full-time equivalent employees in 2011 over 2010, and qualifies for a credit of $1,500 if the credit is still available when he files his 2011 return.

New businesses

For taxpayers who first commence doing business in California during the taxable year, the number of full-time employees for the immediately preceding prior taxable year is set at zero. Therefore, subject to certain limitations, a new business that either first forms in California or moves to California is eligible for the credit.

A new business is defined as a business that first formed and began activities in California on or after January 1, 1994. The new business must be in a division of the Standard Industrial Classification Manual that is different from a taxpayer's existing business or a business owned by the taxpayer during the previous 36 months. If the business is moving into California, no more than 20% of the assets of this new business may have been previously located in California.

Finally, a taxpayer may not acquire an existing business from a related taxpayer as defined by Internal Revenue Code Section 267 or 318 or reform as a different entity with the same ownership.

Credit cut off

Under the law, the Franchise Tax Board (FTB) will grant the New Jobs Credit through the end of the quarter in which the funds are expected to run out. Here is what the law says: "… the cut-off date shall be the last day of the calendar quarter within which the FTB estimates it will have received timely filed original returns claiming credits… that cumulatively total four hundred million dollars ($400,000,000) for all taxable years."

The FTB is tracking the amount of credit generated as returns are filed to determine when to establish the cut-off date and is providing periodic notices on its Web site of the cumulative amount of the credit. The cut-off date will be posted as soon as it is determined. At press time, only $76,008,953 of credits had been claimed. To view the current status of the credit, go to www.ftb.ca.gov/businesses/New_Jobs_Credit.shtml.

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an independent member of
BAKER TILLY
INTERNATIONAL

Headquarters
111 West Ocean Boulevard
Twenty-Second Floor
Long Beach, CA 90802

Tel: (562) 435-1191

Los Angeles Office
601 South Figueroa Street
Suite 4950
Los Angeles, CA 90017

Tel: (213) 239-9745

Orange County Office
18201 Von Karman Avenue
Suite 1060
Irvine, CA 92612

Tel: (949) 271-2600

South Bay Office
21515 Hawthorne Boulevard
Suite 840
Torrance, CA 90503

Tel: (310) 316-8130

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