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March 2012 TAX ALERTS

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New Anaheim California Enterprise Zone!

The Anaheim Enterprise Zone is effective as of February 1, 2012. The Enterprise Zone boundaries include approximately 80% of all Anaheim businesses and nearly all of the City's industrial and commercial areas. The Enterprise Zone designation is for 15 years.

Businesses within the Enterprise Zone are eligible for the following benefits:

- Firms can earn $37,440 or more in state tax credits for each qualified employee hired.
- Corporations can earn sales tax credits on purchases of $20 million per year of qualified machinery and machinery parts.
- The taxpayer can claim up-front expensing of certain depreciable property.
- Lenders to Zone businesses may receive a net interest deduction.
- Unused tax credits can be applied to future tax years, stretching out the benefit of the initial investment.
- Enterprise Zone companies can earn preference points on state contracts.

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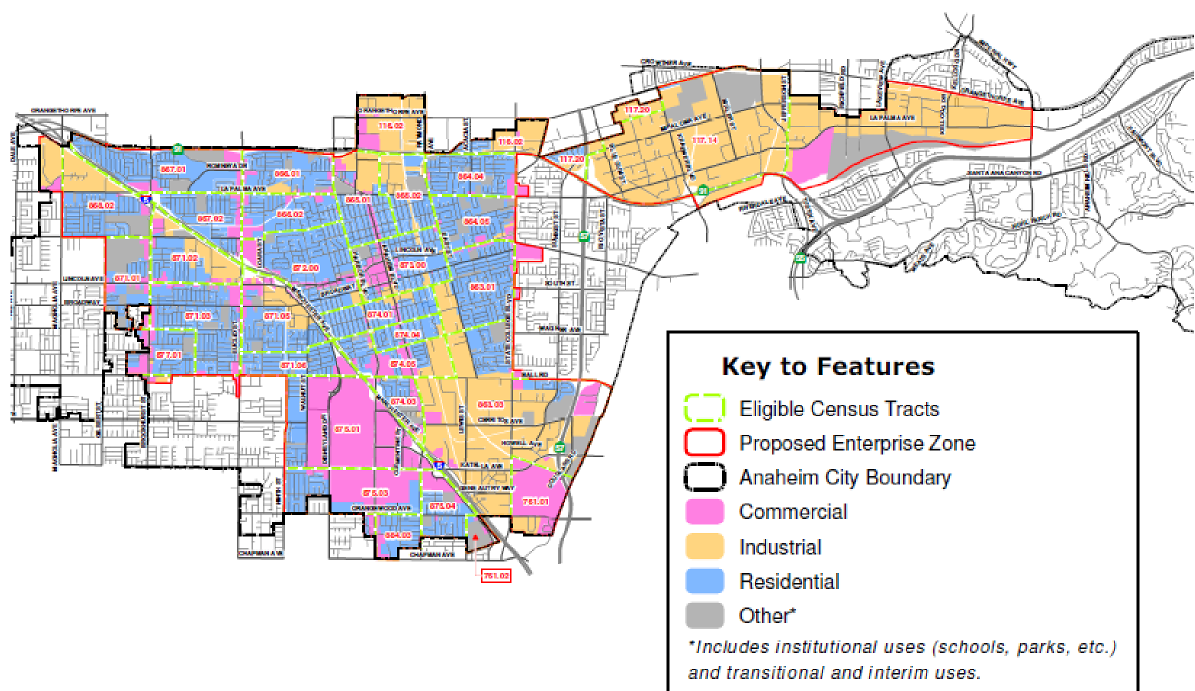

2% Payroll Tax Cut will be Extended for the Entire Year

President Obama signed H.R. 3630, the Middle Class Tax Relief and Job Creation Act of 2012 (Tax Relief Act of 2012), on February 22, 2012.

The Tax Relief Act of 2012 extends the reduction in the social security tax rate paid by employees from 6.2% to 4.2% until the end of 2012. The reduction was first implemented for 2011 by the Tax Relief Act of 2010. With the reduction set to expire December 31, 2011, and the employee social security tax rate scheduled to reset to 6.2%, Congress passed the Temporary Payroll Tax Cut Continuation Act of 2011, which extended the reduction through the end of February 2012.

The Tax Relief Act of 2012 also repeals the 2% "recapture tax" that would have required individuals who are paid more than $18,350 in January and February 2012 to pay an extra 2% tax so they would not gain more of a benefit from the temporary payroll tax cut than employees who were not paid more than that amount during those two months. It also extends and revises unemployment benefits under the Emergency Unemployment Compensation (EUC) Program, which had been set to expire February 29. EUC benefits are payable in four tiers, as under current law, but the payment thresholds are tightened for June through August and again for September through December. The EUC program will not provide benefits after December 31, 2012, and there will be no phase-out of EUC benefits beyond that date. Other changes allow states greater flexibility in administering their unemployment insurance programs and implementing overpayment recovery measures.

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No 1099-K Line on 2012 Business Returns

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The Internal Revenue Service (IRS) has decided that businesses will not be required to reconcile their gross receipts with merchant card transactions reported on Form 1099-K on their 2012 or later returns.

Steven T. Miller, IRS deputy commissioner for services and enforcement, said in writing to the National Federation of Independent Business that no reconciliation will be required on 2012 or future business tax returns. Last October, the IRS had said that no return entry would be required for 2011 tax returns, although they left a line on the returns saying "For 2011, enter 0."

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Many Employers Likely to Pay More Unemployment Tax in 2012

Employers in many states are likely to pay more federal unemployment tax (FUTA) in 2012 than in previous years due to a higher FUTA rate because of outstanding federal loans.

Background

Employers pay FUTA tax at a rate of 6.0% (beginning July 1, 2011) on the first $7,000 of covered wages paid annually to each employee. The rate for the first half of 2011 was 6.2%, including the 6% permanent tax rate and the 0.2% temporary surtax that expired on June 30, 2011. The post-June 2011 rate is thus 6%. This tax may be offset by credits of up to 5.4% (known as the "normal credit") against their FUTA tax liability for amounts paid to a state unemployment fund by January 31 of the subsequent year. As a result, the net FUTA rate for many employers is 0.6% in the second half of 2011 (0.8% in the first half).

Under Title XII of the Social Security Act, states with financial difficulties can borrow funds from the federal government to pay unemployment benefits. However, if a state defaults on its repayment of the loan, the normal credit available is reduced. This effectively increases the employer's FUTA tax rate by 0.3% beginning with the second consecutive January 1 in which the loan is not repaid, then an additional 0.3% annually thereafter. Thus, the net FUTA tax rate paid by an employer in a state that has had an unpaid loan with the federal government for two consecutive years will be 0.3% higher than the net 0.6% rate used by employers in states without past-due loans. The net FUTA tax rate continues to rise 0.3% for each additional year that the loans remain unpaid.

Under the Internal Revenue Code (IRC) Sec. 3302(g), provided that certain requirements are met, a state with an outstanding loan under Title XII may repay any advances using its unemployment trust fund account in lieu of having the credit reduction rules apply to its employers.

Higher FUTA rate

A higher 0.3%, 0.6%, or 0.9% FUTA rate applies for some states, as follows:

- The tax rate on the 2011 federal unemployment tax return due on January 31, 2012 was 0.3% higher than it otherwise would have been because of these 18 states' failure to repay their outstanding federal unemployment insurance (UI) loans for two consecutive years: Arkansas, California, Connecticut, Florida, Georgia, Illinois, Kentucky, Minnesota, Missouri, Nevada, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Virginia, and Wisconsin. Similarly, the tax rate on the 2011 federal unemployment tax return due on January 31, 2012 was 0.3% higher than it otherwise would have been because of the Virgin Islands' failure to repay its outstanding federal UI loans for two consecutive years.

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- The tax rate on the 2011 federal unemployment tax return due on January 31, 2012 was 0.6% higher than it otherwise would have been because of Indiana's failure to repay its outstanding federal UI loans for three consecutive years.
- The tax rate on the 2011 federal unemployment tax return due on January 31, 2012 was 0.9% higher than it otherwise would have been because of Michigan's failure to repay its outstanding federal UI loans for four consecutive years. Michigan has now repaid the federal UI loans, so employers will not pay a higher federal unemployment tax (FUTA) rate on their 2012 federal return (due in 2013).

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New Household Employee Withholding Table Reflects Extension of Reduced Social Security Tax

Internal Revenue Service (IRS) has provided a new Social Security and Medicare tax withholding table for household employees. The table reflects the two-month temporary extension of the 2011 payroll tax cut in the "Temporary Payroll Tax Cut Continuation Act of 2011," which was enacted after the release of Publication 926, Household Employer's Wage Guide (for wages paid in 2012).

Background

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 the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was passed, the FICA tax rate for employees and employers was 7.65% each—6.2% for OASDI and 1.45% for HI. 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%. As a result, for 2011, employees paid only 4.2% Social Security tax on wages up to $106,800.

Under the TTCA, the reduced employee OASDI tax rate of 4.2% under the FICA tax is extended to apply to covered wages paid in the first two months of 2012. In addition, the TTCA also provides for a recapture of any benefit a taxpayer may have received from the reduction in the OASDI tax rate 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.

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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. In Notice 1422, the IRS has now provided a withholding table for household employers that facilitate that guidance.

New withholding table

In Notice 1422, the IRS explains that after Publication 926 was released, the 4.2% employee Social Security tax rate—that had been scheduled to increase to 6.2% for wages paid in January 1, 2012—was extended for wages paid in January and February 2012. Accordingly, Notice 1422 directs household employers to use Table 3 (Employee Social Security (4.2%) and Medicare (1.45%) Tax Withholding Table) to figure the 4.2% employee Social Security tax for employee wages paid in January and February 2012.

If household employers withheld the employee Social Security tax from their household employee's wages at the 6.2% rate (instead of the 4.2% rate) for wages paid in January or February 2012, they should repay the excess withholding to the employee. A 2012 revision of Publication 926 that will address these changes will be available shortly on the IRS's website.

Notice 1422 cautions that the employee Social Security tax rate is scheduled to revert to 6.2% for wages paid after February 29, 2012 but notes that Congress is discussing an extension of the 4.2% rate beyond February 29, 2012. Notice 1422 advises that if the 4.2% rate is extended, an update will be posted on the IRS's website.

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The Congregational Research Service (CRS) Report Highlights Impact of Extending the Payroll Tax Reduction

As the payroll tax cut reduction has been extended, the CRS has released a report on how such an extension would stimulate the economy and some of the ways to pay for it.

Background

To help stimulate the economy, Congress reduced the employee and self-employed shares of payroll tax for 2011 by two points (from 6.4% to 4.2% for employees and from 12.4% to 10.4% for the self-employed). The temporary reduction was scheduled to expire at the end of 2011, but the reduction was extended for two months by the Temporary Payroll Tax Cut Continuation Act of 2011 and has now been extended a second time where it is in effect through the end of the year.

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Stimulus effects of extending the payroll tax cut

The CRS study cites a Congressional Budget Office (CBO) estimate that a temporary reduction of payroll taxes would raise output cumulatively in the next two years by $0.10 to $0.90 per dollar of total budgetary cost and would increase employment by between one and nine jobs per million dollars of budgetary cost. These estimates assume that the majority of the increase in disposable income would be saved or used to pay down debt rather than spend on goods and services. Compared with other household tax reductions, the CRS says that an extension of the reduction in payroll taxes may be a cost-effective stimulus. The report cites CBO estimates finding that the short-term stimulative effect of an extension of the reduction in payroll taxes would be greater than the stimulative effects from extending the Bush tax cuts, on par with a one-year AMT patch, and less than an increase in refundable tax credits.

Paying for the extension

Extending the payroll tax cut at an estimated cost of $99.5 billion without an offset of some sort will be at odds with the long-term goal of deficit reduction and may signal a lack of resolve to reduce deficits to investors. Hence, the conference committee is likely to consider a variety of options for offsetting the cost of any extension, including the following:

- ***A high-income surtax.*** High-income taxpayers will receive a maximum benefit of $2,202 under a one-year, two-percentage-point payroll tax rate reduction. The CRS report says that as a larger share of income is earned above the wage cap, benefits from the payroll tax rate reduction would be diminished. If, however, high-income earners were more likely to save payroll tax rate reduction benefits, rather than spend them, recapturing these benefits through a high-income surtax will be less likely to dampen the stimulative impact of the payroll tax rate reduction. Addressing the concern that a high-income surtax could negatively affect small businesses, the CRS report points out that very few tax returns reporting business income (roughly 1%) report adjusted gross income in excess of $1 million. The report acknowledges that using a high-income surtax would mean a tax benefit received by many would be paid for by a handful of taxpayers (only 0.22% of returns filed in 2009 had an adjusted gross income of $1 million or more).

- ***Limit the value of tax breaks for higher income taxpayers.*** Limiting the value of itemized deductions for high-income earners, for example to 28%, will increase the progressivity of the tax system, says the CRS, but, like a high-income surtax, will lead to an increased tax burden on those with the highest incomes. The higher tax burden, however, will result from scaling back the value of certain tax subsidies, which currently provide a greater benefit to higher-income taxpayers.

- ***Re-indexing the Code.*** Current methods of indexing figures, such as the standard deduction, personal exemption, and the tax brackets have been criticized as overstating actual levels of inflation. The Joint Committee on Taxation (JCT) estimates that indexing the Code for inflation using a "chained" consumer price index (CPI) will generate $59.6 billion in additional revenues over the 2012 through 2021 budget window. The CRS points out that this will result in increased tax liability for taxpayers at all income levels (except for those with incomes over $1 million), thereby offsetting some of the stimulus provided by a payroll tax rate reduction. Much of the additional

revenues, however, will be generated over time. Allowing the re-indexing to go into effect later in the budget window would postpone this contractionary effect, says the CRS, and will also reduce the revenues generated from the policy as measured within the 10-year budget window.

- ***Increasing the payroll tax wage cap.*** This option will increase the tax burden on upper-middle income taxpayers, thereby offsetting some of the benefits associated with the payroll tax rate reduction. However, the CRS says this option will make the payroll tax less regressive and, over the longer term, improve the fiscal outlook of the Social Security trust fund.

- ***Other options.*** These include freezing federal worker pay or reducing annual pay adjustments for federal workers (which would offset the benefits of the payroll tax rate reduction for a targeted group of wage earners), savings from the draw-down in over-seas military operations, and reductions in discretionary spending (which could offset the stimulative effect of a payroll tax rate reduction), and limiting certain federal benefits, such as Medicare and unemployment compensation, for those with higher incomes (which could have a contractionary effect on the economy).

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Proposed Foreign Account Tax Compliance Act (FATCA)

The Treasury and the Internal Revenue Service (IRS) issued proposed regulations implementing the provisions of the Foreign Account Tax Compliance Act (FATCA) on February 8, 2012.

The proposed regulations attempt to reduce the administrative burdens associated with identifying U.S. accounts and the due diligence requirements by permitting foreign financial institutions (FFIs), where possible, to rely on information that they already collect under existing anti-money laundering or "know your customer" rules.

The proposed regulations phase in reporting and withholding obligations under FATCA over a transition period that will provide lead time for financial institutions to develop the requisite systems to comply with the law. Additionally, the categories of deemed compliant FFIs have been expanded.

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Potential Late Filing Penalties for Income Tax and Foreign Bank Account Reporting (FBAR)

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The Internal Revenue Service (IRS) has released a fact sheet that summarizes information about Report of Foreign Bank and Financial Accounts filing requirements and potential penalties for failing to file or pay tax.

Media coverage

The Canadian press has been reporting that the IRS has eased penalties for dual citizens, but, in actuality, the fact sheet only describes existing law. It outlines Foreign Bank Account Reporting (FBAR) relief and late filing of income tax returns that apply to dual U.S. citizens living abroad. U.S. citizens and U.S. residents with offshore bank accounts with a balance of greater than $10,000 at any time during the year are required to file an FBAR report annually. Penalties for failure to file the FBAR are substantial.

Example: Farouk is a married U.S. citizen who lives in Canada and works for a film production company. His wife is a homemaker with no college education. He and his wife only have bank accounts located in Canada, with a balance of $50,000 during the tax year. They complied with Canadian tax laws and reported all of their income on their Canadian tax return. However, they failed to file U.S. income tax returns and FBARs as required.

After reading recent newspaper articles about their U.S. filing requirements, they filed delinquent FBARs to report the Canadian bank accounts and attached statements to the FBARs explaining that they were previously unaware of the obligation to report the existence of the accounts on an FBAR. They also filed joint U.S. income tax returns properly reporting all income, and after computing the foreign tax credit, no U.S. tax was due.

The IRS will determine whether the FBAR violation was due to reasonable cause based on all the facts and circumstances. But Farouk and his wife have a legitimate purpose for maintaining the foreign accounts; there are no indications of any effort to intentionally conceal the reporting of income or assets; and no tax was due.

The taxpayers' explanation for why they failed to timely file an FBAR seems to be reasonable in light of their facts and circumstances. The IRS would likely determine that the FBAR violation was due to reasonable cause, and no FBAR penalty should be assessed.

In addition, U.S. citizens and U.S. residents living in foreign countries are required to file U.S. tax returns reporting their worldwide income. Penalties for failure to file a tax return when required still apply.

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Comment: Although the term "offshore" is used, the requirements apply to all foreign countries - even if they are attached to the U.S. by land like Canada and Mexico.

The fact sheet also states that no penalties will be imposed for failure to file a tax return if no tax is owed. Because both the penalty for failure to pay tax and the penalty for failure to file are based on a percentage of the taxes owed, this is not a concession by the IRS. The no-penalty rule applies to income tax returns but not for failure to file FBAR reports. FBAR penalties apply regardless of the income tax filing requirement.

Reasonable cause and the FBAR

The fact sheet states that there will be no penalty when a tax return or FBAR is filed late and reasonable cause is determined to exist by the IRS. Again, this is no change from the IRS's current position. However, the IRS lists various factors for the determination of reasonable cause (no single factor is determinative):

- Reliance on the advice of a professional tax adviser who was informed of the existence of the foreign financial account;
- The unreported account was established for a legitimate purpose;
- There is no indication of an effort to intentionally conceal the reporting of income or assets; and
- The amount of any tax deficiency (or a tax deficiency is only a de minimis amount) related to the unreported foreign account.

Factors that are against a finding of reasonable cause for an FBAR violation are:

- The taxpayer's background and education suggest that the taxpayer should have been aware of the FBAR reporting requirements;
- Whether there was a tax deficiency related to the unreported foreign account; and
- Whether the taxpayer failed to disclose the existence of the account to the person preparing his or her tax return.

Example: Abner is a married U.S. citizen who permanently moved to Australia with his spouse in 2010. He is an accountant with a master's degree and is working in international finance and banking; his wife is an attorney.

They properly filed their Australian tax returns and have $25,000 in Australian bank accounts and $250,000 in cash and investments located in Switzerland. Abner and his wife filed U.S. income tax returns jointly and FBAR filings late after claiming that they were unaware of the U.S. Filing requirements. After computing the foreign tax credit, Abner and his wife still owe $10,000 in tax to the IRS.

Based upon their facts and circumstances, it appears unlikely that the IRS would accept a claim of reasonable cause for late payment and late filing.

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Tax Breaks Come With Raising a Child

Taxpayers with children should be aware of the numerous tax breaks for which they may qualify. Among them are: the dependency exemption, child tax credit, child care credit, and adoption credit. As they get older, education tax credits for higher education may be available, as is a new tax code requirement for employer-sponsored health care to cover young adults up to age 26. Employers of parents with young children may also qualify for the child care assistance credit.

Dependency Exemption

In addition to the personal exemption an individual taxpayer may take for him or herself to reduce taxable income (Line 42 on Form 1040), that taxpayer may also take an exemption for each qualifying dependent who has lived with the taxpayer for more than half of the tax year. A dependent may be a natural child, step-child, step-sibling, half-sibling, adopted child, eligible foster child, or grandchild, and generally must be under age 19, a full-time student under age 24, or have special needs. The amount of the exemption is the same as the taxpayer's personal exemption, $3,700 for the 2011 tax year and $3,800 for the 2012 tax year.

Child Tax Credit

Parents of children who are under age 17 at the end of the tax year may qualify for a refundable $1,000 tax credit. The credit is a dollar-for-dollar reduction of tax liability and may be listed on Line 51 of Form 1040. For every $1,000 of adjusted gross income above the threshold limit ($110,000 for married joint filers; $75,000 for single filers), the amount of the credit decreases by $50.

Child and Dependent Care Credit

If a taxpayer must pay for child care for a child under age 13 in order to pursue or maintain gainful employment, he or she may claim up to $3,000 of his or her eligible expenses for dependent care. If one parent stays home full-time, however, no child care costs are eligible for the credit.

Adoption Credit

Taxpayers who have incurred qualified adoption expenses in 2011 may claim either a $13,360 credit against tax owed or $13,360 income exclusion if the taxpayer has received payments or reimbursements from his or her employer for adoption expenses. For 2012, the amount of the credit will decrease to $12,650, and in 2013 to $5,000.

Higher Education Credits

There are two education-related credits available for 2012: the American opportunity credit and the lifetime learning credit. The American opportunity credit amount is the sum of 100 percent of the first $2,000 of qualified tuition and related expenses plus 25 percent of the next $2,000 of qualified tuition and related expenses, for a total maximum credit of $2,500 per eligible student per year. The credit is available for the first four years of a student's post-secondary education. The credit amount phases out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and

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$180,000 for joint filers). The lifetime learning credit is equal to 20 percent of the amount of qualified tuition expenses paid on the first $10,000 of tuition per family. The phaseout for 2012 ranges from $52,000 to $62,000 ($104,000 to $124,000 for joint filers). Parents also find tax relief in saving for college though Coverdell accounts, section 529 plans, and specified U.S. savings bonds.

Extended Health Care Coverage

Effective since September 23, 2010, the new health care law requires plans to provide coverage for children until they attain age 26. Further, effective on or after March 30, 2010, children under the age of 27 are considered dependents of a taxpayer for purposes of the general exclusion from income for reimbursements for medical care expenses of an employee, spouse, and dependents under an employer-provided accident or health plan. Therefore, a plan must provide coverage to a child who is still a dependent up to age 26; but can do so up to age 27 without income tax consequences. A child includes a son, daughter, stepson, or stepdaughter of the taxpayer; a foster child placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction; and a legally adopted child of the taxpayer or a child who has been lawfully placed with the taxpayer for legal adoption.

Child Care Assistance Credit (for businesses)

Employers may take up to $150,000 of the eligible costs of providing employees with child care assistance as tax credit. These costs may include a portion of the costs of acquiring, constructing, improving, and operating a child care facility.

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Companies that Buy or Sell Software May Be Entitled to Refunds

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Based on the ***Nortel*** case, software is now exempt from sales and use tax. This article reviews the case and discusses Board of Equalization (BOE) guidance on determining the taxable value of technology transfer agreements (TTAs).

Nortel case

By way of review, Notel sold software that embodied patents and copyrights to Pacific Bell. The Sales and Use Tax Department held that this was a taxable sale, forcing Nortel to sue the BOE for a refund on the tax they had to pay. In the end, the taxpayer prevailed, and Nortel was awarded $29 million plus costs and interest. The case has far-reaching implications and many companies that sell or buy software have filed refund claims.

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Determining the taxable value

The revised 18 California Code Regulation §1507, TTAs, provides that the sale price of the tangible personal property shall be:

1. A reasonable separately stated sale price for the tangible personal property.
2. If there is no separately stated sale price, a comparable sale price at which the property was previously sold can be used.
3. If neither of the above exists, 200% of the costs of the labor and materials used to produce the tangible personal property can be used.

The problem is that in the real world, numbers 1 and 2 above rarely exist and number 3 (according to the memo) requires too much cost accounting for the auditor and/or taxpayer.

Does the sale or purchase of software qualify as a TTA?

The BOE memo dated November 7, 2011, offers the following guidelines.

The seller or purchaser claiming the software qualifies as an exempt TTA must be able to identify to the auditor the patent or copyright interests that are being assigned or licensed to the purchaser under the agreement. Also, the agreement should at least implicitly provide the purchaser with the right to copy the software onto a hard drive, run the software on a computer, and/or make archive copies of the software. The retailer must also demonstrate that it had the legal authority to transfer the intangible rights to the purchaser. If the retailer purchased or received the patent or copyright interest from a third party, it must prove that as well. Clearly, the BOE's position is that the very first step in this process is to make sure the retailer of the software is the holder of the patent or copyright interest and that these rights are transferred to the purchaser.

Most software purchased from the company that developed it (Intuit, for example) will qualify. So, although this seems complicated, don't be discouraged. Once it is determined the software qualifies as a TTA, the BOE still wants tax on a piece of it. As sated previously, that piece (the tangible storage media on which the software is transferred) is what is still under study as to how to quantify it.

When the tangible personal property (TPP) is not separately stated, the taxable amount (until further study) is 200% of the cost of materials and labor to produce the TPP. If we are talking about a CD, that seems to be a pretty simple calculation. If the storage media is a hard drive manufactured by the retailer of the software, the computation could be more complicated.

The BOE is studying this issue to see if they can come up with a percentage of the sell price of the software that represents the fair retail value of the storage media. Quoting from the internal memorandum, "Recognizing the challenges taxpayers and the Board may face in accurately calculating the taxable portion of a TTA's lump-sum sale price for software, the Board authorized staff to conduct a study along with industry to determine the feasibility of adopting an optional percentage of the TTA's lump-sum sales price to represent the value of the TPP transferred under the TTA that would have been calculated if the 200% formula had been utilized."

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It is highly likely that a uniform percentage of the sales price of software would inflate the fair retail value of the storage media. It defies logic to think that a CD-ROM or a manufactured hard drive can have a significant value relative to the underlying software. Patented software, along with license rights, may vary in price by hundreds of thousands or millions of dollars.

It is much more likely that a uniform percentage of the sell price will be another way the state is able to tax an excessive amount, penalizing the unknowing taxpayer who does not separately state the fair retail price of the storage media used to transfer the exempt software.

Recommendations

In summary, it is my recommendation to file a claim for refund with the BOE as soon as possible to keep the three-year statute of limitations from expiring. The dollar amount does not need to be specified to file the claim.

If the purchase was made from a vendor located out of state, it is usually a use tax transaction. As such, the refund would go directly to the purchaser. For a sales tax transaction (i.e. the purchase was from a California vendor), the seller would need to file a claim for refund. As a condition of the seller obtaining this refund, the tax must be refunded to the purchaser. Accordingly, for in-state purchases, the end user of the software should persuade the vendor to file the claim.

Background

Prior to the ***Nortel*** case, the BOE held that prewritten software was taxable when transferred in tangible form. Additionally, prior to ***Nortel***, the exemption provided in 18 California Code Regulation §1507 for TTAs specifically excluded prewritten software, notwithstanding that such software was subject to a patent or copyright.

The Court of Appeals upheld a lower court's decision and scolded the BOE for creating a regulation that was beyond the scope of Revenue & Taxation Code §§6022 and 6012 by arbitrarily excluding software from the definition of a TTA.

Following the ***Nortel*** decision, the BOE issued an internal memorandum dated November 7, 2011, and an internal informal issue paper dated August 4, 2011, giving guidelines on how to interpret ***Nortel*** and process refund claims. Again, the whole theory is that the storage media containing the exempt software has some intrinsic value that is subject to tax. The question is how to determine that value.

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Alternatives to Traditional Health Insurance: High-Deductible and Consumer-Driven Health Plans

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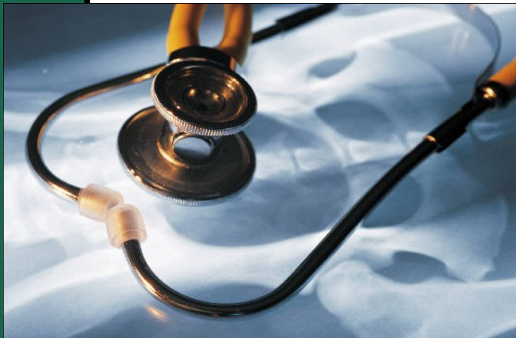

As health care costs rise, employers may choose to offer different types of plans than the usual traditional health care plan. Alternatives include high-deductible health plans (HDHPs) and consumer-driven health plans (CDHPs), both of which experienced growth of usage in the last year. In 2011, 7% of the population was enrolled in a CDHP, up from 5% in 2010, and 16% were enrolled in an HDHP in 2011, up from 14% in 2010. While these plans make it easier for some employers to affordably offer benefits, they are impacting how the insured individuals approach their health care options.

Recent studies released by the Employee Benefit Research Institute (EBRI) and RAND compared individuals who have HDHP and CDHP insurance to individuals with traditional plans and found:

- Individuals insured by HDHPs and CDHPs are more likely to:
    - Check to see if their plan covers a certain type of care;
    - Check the cost of service before getting care;
    - Ask for a generic or less costly drug rather than a brand name; and
    - Talk to their doctor about other treatment options and treatment costs;
- Individuals in HDHPs and CDHPs were less likely to use preventative care options (vaccinations, cancer screenings, mammograms, etc.); and
- Of those who had an HDHP, 38% had not yet set up the health saving account (HSA) to set aside money for paying the deductible (in most cases because the employer did not offer contributions and it was up to the employee to set up the HSA and fund it).

So, while these types of plans promote cost-conscious behavior in the individuals they insure, the research shows this group to be leaning away from preventative care, even though high-deductible plans typically waive the deductible for such services.

High-deductible health plans

HDHPs are just that: the insured individual must pay a higher amount out of pocket (in exchange for lower monthly premiums) before cost coverage kicks in. In order for an individual to open an HSA, he or she must be enrolled in a qualified HDHP.

Consumer-driven health plans

Consumer-driven health plans typically consist of three levels of payment, one of which is a high-deductible plan:

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- First, medical costs are paid out of a tax-advantaged savings account before the deductible is met. This account may be funded by either the employer or the employee;
- Next, after the savings account funds are exhausted, the insured individual must pay for expenses out of pocket until the deductible is met; and
- Last, an HDHP kicks in once the deductible is met, after which the insured individual pays a co-pay and the plan covers health costs for the rest of the year.

Example: Fran is enrolled in a CDHP with an annual deductible of $2,500. Her employer provides an HSA funded with $1,000 to pay part of the deductible. If Fran's medical expenses for the year do not exceed $1,000, any unused portion will roll over into the next year's fund. If Fran uses the $1,000 (plus carryover amounts accumulated from prior years), she is responsible for the remaining $1,500 until she reaches her maximum out-of-pocket amount.

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401(k) Plan Loan Defaults: Trends Show Who Is At Risk

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If a retirement plan allows the plan participant to borrow funds, those borrowed funds must be repaid in full if the participant leaves the job in accordance with the terms of the plan (typically within 60 days). If the outstanding loan cannot be repaid, it is considered to be in default and the amount will be a deemed distribution - taxable and subject to a 10% penalty.

A whitepaper released by the Financial Literacy Center studied 100,000 Vanguard 401(k) plan participants over a three-year period, and found some trends among the taxpayers who defaulted on their plan loans:

- More than 80% of the workers who left employment with a plan loan defaulted (about 10% of the total group studied);
- Those taxpayers who had taken out multiple plan loans defaulted at a higher rate;
- Taxpayers with larger loan balances were more likely to default; and
- The group that defaulted had lower household income, smaller 401(k) balances, and poorer financial wealth.

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The study also explored the possibility that the economic climate was causing more defaults than normal, but the researchers found that while the chance of being laid off from a job had increased (increasing the possibility of defaults), voluntary job changing had decreased (lowering the possibility of defaults).

Suggestions for decreasing the number of defaults include:

- Limit the number of loans that are made available to plan participants;
- Allow participants to repay the loan after leaving employment (which would increase administrative costs and workload); and
- Reduce the percentage limitation on borrowing.

Borrowing from 401(k) plans

If a plan allows participants to take a loan [loans are not permitted from individual retirement accounts (IRAs) and IRA-based plans like simplified employee pension plans (SEPs), salary reduction simplified employee pension plans (SARSEPs), and SIMPLEs], the limit on borrowing is the lesser of:

- $50,000; or
- The greater of;
  - Half of the present value of the participant's nonforfeitable accrued benefit under the plan; or
  - $10,000.

Repayment of loans while still with employer

When paying back a loan, payments are made in substantially equal payments, made at least quarterly, and deducted from pay. However, a plan loan used to purchase a principal residence for the participant is allowed a reasonable amount of time for repayment. The regulations do not define "reasonable time," but the examples in the regulations discuss 15 years on these types of loans.

Example: Christine's nonforfeitable interest in her employer's plan is $15,000. She may borrow $10,000 from the plan, which is greater than 50% of her present value, but less than $50,000.

Rhoda's nonforfeitable interest in her employer's plan is $75,000. She may borrow $37,500 ($75,000 x 50%).

Hortense's nonforfeitable interest in her employer's plan is $200,000. She may borrow $50,000, which is the lesser of $50,000 and her $100,000 half value.

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Taking Advantage of the New Use Tax Lookup Table

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The use tax lookup table provides individuals with a safe harbor when reporting purchases of $1,000 or less per item. Taxpayers who purchase items on the internet, through catalogues, or on television may want to consider using the lookup table to report use tax.

How does the use tax lookup table work?

For tax years beginning on or after January 1, 2011, taxpayers may elect to report use tax for single nonbusiness purchases of $1,000 or less on their California income tax return using either:

- The actual amount of tax due; or
- The amount shown on a lookup table.

Taxpayers who use the lookup table will report use tax due based on adjusted gross income (AGI) rather than actual receipts. The lookup table provides a safe harbor for a taxpayer who:

- Reports use tax on a California income tax return; and
- Does not have a single purchase of $1,000 or more.

Taxpayers with one or more purchases greater than $1,000 may calculate their actual use tax owed on those purchases, and use the table to report use tax on all other purchases. The safe harbor will apply to the purchases of $1,000 or less, but the Board of Equalization (BOE) may assess additional tax on the purchases over $1,000.

Here are some questions regarding the use tax lookup table.

Q. Can I use the consumer use tax form to report use tax and use the lookup table?

A. No, to take advantage of the safe harbor and the lookup table, the taxpayer must report use tax on the California individual income tax return.

Q. Does the $1,000 threshold apply to a single item or a single purchase?

A. It applies to a single item.

> **Example:** Joe buys three laptops for $600 each and a camera for $1,200 in a single purchase. His total credit card charge was $3,000. He must pay use tax on the $1,200 camera, but the $1,800 in computers are included in the amount from the lookup table.

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Q. Where do I report the use tax on a purchase greater than $1,000 if I want to use the lookup table?

A. Add the use tax on the single purchase to the amount from the table.

> **Example:** Joe purchased a painting for $2,000 and has AGI of $95,000. Joe will report use tax on line 85:
>
> $63 from the look up table
> $160 ($2,000 x 8% sales tax assumed)
> $213 total use tax

Q. Must I file Form 540, California individual income tax return, to report use tax?

A. No, you may report use tax on any individual tax return.

> **Example:** Mary is retired and has no filing requirement. She wants to report her use tax using the lookup table. She may file Form 540 2EZ to report her use tax.

Q. Can I elect the use tax the lookup table even if I know my use tax liability is greater than the table amount?

A. Yes, there is no requirement that a taxpayer report actual use tax liability if the table is elected and the taxpayer reports the table amount on the California individual return. The BOE may assess use tax on purchases over $1,000 that were not reported.

> **Example:** Dana's AGI is $100,000 and her use tax lookup table amount is $88. Dana knows she purchased comic books for $50,000 online in 2011, so her use tax would be far in excess of $88. None of the books cost more than $1,000, so she may use the table.

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Maximum Deductible Pension Contributions Chart

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Maximum Deductible Contributions Chart						
Tax Year	Maximum deductible amount of Keogh contribution		Maximum deductible amount of IRA contribution		Maximum deductible amount of SEP contribution	
	Federal	California	Federal	California	Federal	California
1963–67	$1,250[1]	$0				
1968–70	2,500	0				
1971–73	7,500	2,500				
1974	7,500	2,500				
1975	7,500	2,500	$1,500	$0		
1976–78	7,500	2,500	1,500	1,500		
1979–81	7,500	2,500	1,500	1,500	$7,500	$2,500
1982–83	15,000	2,500	2,000	1,500[2]	15,000	2,500
1984–86	30,000	2,500	2,000	1,500[2]	30,000	2,500
1987–93	30,000	30,000	2,000	2,000	30,000	30,000
1994–96	30,000	30,000	2,000	2,000	22,500	22,500
1997–99	30,000	30,000	2,000	2,000	24,000	24,000
2000	30,000	30,000	2,000	2,000	25,500	25,500
2001	35,000	35,000	2,000	2,000	25,500	25,500
2002–03	40,000	40,000	3,000[3]	3,000[3]	40,000	40,000
2004	41,000	41,000	3,000[3]	3,000[3]	41,000	41,000
2005	42,000	42,000	4,000[3]	4,000[3]	42,000	42,000
2006	44,000	44,000	4,000[4]	4,000[4]	44,000	44,000
2007	45,000	45,000	4,000[4]	4,000[4]	45,000	45,000
2008	46,000	46,000	5,000[4]	5,000[4]	46,000	46,000
2009–11	49,000	49,000	5,000[4]	5,000[4]	49,000	49,000
2012	50,000	50,000	5,000[4]	5,000[4]	50,000	50,000

[1] For tax years 1963–67, the maximum allowable Keogh contribution was $2,500, but only 50% of it was deductible
[2] For these years, California did not allow a taxpayer who was covered by an employer's plan at any time during the year to deduct an IRA
[3] Plus $500 if at least age 50 as of the end of the year
[4] Plus $1,000 if at least age 50 as of the end of the year

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Taxability of Disability Retirement Payments

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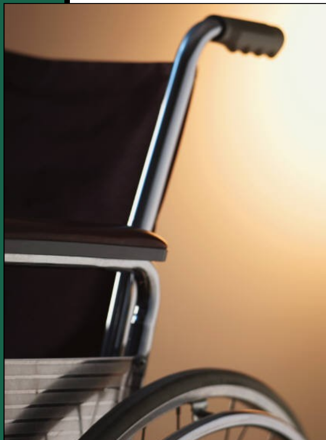

A taxpayer was injured while working as a meat cutter at a grocery store. He began taking disability retirement benefits from a pension plan, based on the number of years he had worked for the company. The payments were made from an employer pension plan.

The taxpayer excluded from income $26,365 in disability pension plan payments on his 2006 return, claiming that they were exempt from tax under the Internal Revenue Code (IRC) §§104(a)(1), (2), and 105(c). The Internal Revenue Service (IRS) adjusted the taxpayer's gross income to include the full amount of disability pension plan payments.

Upon appeal, the court reviewed IRC §§104(a)(1), (2), and 105(c) as they applied to the disability pension plan payments and found the following:

- §104(a)(1): This section excludes income received under workers' compensation as compensation for personal injury or illness, and does not apply to benefits paid under a private contract. The taxpayer received his benefits under a private collective bargaining agreement, so the court deemed them not equivalent to workers' compensation payments;

- §104(a)(2): This section excludes income received through a legal suit or tort-like claim for personal injury or illness. The taxpayer's disability pension plan payments were not paid as a result of litigation or as compensation for an injury; they were a benefit from his previous employment with the grocery store; and

- §105(c): This section excludes income received that constitutes payment for permanent disfigurement or loss of use of any body parts, where the amount of income awarded is dependent on the severity of injury and without regard to the length of time the injured employee was with the company. The taxpayer's disability pension plan payments did not meet the nature-of-the-injury requirement. The payments were calculated based on years worked.

The court upheld the IRS's assessment to include the full amount of disability pension plan payments in the taxpayer's gross income.

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California Does Not Conform to Increased Self-Employment Tax Deduction

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The California Franchise Tax Board (FTB) has confirmed that taxpayers may only deduct 50% of the self-employment tax for California purposes, while they can deduct more than 50% for federal purposes. This will result in an increase in adjusted gross income (AGI) on Schedule CA for virtually all self-employed taxpayers.

The FTB has stated that self-employed taxpayers who have already filed their returns using the greater-than-50% deduction must amend those returns and adjust the deduction on Schedule CA, line 27.

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