

Burdensome 1099 Rules are Repealed

President Obama has signed a law that repeals two sets of rules that had business owners, company managers, and landlords up in arms because of the paperwork nightmare they created. The rules that involved businesses issuing a blizzard of 1099 forms were created by two laws enacted in 2010. Rental property owners had to begin complying with one of the sets of rules this year. The second set for other types of businesses was not scheduled to go into effect until next year.

The new rules ignited an immediate firestorm of criticism, but repealing them took longer than some expected.

Thankfully, all the attempted 1099 rule changes have finally been quashed by the *Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act*, which was signed into law on April 14, 2011.

Here's the 1099 story from beginning to end. We'll start with the longstanding 1099 rules, which will now continue to apply.

Longstanding 1099 Rules Remain in Force

For many years, businesses have been required to report various types of payments to the IRS and to recipient taxpayers.

For example, when a business pays \$600 or more during a calendar year to an unincorporated independent contractor for services rendered, the business must file a Form 1099-MISC with the IRS to report the total amount paid in that year. The business must also send a copy of the Form 1099-MISC to the payee.

Under the longstanding rules, other types of payments that businesses must report to the IRS on 1099s and to payees on payee statements include:

- Commissions, fees, and other forms of compensation paid to a single unincorporated payee when the total amount paid in a calendar year is \$600 or more.
- Interest, rents, royalties, annuities, and other income items paid to a single unincorporated payee when the total amount paid in a calendar year is \$600 or more.

When a 1099 is required, it must show the total amount of payments in the calendar year, the name and address of the payee, the tax ID number (TIN) of the payee, contact information for the

payer, and the payer's TIN. (For privacy reasons, it's OK to show a truncated TIN on a 1099 that reports payments to an individual recipient.)

If a client's business doesn't have a recipient's TIN, it may be required to institute backup federal income tax withholding at a 28 percent rate on payments to that payee.

In most cases, the rules summarized above apply equally to payments made by non-profit organizations, because they are generally considered to be businesses for 1099 reporting purposes.

For 2011, if a payer fails to file a proper 1099 with the government, the IRS can assess a penalty of \$100 or more per failure. For 2011, if a payer fails to send a proper payee statement, the IRS can assess an additional penalty of \$100 or more for each failure. (*Internal Revenue Code Sections 6721, 6722, and 6723*)

Important: Penalties for failing to file 1099s and issue payee statements were increased by a 2010 law. **The increased penalties remain in effect.** To sum up, each time a client fails to file a 1099 and issue the related payee statement, the IRS can still assess a penalty of \$200 or more.

Most Payments to Corporations Need Not Be Reported

Most payments to corporations are exempt from any 1099 reporting requirements. There are a few exceptions. For instance, payments of \$600 or more in a calendar year to a corporate law firm must be reported on a Form 1099-MISC for that year.

Payments for Property Need Not Be Reported

There is generally no requirement to issue 1099s to report payments for property such as merchandise, raw materials, and equipment.

2010 Legislation Tried to Change the Rules

Last year's healthcare legislation and a separate small business law attempted to make big changes to the 1099 reporting rules. The repealed changes are briefly summarized below.

Payments to Corporations: Starting in 2012, if a business paid a corporation \$600 or more in a calendar year, it generally would have been required to file a 1099 and issue a statement to the payee.

Also, the business would have been required to obtain a taxpayer ID number from each corporate payee to avoid the requirement for backup federal income tax withholding.

On the other side of the coin, if a business is incorporated, it would have been required to supply customers with the company's TIN to avoid backup withholding on payments.

Payments for Property: Starting in 2012, if a business paid \$600 or more in a calendar year to any payee as "amounts in consideration for property," it would have been required to file a 1099 and issue a payee statement. Once again, the term "property" means equipment, merchandise, raw materials, and other items.

Also, the business would have been required to obtain a TIN from each affected payee to avoid the requirement for backup withholding of federal income tax.

Again, if a business sells property, it would have had to supply customers with its TIN to avoid backup withholding on payments to it.

Payments of Gross Proceeds: Starting in 2012, a third new rule would have required filing a 1099 and a payee statement if a business paid \$600 or more in "gross proceeds" to any payee in a calendar year. Apparently, this provision was intended to force the filing of millions of 1099s and payee statements to report business expenditures for things like meals at unincorporated restaurants, repairs of business vehicles at unincorporated auto shops, and seminars presented by unincorporated providers.

Payments by Rental Property Owners: Starting this year, owning rental property would have generally been considered a "business" for purposes of the 1099 reporting rules. Therefore, property owners would have generally been required to file 1099s and issue payee statements for any unincorporated service providers that were paid \$600 or more during 2011 (for jobs including yard care, maintenance, and accounting). Starting in 2012, rental property owners would have been required to comply with the other burdensome 1099 changes explained earlier.

All of these now-repealed mandates would have undoubtedly required many millions of additional 1099s and payee statements each year.

Where We Stand Now

Thanks to the recently passed law, none of the attempted 1099 changes will take effect. So if your clients' businesses are currently handling 1099s and payee statements without any problems, they can continue with the status quo. On the other hand, if they have compliance deficiencies, the harsher penalties that are now in effect dictate in favor of cleaning up their reporting.

A Dramatic Shift in the Corporate Ethics and Compliance Landscape

The whistleblower provisions contained in the *Dodd-Frank Act* have the potential to dramatically shift the corporate ethics and compliance landscape. The rewards for blowing the whistle with "original information" are staggering. If the information that an employee provides leads the Securities and Exchange Commission (SEC) to impose penalties of \$1 million or more, the whistleblower stands to receive a payment between 10 to 30 percent of the penalties imposed.

With the potential payout for blowing the whistle on corporate wrongdoing reaching well into the millions of dollars, the incentive for employees to contact the SEC directly and bypass company ethics hotlines is significant.

Under the law, employees may be rewarded for providing information concerning violations of federal securities laws. This includes violations of the *Foreign Corrupt Practices Act*, the *Investment Advisers Act* and the *Investment Company Act* as well as inaccurate disclosures and improper accounting practices by public companies.

Prior legislation, including the *Sarbanes-Oxley Act*, has made it important for companies to have ethics and compliance programs in place. With the implementation of the Dodd-Frank whistleblower provisions, the bar has been significantly raised. Not only must there be a robust program in place, the program must be viewed by employees as the appropriate vehicle to report concerns.

The SEC has reported it is already seeing a large increase in the number of reports from whistleblowers. An agency official recently said that before Dodd-Frank, the SEC used to receive about two dozen "high-value" tips a year about fraud and securities law violations. Now, he added, the agency is sometimes receiving one or two a day.

In light of the Dodd-Frank whistleblower legislation, here are some issues to consider with regard to your clients' ethics and compliance programs:

Speed is of the Essence: The *Dodd-Frank Act* offers would-be whistleblowers the prospect of tremendous financial incentives to report "original information." Therefore, it is prudent to assume that if a company has received information regarding potential wrongdoing, the SEC may have at least the same information, if not more. Therefore, once information is received, it is extremely important to move quickly to uncover all of the facts.

Assign Roles and Responsibilities: Most investigations of wrongdoing are multifaceted and require the involvement of various individuals from across a company. To avoid confusion, companies should clearly define the roles and responsibilities of each department involved in the investigation. There should also be a clear hand off or transition of responsibilities throughout the investigation process.

Thoroughly Document the Results of an Investigation: The probability that the SEC will be aware of potential problems is now potentially much higher. Therefore, conducting a rigorous investigation that appropriately investigates the allegation is even more important as the SEC will potentially request all of the company's files associated with the issue.

Invest in Fraud Investigation Technology: Instead of waiting for an issue to be brought to a company's attention, it should consider investing in technology to help uncover issues before employees feel compelled to contact the SEC. There are a number of third-party solutions available to help detect fraud. Also, before buying a third party solution, a company should assess whether or not it has the capabilities in-house to leverage existing technology to detect fraud.

Commission an Ethics and Compliance "Health Check": In the event that an employee bypasses a company's reporting mechanisms and provides information directly to the SEC, senior executives may begin to question the overall effectiveness of a company's ethics and compliance efforts. Conduct a health check to determine if there are any gaps or overly cumbersome processes in place that could discourage employees from sharing concerns with the company first. Consider selecting a random group of employees and asking them to share their thoughts on the company's hotline reporting process. Ideally, this survey should be administered with safeguards in place to ensure employees that their identities will remain hidden.

Ensure a Company has the Right Type of Hotline: It is crucial that employees trust the hotline a company has in place. With trust, the chances that an employee will report an issue to the company instead of the SEC increase dramatically. A company's hotline should ideally be managed by a third party with experienced representatives who are highly trained in how best to gather and extract information from corporate whistleblowers.

Provide Regular Reports to Executive Management as well as the Board: Information regarding the status of an investigation should be appropriately shared with senior executives and the board. If it isn't, it can slow or delay the company's ability to allocate the appropriate resources to respond, and the lack of information may also frustrate the board and make the company's response appear weak or ineffective.

Build Trust at Every Turn: The importance of trust cannot be understated as it relates to a company's corporate compliance program. Employees must trust that the information they share, as well as their identities, will only be shared with those who have a defined "need to know." Employees must have faith

that the company will handle the information appropriately and not seek to ignore issues or fail to appropriately investigate the information that they provide.

Ensure that Employees' Rights are Protected: In addition to the protections provided to employees under the *Sarbanes Oxley Act*, Dodd-Frank provides additional protection for whistleblowers. Employees supplying "original information" are protected from retaliation by their employers. Retaliation is never appropriate and now even less so. Under the *Dodd-Frank Act*, whistleblowers can take their cases involving retaliation directly to federal court. If a whistleblower prevails, he or she would be entitled to reinstatement at the same seniority, two times the amount of back pay owed plus interest, attorney expenses, expert witness costs, etc., not to mention the adverse publicity that results when a company is found guilty of retaliation.

Companies Should Adopt a Continuous Improvement Mindset: Companies often establish an ethics and compliance program, then fail to frequently review it for effectiveness over time. Dodd-Frank provides the strongest incentive yet for employees to report fraud and abuse. Without continued investment in a company's ethics and compliance program, weaknesses can develop. Employees may uncover the weaknesses, view the company's program as ineffective, and go directly to the SEC. Companies should establish at least a quarterly review to assess the program's overall performance and areas for improvement.

Bottom line: Employers must encourage internal reporting of improper conduct. If a complaint comes in, a company must take prompt and appropriate action in order to reduce exposure to serious charges.

Like-Kind Exchanges:

Follow All Requirements Carefully

If your clients sell commercial or investment real estate that has appreciated significantly, one way to defer a tax bill on the gain is with a "like-kind" exchange. But these transactions must be structured carefully. One Tax Court case shows how a couple tried to engage in a swap, but since they didn't comply with all the rules, the swap did not qualify for like-kind exchange treatment.

A like-kind or Section 1031 exchange of investment or business property allows a taxpayer to acquire another property in a new location -- or a different type of property -- without paying tax on the gain. With these transactions, a taxpayer can defer paying a tax bill and not tie up his or her money.

For example, let's say a client purchased a small strip shopping center 20 years ago. He's moving out of state and wants an income property that requires less work. If the client sells the center, he may have long-term capital gain of hundreds of thousands of dollars, and he'll have unrecaptured Section 1250 gain, leaving him with a lot less cash to reinvest in a new property. A like-kind exchange allows the client to defer the gain indefinitely until the property is ultimately sold.

There are two basic ways to complete a like-kind transaction. The client can find a property he wants and exchange his property for it. But that's unlikely because it's difficult to find another real estate investor who wants to make an exchange of suitable property at the same time the client does. There's a second, more common approach.

For a number of years, the IRS has allowed a deferred exchange through the use of qualified escrow accounts or qualified intermediaries. In a typical situation, the property is sold with a qualified

intermediary receiving the proceeds. The intermediary then acquires replacement property the taxpayer designates and transfers that property to the taxpayer. *The key:* A taxpayer can't have control over the funds.

In one Tax Court case, the property owners did not follow all the rules so their exchange did not qualify for tax-favored treatment.

Facts of the Case: Ralph Crandall and Dene Dulin sold an undeveloped parcel of property in Arizona that they held for investment. The taxpayers tried to engage in a like-kind exchange to acquire property in California. After receiving some limited advice concerning a tax-free exchange of properties, the taxpayers took steps to sell the Arizona property and purchase a new property with the intention of executing a tax-free exchange.

They sold the Arizona property for \$76,000. The buyers paid \$10,000 and the remaining \$66,000 was placed in an escrow account with a title company. At the taxpayer's direction \$61,743 was held in the escrow account but later transferred to a second title company to purchase the replacement property. The escrow agreements did not reference a like-kind exchange, nor did they expressly limit the taxpayer's "right to receive, pledge, borrow, or otherwise obtain the benefits of the funds," according to the Tax Court.

To qualify as a deferred exchange, the court noted, the transaction must be an exchange of *property*, not a transfer of property for money. The reinvestment of cash proceeds from one property into a second property will not qualify as a Section 1031 exchange. Gain or loss may be recognized if a taxpayer actually or constructively receives money before receiving like-kind property.

To avoid being in constructive receipt of money or property, a taxpayer must use a qualified escrow account. But in this case, the taxpayers had control of the funds. The court held the transaction did not qualify for like-kind exchange treatment. (*Ralph E. Crandall Jr. and Dene D. Dulin*, T.C. Summary Opinion 2011-14)

The dollar amounts involved in this Tax Court case were relatively small. More often, the amounts in real estate transactions are much larger. This is one of those times when taxpayers want to make sure they follow all the requirements carefully. Fortunately, there are many qualified intermediaries who know the rules and will help ensure compliance. Moreover, the fee for the service is usually minor.

Even with the use of a qualified escrow account or intermediary, not all exchanges qualify. Here's a short checklist of the basics:

- The property a taxpayer is disposing of and the one he or she is acquiring must be held for investment or for productive use in a trade or business. A rental property or vacant land held for appreciation qualifies -- a principal residence or a vacation home does not. The property disposed of and the one acquired must be like-kind. When dealing with real property, most property qualifies, but the rules are much stricter for other property. A truck and an auto, both used in a business, aren't like-kind. (The like-kind exchange rules generally don't apply to stocks, bonds, etc.)
- The receipt of some unlike property (transferring a property for cash and another property) doesn't disqualify the transaction, but could generate taxable gain.
- If the exchange is not simultaneous, a taxpayer must identify the replacement property within 45 days after transferring the relinquished property and receive the replacement property within 180 days (or, if earlier, the due date of the taxpayer's return).
- If the property a taxpayer is exchanging is encumbered by a mortgage, and he or she is relieved of the debt, the rules are more complicated.
- Special rules apply to transactions between related parties.

They may have other options. Another approach is a "reverse-Starker" exchange or "parking transaction" where a taxpayer acquires the replacement property first. And, while deferring the gain is generally a smart move, there are situations where clients may want to recognize all or part of the gain immediately.

Private Companies Need Modified Standards, Not Separate Rules

Private companies have long argued that U.S. Generally Accepted Accounting Principles (GAAP) are too expensive to apply and that the results are often of marginal benefit to end users.

So the American Institute of Certified Public Accountants and the Financial Accounting Foundation (FAF) created a "Blue Ribbon Panel" to analyze how existing U.S. accounting standards could be leveraged to help improve the usability of private company financial statements.

The panel recently issued a report on its findings, which are summarized below.

There are approximately 28 million private companies in the United States. In contrast, there are approximately 14,000 public companies that have reporting requirements with the U.S. Securities and Exchange Commission (SEC).

Although private companies may not need to prepare GAAP financial statements for the SEC, they might need them for lenders, bonding companies, regulators, and others.

Depending on the size of a public company, the number of shareholders can reach well into the hundreds of thousands. A public company's shareholder population typically includes a broad range of investor types with a wide variety of expectations regarding the information needed from the company's financial statements.

Alternatively, the shareholder population of a private company is generally far smaller with relatively defined needs and expectations for the company's financial statements.

What both public and private shareholders do expect is accurate, reliable, and comparable financial statements that paint a clear picture of the company's financial performance over time.

Applying U.S. GAAP to private companies has resulted in a number of unintended consequences including the following:

- Private companies often incur considerable costs to apply U.S. GAAP. These costs may, or may not, improve the usability of their financial statements. In many cases, it can actually complicate the financial reporting process.
- Since private companies can choose to ignore GAAP, it is often difficult to compare financial statements for private companies with other entities.
- Stakeholders may not be familiar with U.S. GAAP or they may have specific questions that are not easily answered by reviewing the company's financial statements. As a result, stakeholders often request additional information or an ad-hoc analysis in order to make sense of the financial statements.
- Accounting staff members with U.S. GAAP experience can be relatively expensive to hire and retain since they can work with private *and* public companies.

The Blue Ribbon Panel issued a report earlier this year, which includes the following recommendations:

- The panel concluded there are "urgent and growing systemic issues that need to be addressed in the current system of U.S. accounting standard setting."
- However, the panel did *not* recommend a wholesale departure for private companies from U.S. GAAP. In the near term, the report stated, "The system should focus on making exceptions and modifications to U.S. GAAP for private companies that better respond to the needs of the private company sector."
- A new board should be created that would be overseen by the Financial Accounting Foundation (FAF). The board would be tasked with developing exceptions and modifications to U.S. GAAP to better suit the needs of private companies.
- A framework should be developed that the newly formed board could use to determine whether a specific exception or modification to U.S. GAAP is appropriate. The framework would take into account costs, complexity of the revisions, and the overall impact on the relevance and accuracy of a private company's financial statement.

The FAF is considering the panel's recommendations. It is likely that the foundation will release a final recommendation that will be available for public comment. It is possible that the FAF will finalize the changes to private company reporting later this year.

What do the panel's recommendations mean for companies? Will the users of private company financial statements welcome the exceptions and modifications produced by the newly appointed FAF board? Time will tell. However, consider the following steps that a company can take to prepare for the finalized changes:

Another View of the Panel's Proposal

The panel's recommendations are not without critics. Some have suggested that the plan is unrealistic because it puts forth solutions without adequately addressing the risks inherent in the solutions. Critics say we need to take another look, this time with a keen awareness of risk management. Successful implementation is not automatic and requires careful development and monitoring. For example, implementation might fail because of real-world resource constraints, or because the costs of implementation could exceed the benefits gained by resolving the issue. A solution with high implementation risk, critics argue, will probably prove useless.

Arguably, U.S. GAAP is most suited to public companies. The changes proposed by the Blue Ribbon Panel may be the first step in a long process that has the potential to dramatically improve the overall quality and consistency of private company financial reporting.

About the Blue Ribbon Panel

- The Blue Ribbon Panel was established in December 2009.
- It was made up of 18 members who are senior leaders representing a cross-section of financial reporting constituencies, including lenders, investors, and owners, as well as preparers and auditors.
- In January 2011, the panel issued a report with recommendations to the Board of Trustees of the Financial Accounting Foundation.
- The panel limited its work to private for-profit companies, and did not include private-sector not-for-profit entities.