Client advisor

CURRENT INFORMATION, NEWS AND TRENDS

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Health Care Reform Provides New Tax Credit for Small Employers

The Patient Protection and Affordable Care Act provides a tax credit for an eligible small employer (ESE) for non-elective contributions to purchase health insurance for its employees. The term "non-elective contribution" means an employer contribution other than an employer contribution pursuant to a salary reduction arrangement.

- **2010 through 2013 –** For tax years 2010 through 2013, qualified small employers, generally those with no more than 25 full-time employees with an average annual full-time equivalent wage of no more than $50,000 will be eligible for a tax credit of up to 35% of the cost of non-elective contributions to purchase health insurance for their employees. (Note, however, that the phase-out of the credit operates in such a way that an employer with exactly 25 full-time equivalent employees or with average annual wages exactly equal to $50,000 is not eligible for the credit.)
- **2014 and Later –** In 2014 and later, eligible small employers who purchase coverage through a state insurance exchange would be eligible for a tax credit for two years of up to 50% of their contribution.

The credit percentage that can be claimed varies with the number of employees and average wages. The full amount of the credit is available only to an employer with 10 or fewer full-time equivalent employees and whose employees have average annual full-time equivalent wages (AAEW) from the employer of less than $25,000.

Calculating the Credit Amount – The credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage (shown in the table provided) and subject to a phase-out:

(1) The amount of contributions the eligible small employer made on behalf of the employees during the tax year for the qualifying health coverage.

(2) The amount of contributions that the employer would have made during the tax year if each employee had enrolled in coverage with a small business benchmark premium. Contributions under this method are determined by multiplying the benchmark premium by the number of employees enrolled in coverage and then multiplying by the uniform percentage that applies for calculating the level of coverage selected by the employer. The IRS has published a benchmark premium table (by state) for 2010; for single coverage, the rates vary from $4,215 to $6,204, and $9,365 through $14,138 for family coverage.

Applicable Credit Percentage

	2010 – 2013	2014 & After*
Eligible Small Employers	35%	50%
Tax-Exempt 501(c) Organizations	25%	35%

** For years after 2013, only available for a maximum coverage period of two consecutive tax years*

Credit Phase-Out – The full credit is available only to eligible small employers with 10 or fewer full-time equivalent employees with an average annual full-time equivalent wage (AAEW) of $25,000 or less. If either or both of these thresholds is exceeded, then the credit is reduced.

Full-Time Equivalent Employees – The number of full-time equivalent employees (FTEs) is determined by dividing the total hours (limited to 2,080 per employee) that the employer pays wages during the year by 2,080 (rounded down).

Average Annual Full-Time Equivalent Wages – This amount is the employer's total FICA wages (without regard to the wage base limitation) for the tax year divided by the number of FTEs for the year (rounded down to the nearest $1,000, if need be).

Other Issues:

- The credit reduces the employer's deduction for employee health insurance.
- Aggregation rules apply in determining the employer.
- Self-employed individuals, including partners and sole proprietors, 2% shareholders of S corporations, and 5% owners of the employer are not treated as employees for purposes of this credit.
- The credit is not available for a domestic employee of a sole proprietor of a business, and there is a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members.
- The credit is a general business credit, and can be carried back one year and forward for 20 years. However, because an unused credit amount cannot be carried back to a year before the effective date of the credit, any unused credit amounts for taxable years beginning in 2010 can only be carried forward.
- The credit is available for tax liability under the alternative minimum tax.
- For certain 503(c) non-profits, the credit is used to reduce payroll taxes.

Please call this office if you have questions related to this tax credit.

“Reasonable” Compensation

Under Heightened Scrutiny

Corporate officers will sometimes attempt to disguise what should be payment for services as distributions of cash, dividends, and loans as a means of avoiding payroll taxes on the income. Because they are pass-through entities, Sub Chapter S corporations are especially prone to the misclassification of income attributable to a misunderstanding of the compensation rules or by deliberate attempts to reduce the payroll tax bite. Hence, the IRS and Congress are placing an increased emphasis on “reasonable compensation” and the collection of additional payroll taxes from the business and additional withholding from the officer or owner.

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

Who's an Employee of the Corporation? Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officers/shareholders who provide more than minor services to their corporations and receive (or are entitled to receive) payment are employees whose compensation is subject to federal employment taxes.

Treasury regulations provide an exception for an officer of a corporation who does not perform any services or who performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

What's a Reasonable Salary? The instructions for Form 1120S, U.S. Income Tax Return for an S Corporation, state that “Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.”

The amount of compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, then a salary amount must be determined and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

In IRS Fact Sheet 2008-25, the IRS warns S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

The following are some factors considered by the courts in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

In a recent district court case (Watson v. U.S., (DC IA 05/27/2010)) in which the IRS claimed that a portion of the dividend distributions by an S corporation to its sole owner should be recharacterized as wages subject to employment taxes, the court sided with the IRS and rejected the corporation's assertion that the IRS could not compel the corporation to pay a higher salary to the owner.

The American Jobs, Closing Tax Loopholes and Preventing Outsourcing Act of 2010, which passed the House on May 28, 2010 (currently awaiting Senate action), contains a provision that would clamp down on certain service professionals who try to minimize Medicare and Social Security taxes by routing their self-employment income through S corporations and then paying themselves nominal salaries.

If you have questions about this hot-button topic, please give this office a call.

American Opportunity Tax Credit Scheduled to Sunset at the End of 2010

Without Congressional intervention, 2010 will be the final year for the American Opportunity credit, which is a modified version of the Hope Education credit for tax years 2009 and 2010. The American Opportunity credit is available to a broader range of taxpayers with expanded income limitations and a more liberal list of qualified expenses than was the Hope credit. Many of those eligible will qualify for the maximum annual tax credit of $2,500 per student.

The American Opportunity credit, in many cases, offers greater tax savings than other existing education tax breaks! Here are some key features of the credit:

- Tuition, related fees, books, and other required course materials generally qualify. In the past, books usually were not eligible for education-related credits and deductions.
- The credit is equal to 100 percent of the first $2,000 spent and 25 percent of the next $2,000. That means the full $2,500 credit may be available to a taxpayer who pays $4,000 or more in qualified expenses for an eligible student.
- If you otherwise qualify, you can take this credit even if you have previously taken the Hope or Lifetime Learning credit in years prior to 2009.
- The full credit is available for taxpayers whose modified adjusted gross incomes (MAGI) are $80,000 or less (for married couples filing a joint return, the limit is $160,000 or less). The credit is phased out for taxpayers with incomes above these levels. These income limits are higher than under the former Hope and current Lifetime Learning credits.
- Forty percent of the American Opportunity credit is refundable. This means that even people who owe no tax can receive an annual payment of the credit of up to $1,000 for each eligible student. Other existing education-related credits and deductions do not provide benefits to people who owe no tax. The refundable portion of the credit is not available to any student whose investment income is taxed at the parent’s rate, commonly referred to as the “kiddie tax.”

Although most taxpayers who pay for post-secondary education will qualify for the American Opportunity credit, some will not. The limitations include a married person filing a separate return, regardless of income, joint filers whose MAGI is $180,000 or more, and, finally, single taxpayers, heads of households, and some widows and widowers whose MAGIs are $90,000 or more.

There are some post-secondary education expenses that do not qualify for the American Opportunity credit. They include expenses paid for a student who, as of the beginning of the tax year, has already completed the first four years of college. That’s because the credit is allowed for only the first four years of post-secondary education. However, for those students who qualify, the Lifetime Learning credit may be claimed instead.

To maximize your credit for 2010, it may be appropriate for you to prepay certain education expenses that apply to the first quarter of 2011. For additional information on this tax strategy or other issues relating to education tax benefits and credits, please give this office a call.

Clock is Ticking

for the Lean Burn Vehicle Credit

2010 is the final year during which taxpayers can purchase an advanced lean burn technology vehicle and claim a tax credit for the purchase. Unlike the hybrid credit, the lean burn credit is available to vehicles with internal combustion engines that are designed to operate primarily using more air than is necessary for complete combustion of the fuel, incorporate direct injection, and achieve at least 125% of the 2002 model year city fuel economy rating. The table below lists the vehicles currently certified by the IRS as qualifying for the advanced lean burn credit.

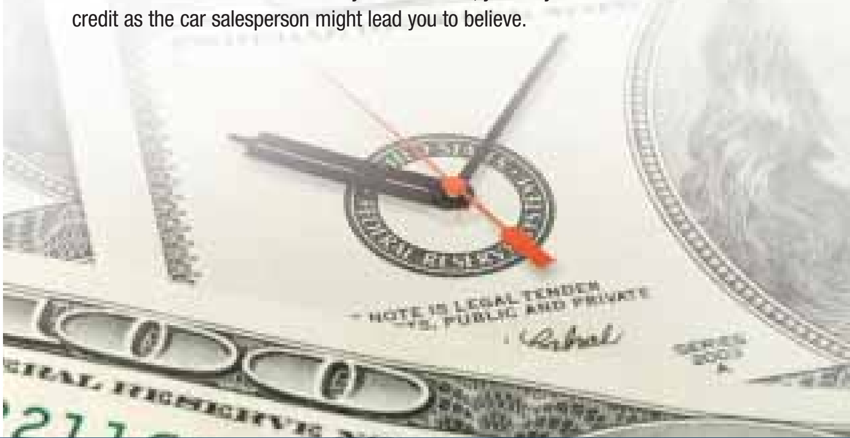
If a vehicle is used both for business and personal use, the credits are divided between personal and business use and can be used to offset both the regular and alternative minimum tax. The personal portion is a non-refundable credit, and can only reduce your current year tax to zero; any excess is lost. The business portion becomes part of the general business credit, and unused credits are carried back one year and forward twenty years.

The credit will be phased out starting in the quarter following the one in which the manufacturer records its 60,000th sale of hybrid and lean burn vehicles. Volkswagen Group America (includes Audi vehicles) has already reached that limit; thus, the allowable credits (as shown in the table below) are reduced by 50% for Audi and Volkswagen vehicles purchased for the balance of 2010.

2010 VEHICLES CURRENTLY CERTIFIED FOR THE LEAN BURN CREDIT

Mfg	Vehicle Description	Credit
Volkswagen	Jetta–2.0L TDI (manual and automatic)	$1,300
	Sportwagen - 2.0L TDI (manual and automatic)	$1,300
	Touareg – 3.0L TDI	$1,150
	Golf 2.0L TDI (automatic)	$1,700
	Golf 2.0L TDI (manual)	$1,300
	Audi A3 2.0L TDI Automatic	$1,300
	Audi Q7 3.0L TDI	$1,150
Mercedes-Benz	GL350 Bluetec	$1,800
	R350 Bluetec	$1,550
	ML350 Bluetec	$900
BMW	335d Sedan	$900
	X5 xDrive35d	$1,800
	ActiveHybrid x6	$1,550

If you are contemplating the purchase of a vehicle that qualifies for the advanced lean burn technology tax credit or one that qualifies for the hybrid tax credit, it may be appropriate for you to call this office in advance to see how the credits will or won't benefit you. This is especially true if you are basing your purchase decision on receiving the credit. Keep in mind that the personal portion of the credit is not refundable and cannot be carried over to another year. Therefore, you may not benefit as much from the credit as the car salesperson might lead you to believe.



Coming of Age: Extended Health Coverage for Adult Children

Before the passage of the Affordable Care Act into law, many health plans and issuers could remove adult children from their parents' policies because of their age, whether or not they were students or where they lived. Under this new law, plans and issuers that offer dependent coverage will be required to make the coverage available until adult children reach the age of 26. Although this new law is generally effective for plan years beginning on or after September 23, 2010, a large number of major insurers have agreed to an early implementation of this provision.

Tax Benefits – Under this new law, the value of any employer-provided health coverage for an employee's child is excluded from the employee's income through the end of the taxable year in which the child turns 26. This tax benefit is effective March 30, 2010. Consequently, the exclusion applies to any coverage that is provided to an adult child from that date through the end of the taxable year in which the child turns 26.

Being a Child under Age 27 is the ONLY Requirement! There are no additional requirements other than being the taxpayer's child under the age of 27. There is no income limitation or reference to marital status, student status, or any other requirement. Thus, an emancipated child, and even a married child of the insured will qualify, but not an in-law; therefore, the spouse of a child will not qualify. The definition of "child" for this purpose includes the individual's:

- child,
- stepchild,
- legally-adopted individual,
- an individual lawfully placed with the employee for legal adoption, and
- an eligible foster child.

Big Break for Self-Employed Health Insurance Deduction – A self-employed individual (or a partner or a more-than-2%-shareholder of an S corporation) can deduct as an above-the-line expense 100% of the amount paid during the tax year for medical insurance on behalf of himself or herself, his or her spouse and dependents, but limited to the net income of the business under which the plan was established. As part of the new health care reform law, this deduction, as of March 30, 2010, also applies to the health insurance premiums paid by the self-employed individual for his or her child under the age of 27 as of the end of the year.

Pre-Tax Coverage Through Employer's Cafeteria Plan – In addition to the exclusion from income of any employer contribution toward qualifying adult child coverage, an employee may pay the employee's portion of the health care coverage for an adult child on a pre-tax basis through the employer's cafeteria plan - a plan that allows employees to choose from a menu of tax-free benefit options and cash or taxable benefits. The IRS provided in recent guidance that the cafeteria plan could be amended retroactively up until December 31, 2010 to permit these pre-tax salary reduction contributions.

Equal Benefits – Any qualified young adult must be offered all of the benefit packages available to similarly situated individuals who did not lose coverage because of the cessation of dependent status. The qualified individual cannot be required to pay more for coverage than those similarly situated individuals. The new policy applies only to health insurance plans that offer dependent coverage in the first place; while most insurers and employer-sponsored plans offer dependent coverage, there is no requirement for them to do so.

If you have questions related to the tax treatment of health care benefits or expenses for children, please give this office a call.

Tax calendar

Sept. - Dec. 2010

September – December:

- Time for your 2010 fall and 2011 tax planning. Contact this office to schedule a consultation appointment.

September 15, 2010:

- The third installment of 2010 individual estimated taxes is due.
- This is the FINAL extended filing due date for your 2009 calendar year partnership returns (Form 1065), fiduciary returns (Form 1041), S corporation returns (Form 1120S), and corporation returns (Form 1120).

October 15, 2010:

- This is the FINAL extended filing due date for your 2009 individual income tax return.

December 31, 2010:

- Last day for taxpayers who began their minimum IRA distributions in a year before 2010 (including those whose first required distribution would have been in 2009 except for the waiver of distributions in 2009) to make their required withdrawal for 2010.
- This is generally the LAST day that you can pay tax-deductible expenses for the year. IRA contributions and some self-employed retirement plan contributions can be made after the close of the year.

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

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CURRENT INFORMATION, NEWS AND TRENDS

Since You Asked...

You Asked: **My brother is a carpenter and has had very little income in the past couple of years. Thus, I loaned him $10,000 last year. Because of his continued financial difficulties, he is unable to pay the loan back now or in the foreseeable future. I have decided to forgive the loan and write it off on my taxes. How do I report this loss on my tax return?**

Answer: Non-business bad debts are reported on Schedule D as a short-term capital loss. The information required includes the name of the debtor. The reason for that is a forgiven debt constitutes income to the debtor. Unfortunately in your case, you cannot write off the $10,000. To be deductible, a non-business bad debt must be enforceable debt and you, as the lender, must make reasonable efforts to collect on that debt. Such efforts to collect include legal action. Thus, if you decide to forgive your brother's debt, the loss is non-deductible.

You Asked: **I am considering hiring my spouse in my business. I understand that there is a new tax credit for hiring someone who has been unemployed for 60 days or more (this applies to my spouse), under which my business would be exempt from having to pay the employer's 6.2% share of the Social Security payroll tax on her wages for the remainder of 2010. Will it prevent my business from qualifying for the credit because she is my spouse?**

Answer: The law specifically excludes the taxpayer's children or their descendants, siblings or step-siblings, parents or a parent's ancestor, step-parents, nephews, nieces, uncles, or aunts, and in-laws but not the business owner's spouse from the credit you are describing. Thus, it would appear that your spouse's wages will qualify for the payroll tax holiday. In addition, if she continues to work for a continuous 52 weeks, your business would also be eligible for the non-refundable tax credit of up to $1,000 in 2011.