CORDASCO
& COMPANY P.C.
Certified Public Accountants

2010

YEAR-END INCOME TAX PLANNING FOR CORPORATE AND NON-CORPORATE BUISNESSES

UPDATED NOVEMBER 15, 2010

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INTRODUCTION

It is that time of year again to evaluate year-end tax planning for corporations and other businesses. Year-end tax planning is particularly critical for 2010 because Congress has enacted a series of business tax breaks that are scheduled to expire **after 2010,** and several others that expire **after 2011.** These tax provisions are contained in: **1)** The ***Hiring Incentives Act of 2010*** (HIRE Act) which addresses high unemployment; **2)** The ***Health Care Act of 2010*** (Health Care Act) which overhauls the health care industry (but also contains an array of tax provisions impacting businesses), and **3)** The ***Small Business Jobs Act of 2010*** (Jobs Act) with tax incentives that encourage businesses to make capital investments. Collectively, this legislation contains an extended menu of new tax breaks and temporary tax incentives for businesses, including: a credit for small employers offering employee health insurance; tax incentives for employers that hire qualified unemployed workers; extension of the 50% bonus depreciation; a doubling of the §179 expense deduction; 100% gain exclusion for "qualified small business stock;" relaxation of the S corporation built-in gains tax rules; extension of the carryback period for eligible small business credits to five years (instead of one year); relief from rigid documentation rules for business use of cell phones; enhancement of the deduction for "start-up expenses;" and a SECA tax deduction for a self-employed's health insurance costs. Also, **starting in 2013,** the *Health Care Act* not only imposes a new Medicare Surtax on a higher-income taxpayer's earned income, it also creates a separate Medicare Surtax on "investment income" that could apply to the pass-through operating business income of "passive" owners of S corporations, partnerships, and limited liability companies (LLCs).

We are sending you this letter to bring you up-to-date on these new rules, and the planning opportunities that they create for corporate and non-corporate businesses. This letter also reminds you of the *traditional* year-end tax planning strategies for businesses (including regular "C" corporations, "S" corporations, partnerships, LLCs, and self-employed individuals).

> **Caution!** Several of the most significant new tax breaks **expire after 2010** (and others after 2011). Consequently, you may have to act promptly to take advantage of these short-lived provisions!
>
> **Planning Alert!** Although this letter contains many planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability (including the alternative minimum tax) with and without the strategy. You should also consider any state income tax consequences of a particular planning strategy. We recommend that **you call our firm before implementing any tax planning technique** discussed in this letter, or if you need more information.

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***HiGHLIGHTS* OF RECENT LEGISLATION IMPACTING YEAR-END PLANNING FOR BUSINESSES**

Overview

One of the key features of the ***Health Care Act of 2010*** (Health Care Act) is that its expansive provisions are phased in incrementally over an eight-year period. Thus, it will take several years before the full impact of this massive legislation is felt. Most of the *Health Care Act's* insurance coverage mandates are **not required until 2014,** however several of the most important *tax changes that* impact business are effective **as early as 2010,** and other key tax changes **become effective in 2011.** Therefore, businesses generally have several years to prepare for the Act's insurance coverage mandates, but the *tax changes* will require more immediate attention. Consequently, this letter addresses primarily the **tax provisions** in the *Health Care Act.* By contrast, most of the tax provisions in the ***Hiring Incentives To Restore Employment Act of 2010*** (HIRE Act) and the ***Small Business Jobs Act of 2010*** (Jobs Act) have a very short life, with some of the tax breaks **available only in 2010,** and several **others expiring in 2011.**

The following are *selected* provisions from this tax legislation that we believe will have the greatest impact on 2010 year-end planning for corporations and other businesses.

> **Planning Alert!** Due to the temporary nature of many of these tax breaks, please pay careful attention to the **effective date** and **expiration date** (if applicable) for each new provision, which we ***highlight prominently*** in each segment.
>
> **Tax Tip.** The recent legislation contains a host of accelerated depreciation write-offs for qualifying equipment, vehicles, buildings, software, start-up expenses, and capital improvements to certain buildings, several of which are available only if the property is *"placed-in-service"* generally **no later than December 31, 2010.** If your business plans to take advantage of any of these increased write-offs for 2010, make sure that you order, purchase, acquire, or construct the property early enough so that your business can actually *place it in service* **no later than December 31, 2010!**

§179 Deduction Increased From $250,000 To $500,000 For 2010 And 2011. In the last several years, Congress has temporarily increased the maximum §179 deduction for the cost of qualifying new or used depreciable tangible "personal" business property (e.g., machinery, equipment, off-the-counter computer software) to help spur the economy. As 2010 started, the §179 deduction was limited to $250,000, and was reduced by the amount that the §179 property acquisitions exceeded $800,000. For **property placed in service in tax years beginning in 2010 and 2011,** the *Jobs Act* increased this cap from $250,000 to **$500,000,** and also increased the beginning phase-out threshold from $800,000 to **$2,000,000.** In addition, for **2010 and 2011 purchases,** the §179 deduction *temporarily* includes *"qualified real property"* (discussed in the next segment).

> **Tax Tip.** If earlier in 2010 you had previously maxed out under the old $250,000 cap, you now have an additional $250,000 you can use to buy and *place in service* §179 property before the end of 2010. Generally, "placed-in-service" means the property is ready and available for use. If you want to take the increased deduction **for 2010,** to be safe, qualifying property acquired by calendar-year businesses should be set up and tested **by December 31, 2010.**
>
> **Planning Alert!** For tax years beginning *after* 2011, the maximum §179 deduction cap is currently scheduled to drop back to $25,000.

- **Beware Of Taxable Income Limitation!** The §179 deduction generally is not allowed to the extent the deduction exceeds the taxpayer's business taxable income (determined without the §179 deduction). Thus, due to this so-called *taxable income limitation*, the §179 deduction generally cannot create a taxable loss (or NOL).

  Tax Tip. On a joint return, spouses can combine their business income from all sources for purposes of the *taxable income limitation*. Thus, business income includes not only trade or business income, but also W-2 compensation income of either spouse on a joint return. For example, a wife who generates a §179 deduction from her sole proprietorship, partnership, or S corporation may use her husband's W-2 compensation (as well as her own W-2 income) generated from an entirely separate business to satisfy the §179 taxable income limitation, if they file jointly. Thus, the §179 deduction from one source can essentially be used to offset the taxpayer's (and spouse's) W-2 income or other business income from other sources.

  Planning Alert! If the §179 deduction is limited by the *taxable income limitation, the excess* is generally carried forward indefinitely to future tax years and may be used to offset taxable income in later years.

- **Two Limitations From Pass-Through Entities.** If you have a pass-through business entity (e.g., S corporation, LLC, partnership), you must apply the $500,000/$2,000,000 limitations and the *taxable income* limitation twice, once at the entity level and again to the owners (i.e., to the S corporation shareholders, LLC members, and partners).

  Tax Tip. If wages are paid to a more than 2% S corporation shareholder or if "guaranteed payments" are paid to an owner of a partnership (or LLC), these payments are added back to the entity's business income for purposes of determining the entity's *taxable income limitation.* Consequently, in that situation, the S corporation's or partnership's §179 deduction can actually exceed the pass-through entity's *taxable income*, and create a pass-through loss. These rules can get quite complicated, please call us if you need additional guidance.

Please Note. If your business is considering a significant equipment or business vehicle purchase, please call our office. We will help you develop a strategy to maximize tax savings.

Taxpayer May "Elect" To Treat *"Qualified Real Property"* As §179 Property *For 2010 And 2011.*
Traditionally, the §179 deduction has been limited to depreciable, tangible, "personal" property, such as equipment, computers, vehicles, etc. The *Jobs Act temporarily* allows taxpayers to "elect" to treat qualified "real" property as §179 property, provided the property is **placed-in-service in tax years beginning in 2010 and 2011.** The maximum §179 deduction that is allowed for *qualified real property* is $250,000. "Qualified Real Property" includes property within any of the following three categories: **1) Qualified Leasehold Improvement Property** (generally capital improvements to an interior portion of certain leased buildings that are used for nonresidential commercial purposes); **2) Qualified Retail Improvement Property** (generally capital improvements made to certain buildings which are open to the general public **for the sale of tangible personal property**); and **3) Qualified Restaurant Property** (generally capital expenditures for the improvement, purchase, or construction of any building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals). If you elect to take up to $250,000 of the §179 deduction on qualified real property, the $500,000 overall §179 deduction limitation is reduced to $250,000 ($500,000 - $250,000).

Tax Tip. If your calendar-year business is currently acquiring business assets or making capital improvements to "qualified real property," and you want to take the §179 write-off **for 2010,** you must place the building (or capital improvement) in service **by December 31, 2010!** A certificate of occupancy will generally constitute placing the building in service.

Planning Alert! The rules dealing with improvements to leased commercial buildings, buildings used for retail, and buildings used as restaurants are extremely tricky and time sensitive. Furthermore, the depreciation rules become even more complicated if you are planning to do a cost segregation study where you break out nonstructural components of a building for depreciation purposes. Please call our firm if you are improving, acquiring, or constructing a building. We will help you devise a strategy that will maximize depreciation and §179 deductions.

50% Bonus Depreciation Extended *Through 2010*. The original bonus depreciation was first allowed in 2001 and generally sunset after 2004. In 2008, Congress reinstated the 50% bonus depreciation deduction for 2008, and later extended it to 2009. The *Jobs Act* extends the 50% bonus depreciation for one more year, **through 2010.** Therefore, the 50% bonus depreciation deduction is available for new "qualifying property" **acquired and placed-in-service during calendar years 2008, 2009, and 2010** (2011 for certain long production period property or specified aircraft).

Planning Alert! Whether your business uses a fiscal or calendar tax year, the 50% bonus depreciation is allowed only if "qualified property" is "acquired" and "placed-in-service" **during calendar years 2008, 2009, or 2010.**

Qualifying 50% Bonus Depreciation Property. This generally includes *new* property that has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, qualified motor fuels facilities) and "qualified leasehold improvements" (capital improvements to certain commercial buildings under lease).

Planning Alert! These are only *examples* of qualifying property. If you have a question about property that we have not mentioned, call us and we'll help you determine if it qualifies.

- **Special Rule For Long-Term Contractors. For property placed-in-service in 2010 that has a *depreciable life of 7 years or less*,** the *Jobs Act* provides that income reported under the "percentage of completion" method will be determined without taking into account the 50% bonus depreciation. If your business is using the percentage of completion method for long-term construction or production projects, **please call our office**. We will give you more information on how this **"2010 only"** provision could provide tax relief to your business.

- **Pay Close Attention To Property Classification.** Make sure you properly classify "land improvements" as "15-year property" (and not as part of the building) since land improvements qualify for the 50% bonus depreciation, and buildings (other than "qualified leasehold improvements") generally do not. Furthermore, property within a new building that is not a structural component of the building (e.g., pursuant to a *cost segregation study*) may be treated as "tangible personal property." If you can effectively segregate these costs, you may qualify for three favorable depreciation benefits: **1)** §179 treatment, **2)** the 50% bonus depreciation deduction for new property, **and 3)** more rapid MACRS depreciation write-offs.

- **50% Bonus Depreciation Has No Taxable Income Limitation.** Unlike the §179 deduction, there is no "taxable income" limitation on the 50 % bonus depreciation. Therefore, the deduction for 50% bonus depreciation can create or add to a net operating loss (NOL).

  Planning Alert! A 2010 NOL may generally be carried back 2 years, and carried forward 20 years.

Bonus Depreciation For Passenger Automobiles, Trucks, And SUVs. The maximum annual depreciation deduction (including the §179 deduction) for most *business automobiles* is capped at certain dollar amounts. **For 2010,** the maximum first-year depreciation for a business automobile is generally capped at $3,060 ($3,160 for trucks and vans not weighing over 6,000 lbs). However, Congress previously increased the first-year depreciation cap for vehicles by $8,000 for 2008 and 2009. The *Jobs Act* **extends this $8,000 increase through 2010. For example,** let's say you are self-employed and you are planning to purchase a *new* vehicle weighing 6,000 lbs or less that will be used 100% in your business. If you buy a new car and place it in service before the end of 2010, your first-year depreciation deduction will be $11,060. If you wait until 2011 (assuming Congress doesn't extend the bonus depreciation deduction and the 2011 first-year depreciation cap is the same as for 2010), your first-year depreciation deduction would be only $3,060. **Trucks And SUVs Over 6,000 Lbs.** Trucks and SUVs with loaded vehicle weights over 6,000 lbs are generally exempt from the passenger auto annual depreciation caps discussed above. However, the §179 deduction for an *SUV* is limited to $25,000 (instead of $500,000 for 2010 and 2011). However, *pickup trucks* heavier than 6,000 lbs are *not* subject to the $25,000 limit imposed on SUVs, if the truck bed is at least six feet long.

Tax Tip. If you purchase the passenger vehicle, truck, or SUV in 2010, to qualify for the §179 deduction and/or the 50% bonus depreciation, your business mileage of the vehicle through **December 31, 2010** must exceed 50% of the total mileage. Therefore, by keeping your personal use to a minimum, you will maximize your business percentage for 2010 which could dramatically increase your 2010 depreciation deduction.

Planning Alert! If your business use percentage drops to 50% or below after 2010, you may be required to bring into income a significant portion of the depreciation and/or §179 deduction that was originally taken. Therefore, it is imperative that the business use of the vehicle exceeds 50% for subsequent years.

Self-Employed Individuals May Deduct Health Insurance Premiums In Calculating Self-Employment Taxes *For 2010 Only.* Generally, if you are self-employed, you are entitled to deduct your health insurance premiums, paid for you and your family, as an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions"). However, traditionally, your health insurance premiums *were not deductible* for purposes of computing the Self-Employment (S/E) tax (Social Security and Medicare taxes) that is imposed on your self-employed income. **For tax years beginning in 2010,** the *Jobs Act* allows self-employed individuals to deduct their health insurance premiums for S/E tax purposes, as well as for regular income tax purposes.

Planning Alert! For 2010, the S/E tax rate is 15.3% for the first $106,800 of self-employed income, and 2.9% on the income exceeding $106,800. Thus, if your self-employed income for 2010 does not exceed $106,800, this temporary deduction will generally save you S/E tax equal to 15.3% of the cost of your health insurance. However, you are also allowed an above-the-line deduction for one-half of your S/E tax. So, your income tax deduction will also be reduced by one-half of any reduction in your S/E tax.

Tax Tip. If you are self-employed and you are planning to pay health insurance premiums in the early part of 2011, **accelerating that payment into 2010** will salvage a deduction for S/E tax purposes. Also, if you are a partner in a partnership or a member of an LLC, you should receive this same S/E tax benefit (**for 2010**) for health insurance paid on your behalf by the partnership or LLC.

"Qualified Small Business Stock" Exclusion *Temporarily* Increased To 100%. As a result of the *Jobs Act,* if you sell "qualified small business stock" (QSBS) **acquired after September 27, 2010 and before January 1, 2011,** you will be able to exclude the **entire gain** from taxable income (the gain will also be exempt from the alternative minimum tax). QSBS is generally stock of a non-publicly traded domestic "C" corporation engaged in a qualifying business, purchased directly from the corporation, **held for more than 5 years,** where the issuing corporation meets certain active business requirements and owned assets at the time the stock is issued of $50 million or less. Businesses engaged in a professional service, banking, hotel, motel, restaurant, or farming activity generally *do not* qualify.

Planning Alert! If you are considering starting a business, we would be glad to help you evaluate whether structuring your business so that it can issue QSBS will work to your overall tax advantage. However, you must act promptly to take advantage of this narrow window of opportunity to qualify for the 100% exclusion (only stock acquired **from September 28, 2010 through December 31, 2010** qualifies).

Caution! One of the key requirements for QSBS is that it be issued by a regular "C" corporation. Traditionally, a "C" corporation has not been the preferred entity for many new business ventures for various reasons, including the fact that the corporation's operating income is potentially subject to double taxation (once when earned by the corporation, and a second time when it is distributed to a shareholder as a taxable dividend).

Up-Front Deduction For Business Start-Up Expenses Increased *For 2010 Only*. If you start a new business, you are generally not allowed to deduct any portion of your start-up expenses until the tax year your business actually begins operations. Under the *Jobs Act*, for tax years **beginning in 2010,** the first $10,000 (up from the previous $5,000 limit) of start-up expenses are deductible up-front. However, the $10,000 immediate deduction is reduced by each dollar the total start-up expenditures exceed $60,000. Start-up expenses in excess of the up-front deduction amount are amortized over 180 months.

Tax Tip. If you are in the process of starting a new business operation (whether a sole proprietorship, corporation, partnership, or LLC) which is a calendar-year business, and wish to take advantage of the increased deduction of *start-up expenses* **for the 2010 calendar year,** you should take steps to establish that your business has actually begun operations (e.g., offer your product or service to the public, engage a client or customer, open your doors for business, begin manufacturing operations) **no later than December 31, 2010!**

Tax Incentives To Hire The Unemployed. Under the *HIRE Act*, an employer **that *hires* a *qualified unemployed worker* after February 3, 2010 and before January 1, 2011,** will get an exemption from the employer's 6.2% share of the Social Security taxes on *wages paid* to the employee from **March 19, 2010 through December 31, 2010.** In addition, for each qualifying worker retained for at least 52 **consecutive** weeks, the employer will generally get an "income tax" credit, of up to $1,000. A **Qualified Unemployed Worker** generally includes workers who began employment **after February 3, 2010** and **before January 1, 2011,** if the new worker: **1)** has been employed for no more than 40 hours during the 60-day period immediately preceding the date the employment begins, **2)** is *not related* to a more than 50% owner of the employer, **3)** signs an affidavit (using Form W-11) that he or she meets the 40-hour/60-day requirement, and **4)** was not hired to replace an existing worker who was terminated (*unless* the previous worker terminated voluntarily or was terminated for cause).

Tax Tip. The 6.2% exemption applies to compensation "paid" from **March 19, 2010 through December 31, 2010,** regardless of when the compensation is "earned." Thus, a bonus paid to a qualified unemployed worker on December 31, 2010 would qualify, while the same bonus in early January, 2011 would not. Likewise, a signing bonus for a qualified worker (who could presumably be an executive meeting the 40- hour/60-day requirement) hired late in 2010, that is **paid no later than December 31, 2010,** should qualify.

Small Employers Get New Credit For Providing Employee Health Insurance. One of the pleasant surprises included in the *Health Care Act* is a new tax credit for ***"eligible small employers"*** that **1)** offer health insurance to employees, **2)** pay a uniform percentage of the cost for each covered employee, and **3)** pay at least 50% of the cost of insurance. For **tax years beginning after 2009 and before 2014,** *the Health Care Act* allows an *eligible small employer* a credit of up to 35% (up to a 25% "refundable" credit for tax exempts) of the cost of qualifying employee health insurance. **For tax years beginning after 2013,** the maximum credit is increased to 50% (35% for tax exempts).

Tax Tip. Although, in certain situations, these rules can be quite technical and complicated, the IRS has implemented a significant initiative to help small businesses get the guidance and information they need to determine if they qualify. For example, the IRS has sent out postcards to millions of small businesses encouraging them to take advantage of this credit if they qualify. The IRS has also recently added links to its main website (www.irs.gov) providing "tax tips," "guidance," and "answers to frequently asked questions" with respect to this credit. An **Eligible Small Employer (ESE)** must have less than **25** *full-time equivalent employees* (FTEs) during the year, and *average annual FTE wages* of **under $50,000. Please call our firm** if you think that your business may qualify for this credit. We will help you determine whether your business qualifies, and the amount of credit you can expect.

- **Credit For *2010 Only* May Qualify For 5-Year Carryback.** Generally, if your business does not have enough tax liability to offset the health insurance credit, the unused portion can generally be carried back one year and offset taxes you paid in that previous year. Any remaining credit can be carried forward for up to 20 years to offset future tax liabilities.

  Planning Alert! If your business qualifies as an "*eligible small business"* (as discussed in the next segment of this letter), your health insurance credit **generated in 2010** can be carried back to the preceding 5 years.

  Tax Tip. This temporary provision is particularly beneficial for businesses that: **1)** are paying health insurance premiums that qualify for the credit, **2)** are generating negligible taxable income in 2010, and **3)** paid taxes on profits it generated during the preceding 5 years.

- **Planning With Personal Service Corporations (PSCs).** If you have a professional practice (e.g., doctor, attorney, dentist, engineer, accountant, etc.) that operates as a "professional service corporation" (a regular "C" corporation), any taxable income you retain in the corporation is generally taxed at a flat rate of 35%. Consequently, it is common for PSCs to pay all earnings out as deductible compensation to the shareholder/employees, while leaving little or no taxable income in the corporation. In that case, if the PSC potentially qualifies for the new *health insurance credit*, it will not have sufficient corporate tax liability to utilize the credit. If you are in that situation, you should consider retaining enough taxable income in your PSC to create sufficient corporate tax liability to absorb the health insurance credit. This might be accomplished by replacing a portion of the compensation paid to the shareholder/employees with dividend distributions (taxed at a maximum rate of 15% for 2010).

Planning Alert! Using this planning technique can be both tricky and time sensitive. **Please do not attempt** this strategy without calling us first. We will help you determine whether this planning technique is advisable for your PSC.

"Eligible Small Businesses" Get Temporary Tax Breaks For General Business Tax Credits. Generally, a business may carry its unused general business tax credits back one taxable year to offset the taxes it paid in that previous year. Any remaining amount may be carried forward up to 20 years to offset future tax liabilities. Moreover, many business tax credits are not available to offset a taxpayer's alternative minimum tax (AMT) liability and, therefore, have limited benefit. Under the *Jobs Act,* "eligible small business credits" **determined in the first tax year beginning in 2010** can be carried back to the 5 years (instead of 1 year) preceding 2010, and will also offset the taxpayer's AMT. An *"eligible small business credit"* is a general business credit generated by taxpayer :**1)** that is a sole proprietorship, a partnership (which generally includes a limited liability company), or a non-publicly traded corporation (which includes S corporations and closely-held C corporations), and **2)** that has $50 million or less in average annual gross receipts for the prior three years.

Planning Alert! Calendar-year businesses that wish to take advantage of this **"2010 only"** tax break, should take all necessary steps to make the expenditure, or place the property in service, that generates the business credit – **no later than December 31, 2010.**

S Corp 10-Year Built-In Gain Period Temporarily Shortened To 5 Years. If a regular "C" corporation elects "S" corporation status (a "Converted S Corporation"), the election itself generally does not trigger income. However, the Converted S Corporation must generally pay a 35% corporate "built-in gains tax" on the sale of any built-in gain asset, if sold during the first 10 years following the S election ("10-Year Recognition Period"). A *built-in gain* asset is generally any asset with a market value greater than the asset's basis on the effective date of the S election. The *Jobs Act temporarily* reduces the original 10-Year Recognition Period *to 5 years* **for tax years beginning in 2011.** The Act provides that there will be no tax on the net recognized built-in gain of an S corporation for any taxable year beginning in 2011, if the 5th year (i.e., 12-month period) in the recognition period precedes such year.

Recordkeeping Rules For Cell Phones Relaxed. Effective for tax years beginning after 2009, the *Jobs Act* provides that cell phones and similar telecommunications equipment (including PDAs and Blackberry devices) are no longer classified as "listed property". In order to obtain a deduction for the business use of listed property, detailed contemporaneous recordkeeping is required. Therefore, after 2009, the general documentation rules for business deductions apply to cell phones and similar devices used for business.

Form 1099 Required For Payments Of $600 Or More To *Corporations.* Businesses that make payments of compensation, interest, rents, royalties, income, etc. aggregating $600 or more for the year to a single payee is required to report the payments to the IRS, generally by filing a Form 1099. Under current law, this reporting requirement, subject to certain exceptions, *does not apply to payments to a corporation*. **Effective for payments made after 2011,** this new Form 1099 reporting rule will apply to payments aggregating $600 or more to corporations as well as others.

Increase In Information Return Penalties. The *Jobs Act* increases the penalties for failure to file a correct information return (e.g., Form 1099), effective for information returns that **must be filed after 2010** (**i.e., information returns for the 2010 tax year).** For example, unless there is reasonable cause for the failure, if 2010 1099s are not filed by August 1st 2011, the penalty is generally $200 per failure. $100 for failing to file the 1099 with the Internal Revenue Service and $100 for failing to file a copy of the 1099 with the recipient of the payment.

Planning Alert! These increased penalties make it even more important that businesses file information returns timely with both the IRS and, with the payee.

Form 1099 Required For Payments Of $600 Or More For The Purchase Of Property. Effective **for payments after 2011,** the *Health Care Act* requires a person engaged in a trade or business to file a Form 1099 for payments made for the purchase of property, if the gross payments are $600 or more.

Planning Alert! This provision has generated a tremendous amount of negative feedback from the business community and various professional groups. Don't be surprised if this reporting requirement is scaled back significantly before it becomes effective in 2012.

Employers Will Be Required To Include Cost Of Health Insurance On W-2s. For **tax years beginning after 2011,** employers will be required to report the annual aggregate cost of group health plan coverage on an employee's Form W-2 (the inclusion is optional for tax years beginning after 2010).

Planning Alert! This is only an information reporting requirement and will generally not change the tax-free treatment of employer-provided health coverage that exists under current law.

PAY CLOSE ATTENTION TO "OTHER" EXPIRING (AND EXPIRED) BUSINESS TAX BREAKS

Congress has given us an ever- expanding list of temporary tax breaks that expire every few years. However, even though it often waits until the last minute, Congress has historically extended most of the more popular provisions before they actually expire. Unfortunately, Congress has yet to extend many of the commonly-used tax breaks.

Selected **Business Tax Breaks That Expired At The *End Of 2009*.** Some of the more popular business tax benefits that **expired at the end of 2009** include the: **1)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Leasehold Improvements;" **2)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Restaurant Improvement Property;" **3)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Retail Improvement Property;" **4)** 5-Year (instead of 7 year) Depreciation Period for Certain Farming Business Machinery and Equipment; **5)** Research and Development Credit; **6)** Employer Differential Wage Credit for Payments to Military Personnel; **7)** Various Tax Incentives for Investing in the District of Columbia; **8)** Favorable S Corporation Charitable Contribution Provisions; and **9)** Enhanced Charitable Contribution Rules for Qualifying Business Entities Contributing Computer Equipment, Book, and Food Inventory.

> **Planning Alert!** Although several pieces of "proposed" legislation would have extended these provisions, at least through 2010, they have yet to be enacted. Our firm monitors the status of these expired provisions closely. Please call us if you want an up-to-date report.

Selected **Business Tax Breaks That Are Currently Scheduled To Expire At The *End Of 2010*.** The following are selected tax breaks that are scheduled to expire **after 2010;** consequently, this will be the last year you will able to take advantage of these tax breaks unless Congress decides to extend them beyond 2010: **1)** Maximum Long-Term Capital Gain and Qualified Dividend Rates of 15% (Scheduled to Return to 20% and 39.6%, respectively, after 2010); **2)** Employer-Provided Educational Assistance Tax-Free Fringe; **3)** Credit For Employer-Provided Child Care Facilities; **4)** *Accumulated Earnings* and *Personal Holding Company* penalty tax rates of 15% (scheduled to return to 39.6% after 2010); **5)** Work Opportunity Tax Credit (WOTC) For Certain *Unemployed Veterans* And *Disconnected Youth*; and **6)** Deferral And Ratable Inclusion Of Income From Certain Business Debt Discharges. **Please note** that our firm also monitors these expiring provisions and feel free to call us if you need a status report.

PREPARING FOR POTENTIAL TAX RATE INCREASES

Unless Congress changes current law, higher-income individual owners of pass through business entities are facing an increase in their federal income tax rates beginning next year. **In 2011,** the top individual income tax rate on income, other than long-term capital gains, is scheduled to jump from 35% to 39.6%. The maximum tax rate on long-term capital gains is scheduled to increase from 15% to 20%. And, the top tax rate on dividends is scheduled to increase from 15% to 39.6%. Furthermore, **starting in 2013**, the *Health Care Act* imposes a new **.9% Medicare Surtax** on the *earned income* of higher-income taxpayers. Also, beginning **in 2013,** the new law also contains a **3.8% Medicare Surtax** on the *investment income* of higher-income taxpayers, which could apply to the pass-through operating income taxed to a "passive" owner of an S corporation, partnership, or LLC (discussed in more detail below). **Please note** that there is no scheduled increase after 2010 in the maximum 35% tax rate for regular "C" corporations.

> **Planning Alert!** The "accumulated earnings" and "personal holding company" corporate penalty taxes are scheduled to increase from 15% to 39.6% **after 2010.**

Until we have firm guidance as to the 2011 rates for individual owners, dividends, long-term capital gains, and the corporate penalty taxes, taking actions in 2010 in anticipation of the 2011 rates is full of uncertainties.

> **Tax Tip.** Regardless of what happens to tax rates after 2010, there are several actions you should consider for 2010 regarding your regular "C" corporation:

Closely-Held "C" Corporations Should Consider Paying Dividends In Lieu Of Year-End Bonuses. Since your regular "C" corporation can generally deduct a bonus, and cannot deduct a dividend, the advisability of paying a shareholder/employee a dividend in lieu of a year-end bonus is based largely on the tax brackets of both the corporation and the shareholder. If your corporation is feeling the effects of the recession and would receive little or no tax benefit from a year-end bonus deduction (e.g., it is incurring current losses and/or has net operating loss carryovers to the current year), then a dividend **paid in 2010** taxed at a maximum rate of 15% will generally save taxes. On the other hand, if your corporation has significant income and is currently in a high tax bracket, then a bonus **paid in 2010** would likely save taxes.

> **Planning Alert!** If you decide that a 2010 dividend will save you and your corporation overall taxes, the corporation should declare and pay the dividend no later than **December 31, 2010** to ensure the benefit of the current 15% maximum tax rate (assuming that Congress does not extend the 15% dividend rate beyond 2010). On the other hand, if you decide that a year-end bonus would be more tax beneficial, be sure that you can justify the reasonableness of the bonus. If your corporation pays compensation to a shareholder/employee that is considered unreasonably high, the IRS may attempt to re-classify the payment as a dividend payment. Therefore, the corporation should document the reasonableness of compensation paid to all shareholders/employees.
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> **Tax Tip.** We will gladly help you tailor a compensation plan that will maximize the tax savings to you and your corporation.
>
> **Caution!** Paying dividends to shareholders of Personal Service Regular "C" Corporations (in lieu of compensation) will generally not save you taxes. Personal Service Corporations generally are required to pay a flat 35% corporate tax rate on all taxable income (as discussed below).

Year-End Planning For Personal Service Corporations. If you own a "C" corporation that is a personal service corporation (PSC), all income retained in that corporation is taxed at a flat rate of 35%. Your C corporation is a PSC if its business is primarily in the areas of health, law, accounting, engineering, actuarial sciences, performing arts, or consulting. Furthermore, in order to be classified as a PSC, substantially all of your corporation's stock must be held by employees who are performing those services.

> **Tax Tip.** Generally, it is preferable from a tax standpoint to leave as little taxable income in a PSC as possible. This may be accomplished by paying reasonable salaries and compensation to the stockholders/employees **by year-end.**

"Passive" Pass-Through Owners May Be Hit By New 3.8% Medicare Surtax On *Investment* Income Starting In 2013! It is not too early to begin thinking about (and developing a strategy for) the new 3.8% Medicare Surtax that begins **in 2013.** Since the inception of the Medicare program, the Medicare tax has only been imposed on an employee's "*wages"* and a self-employed individual's "income from self employment." Under the *2010 Health Care Act*, **after 2012,** a new 3.8% Medicare Surtax may be imposed on the *net investment income* (e.g., interest, dividends, annuities, royalties, rents, and capital gains) **of higher-income individuals. The tax will apply to married individuals filing jointly** with modified adjusted gross income (MAGI) **exceeding $250,000 (exceeding $200,000 if single).**

- **Net Investment Income** also generally includes *operating* business income that is taxed to a "passive" owner (unless the operating income constitutes *self-employment* income to the owner that is subject to the 2.9% Medicare). For this purpose, an owner is considered "passive" in a business activity (excluding activities conducted through a C corporation) if the owner is subject to the passive loss limitation rules because the owner does not *materially participate* in the business. For example, you are deemed to *materially participate* in a business and, therefore, the business is not passive, if you spend more than 500 hours during the year working in the business.

  > **Tax Tip.** To avoid the surtax, **after 2012,** the owner should consider taking the steps necessary to materially participate in the activity (e.g., working in the entity for more than 500 hours during the year).
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  > **Planning Alert!** If the owner has other passive activities with losses, the owner may prefer to remain "passive" so that the income from the S corporation or partnership may be used to offset the passive losses of the other activities.

TRADITIONAL YEAR-END PLANNING FOR REGULAR "C" CORPORATIONS

Be Wary Of Passive Loss Trap When Leasing Property To Your Closely-Held Corporation. Owners of a closely-held C corporation frequently own the business office building, warehouse, etc. individually (or through a partnership or LLC), and lease the facility to their corporation. This is often recommended **1)** to help protect the leased facility from potential claims of the corporation's creditors, and **2)** to avoid the potential of generating a double tax (one tax at the corporate level and another at the shareholder level) when the building is sold. However, a recent Tax Court case reminds us that this planning technique can also create a "passive loss" trap. In this case, the Tax Court concluded that any rental loss generated from the shareholders' leasing property to their controlled C corporation will generally be classified as a "passive loss." Therefore, the shareholders must "suspend" the loss, and will not be able to deduct the rental loss on their current returns unless they have other passive income.

> **Tax Tip.** To avoid this trap, the shareholders should set the lease payments at a level (assuming the lease amount is reasonable) so that the rental property does not generate a tax loss.

Newly-Formed Corporations. If you have started a new business this year and have filed articles of incorporation with the Secretary of State, you generally must treat the corporation as a regular C corporation. This can create a tax trap if your new business generates a tax loss in its first year. As a C corporation, the loss will be trapped inside the corporation and you will not be able to use the loss to offset income on your personal income tax return.

> **Tax Tip.** You may, however, be able to take this loss on your personal return if you file a timely S election for the first year of the new corporation. Generally, this election must be made no later than the 15th day of the third month following the date your corporation starts business. However, in certain situations, the IRS may allow a late S election if you intended to make a timely election, but failed to do so. Please call our office before you set up a new corporation, and we will help you decide whether an S election is advisable.
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> **Planning Alert!** It is always best to call us before you set up any new business so we can help select the business entity that will offer the most flexible tax planning opportunities, and so we can assist you in filing any necessary elections, etc.

Pay Sufficient Estimated Tax. If your C corporation had less than $1 million of taxable income for each of the past three tax years, it will be classified as a "small corporation" and may base its current year quarterly estimated tax payments on 100% of its "prior" year tax liability. If the corporation is not a "small corporation," it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its "current" year tax liability, or 100% of its annualized tax liability.

> **Planning Alert!** If your "small corporation" had no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the "current" year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty.
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> **Tax Tip.** If your "small corporation" anticipates showing a small tax loss in 2010, you may want to accelerate income (or defer expenses) in order to generate a **small income tax liability in 2010.** This will preserve the corporation's ability to use the "100% of last year's tax" safe harbor for 2011 estimates. If the corporation expects taxable income of more than $1 million for the first time in 2010, you should consider **deferring income into 2011** or **accelerating deductions into 2010** to ensure the corporation's 2010 taxable income does not exceed $1 million, so that it maintains its "small corporation" status for 2011.

Properly Document Loans To Shareholders. If you borrow from your closely-held corporation, you should make sure there is a written agreement to repay your loan, a fair interest rate is charged, and the loan is authorized by a corporate resolution. Without adequate interest and proper documentation, the IRS may treat your loans as constructive distributions which could result in dividend treatment and double taxation.

> **Planning Alert!** A corporation should charge interest at least equal to the Applicable Federal Rate (AFR) on loans to shareholders. Otherwise, subject to certain exceptions, the IRS will impute interest and the imputed interest (in excess of the interest actually charged) will result in dividend treatment if the corporation has earnings and profits.

Document Uncollectible Debts. In these tough economic times, an increasing number of shareholders have loaned money to their closely-held corporations to help fund the company's cash-flow needs. If you have loaned money to your corporation and the corporation cannot repay the loan, you may be entitled to a bad debt deduction. To take the deduction in 2010, you must establish that the debt was worthless **by December 31, 2010.**

> **Tax Tip.** Generally, a shareholder's bad debt from the corporation is treated as a short-term capital loss (i.e., deductible up to the shareholder's capital gains plus $3,000). However, if you can establish that the primary purpose for loaning the funds to your corporation was to preserve your employment by the corporation, you may be entitled to a deductible "business bad debt" and avoid the limitations on capital losses. The IRS typically requires significant evidence showing you made the loan to preserve your job.
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> **Planning Alert!** If your loan to your corporation is treated as a business bad debt, it will constitute a "miscellaneous itemized deduction" which is subject to the 2% reduction rule, and is not deductible at all for alternative minimum tax purposes.

Charitable Contribution Planning. If your regular C corporation uses the accrual method for tax purposes, it can deduct an accrued charitable contribution if the contribution is authorized by the company's Board of Directors by year-end, and the contribution is paid on or before the 15th day of the third month after that year-end (e.g., March 15, 2011 for December 31, 2010 year-ends). Your corporation should have a "Board of Directors Charitable Contribution Resolution" on its year-end tax planning checklist.

> **Planning Alert!** A regular C corporation's charitable contributions generally cannot exceed 10% of its taxable income (after certain adjustments). Furthermore, contributions in excess of the 10% cap cannot be carried back to previous years, but may be carried forward for up to five years. This rule for accruing charitable contributions applies to regular corporations but not to S corporations.
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> **Tax Tip.** If you own a closely-held C corporation, it may be more beneficial for you to make charitable contributions individually, rather than allowing your corporation to make contributions in excess of the 10% of taxable income limitation.

TRADITIONAL YEAR-END PLANNING FOR "S" CORPORATIONS

Check Your Stock And Debt Basis Before Year End. If your S corporation is anticipating a taxable loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless you have adequate "basis" in your S corporation. You will have basis to the extent of the amounts paid for your stock (adjusted for net pass-through items and distributions), plus any amounts you have personally loaned to your S corporation. If you do not have sufficient stock basis for the pass-through loss, a mere guarantee of a third-party loan made to your S corporation will not give you basis.

> **Tax Tip.** It may be possible to restructure an outside loan to your corporation in a way that will give you adequate basis. However, this restructuring must occur **before the end of the tax year**.
>
> **Planning Alert!** Making sure that you have sufficient basis is particularly important **in 2010** if your S corporation anticipates generating losses from the ***"2010 only"*** 50% bonus depreciation. The rules for restructuring existing loans to an S corporation to ensure basis are complicated. **Please do not attempt to restructure your loans without contacting us first.** Also, if you finance losses of an S corporation with loans from other entities controlled by you, or if you borrow from another shareholder, the IRS may take the position that these loans do not give you basis. It is best not to finance S operations with funds borrowed directly from related corporations or from other shareholders.

Pay Careful Attention To Payments On S Corporation Shareholder Loans. As discussed above, let's assume that you have previously loaned funds to your S Corporation which, in turn, created basis that you have used to deduct pass-through losses. If all or a portion of the loan is paid back after the loan's basis has been reduced by pass-through losses, you will recognize a gain on the repayment. The amount, character, and timing of the gain is dependent on several factors, including: **1)** when during the tax year the payment is made, **2)** whether the loan is an "open account" advance, or evidenced by a written promissory note, and **3)** the amount of the unpaid balance on an "open account" advance as of the end of the tax year. For example, if the loan is an "open account" (i.e., not evidenced by a written promissory note), the gain will generally be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note and has been outstanding for over one year, the gain on the payback may qualify for favorable long-term capital gains treatment.

> **Tax Tip.** It may save you taxes in the long run if you postpone principal payments on the depleted-basis loan until the loan's basis has been restored by subsequent S corporation pass-through income. **Please consult with us before you make any payments on your shareholder loans.** We will help you structure the loans and any loan repayments to your maximum tax advantage.

Salaries For S Corporation Stockholders/Employees. The combined employer and employee FICA tax rate is 15.3% of your wages up to $106,800 **for 2010.** The combined rate drops to 2.9% for wages in excess of $106,800.

> **Tax Tip.** If you are a stockholder/employee of an S corporation, you may wish to take no more than a "reasonable salary" from your corporation to minimize your FICA tax. Other income that passes through to you or is distributed to you as a distribution on your stock is not subject to FICA tax.

Planning Alert! Determining “reasonable salaries” for S corporation stockholders/employees is a hot audit issue, and the IRS has a winning record on taking taxpayers to court on this issue. The IRS has been particularly successful where S corporation owners pay themselves no salary even though they provided significant services to the corporation. In these cases, the courts have generally held that all amounts paid out to the S corporation owners were actually wages subject to FICA and Medicare taxation.

Caution! Minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your “wages.”

TRADITIONAL YEAR-END GENERAL BUSINESS PLANNING

Self-Employed Business Income. If you are self-employed, it continues to be a good idea to defer as much income into 2011 as possible, if you believe that your marginal tax rate for 2011 will be equal to or less than your 2010 marginal tax rate. If you think that deferring 2010 income to 2011 will save you overall taxes, and you use the cash method of accounting, consider delaying year-end billings until 2011.

> **Planning Alert!** If you have already received the check in 2010, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

Year-End Accruals To Employees. Generally, if an accrual-basis business accrues year-end compensation to its rank-in-file employees (nonshareholder employees), the accrual must be paid no later than the 15th day of the third month after year-end to be deductible for the year of the accrual. Otherwise, the accrual is not deductible until paid.

> **Planning Alert!** These rules also apply to accrued vacation pay, and to accruals for services provided by independent contractors (e.g., accountants, attorneys, etc.).

Accruals To "Related Parties." Year-end accruals to certain cash-basis recipients must satisfy the following rules in order for an accrual-basis business to deduct the accruals. **These rules apply to fiscal year as well as calendar year businesses:**

- **Regular "C" Corporations.** If your regular C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning more than 50% (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income.

  > **Tax Tip.** If the corporation's tax rate for 2010 is significantly greater than the more-than-50% stockholder's individual rate for 2010, the accrued amount should be paid by the **end of 2010.**

- **S Corporations And Personal Service Corporations.** If your S corporation or personal service C corporation accrues an expense to any shareholder (regardless of the amount of stock owned), the accrual is not deductible until the day it is includable in the shareholder's income.

- **Partnerships, LLCs, LLPs.** If your business is taxed as a partnership, its accrual of an expense to **any owner** will not be deductible until the day it is includable in the owner's income.

- **Other Related Entities.** Generally, an expense accrued by one related partnership or corporation to another **cash-basis** related partnership or corporation is not deductible until the day it is includable in the cash-basis entity's income.

Establishing A New Retirement Plan For 2010. Calendar-year taxpayers wishing to establish a qualified retirement plan for 2010 (e.g. profit-sharing, 401(k), or defined benefit plan) *generally* must adopt the plan **no later than December 31, 2010**. However, an SEP may be established by the due date of the tax return (including extensions), and a SIMPLE plan must be established no later than October 1, 2010.

FICA Withholding On Deferred Compensation. If your business sponsors a nonqualified deferred compensation plan, you may have certain FICA tax withholding and reporting responsibilities. IRS regulations provide that FICA taxes are due on most deferred compensation in the year the compensation is **earned, rather than the year it is paid.** The IRS says that your business can pay its portion of the FICA tax (and can withhold the executive's portion) with the final payroll of the year.

Personal Use Of Company Cars. If your company provides employees with company-owned cars, the company is required to include the value of the personal use of the car in the employees' W-2 income. However, this is not required if the employee reimburses the company for the personal use.

> **Planning Alert!** If your company does not report the employee's personal use as W-2 income and the employee does not reimburse the company for the personal use, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion.
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> **Tax Tip.** If the employee chooses to reimburse the company for personal use of the car, the obligation for reimbursement should be established **on or before December 31st** so the employee will not have income in one year and a deduction in the next. This can be accomplished by establishing a published policy for reimbursement of personal use. Furthermore, your company should obtain signed statements from employees documenting their business and personal mileage for the company car.

Mileage Reimbursement Rates. Each year the IRS provides an amount per mile that employers may reimburse employees for the business use of their vehicles rather than reimbursing actual expenses. This standard mileage reimbursement amount for 2010 is **50 cents-per-mile.**

Your Daily Transportation Might Constitute "Business Travel." Generally, daily travel from your home to your "regular place of business" is considered a nondeductible, personal commuting expense. However, the IRS says that if you have a "regular place of business," you can deduct daily travel from your home to any "temporary work location" even if the work location is within the metropolitan area in which you live. If you have no regular place of business, the temporary work location must be outside your "metropolitan area" for your daily travel to qualify as business mileage.

> **Tax Tip.** The IRS says you are considered traveling to a "temporary work location" if you realistically expect your work assignment there to last for *one year or less.* The IRS also says that if you have a qualifying home office, travel from your home to any other business location is generally business travel regardless of the distance or frequency. Please call us if you need additional information on what constitutes a *qualifying home office* or legitimate *business travel*.

Certain Business Modifications To Trucks And Vans Make Them 100% Business. Generally, if you use a passenger vehicle in your business, you are required to keep a log or other documentation to support your business mileage. However, if you make certain modifications to your business pick-up or van, the IRS says that, for tax purposes, the vehicle will be deemed to be used 100% for business, even though you have some nonbusiness use. For example, a pick-up truck that has either permanently affixed decals or special painting advertising your business, and is equipped with either a hydraulic lift gate, permanently installed tanks or drums, or permanently installed side boards, is deemed to be used 100% for business. The same is true of a van that has the company name permanently affixed to the vehicle, has only seats for the driver and one passenger, and the back of the van is generally filled with shelving or merchandise during on-duty and off-duty hours.

Tax Tip. These specially-equipped business vehicles are not limited by the passenger automobile depreciation caps even if they do not have a gross vehicle weight of more than 6,000 lbs. Furthermore, if you inadvertently applied the depreciation limits to these vehicles in prior years, the IRS says that you may use the automatic accounting method change procedures to correct the prior year's returns.

Be Careful Before You Trade In A Business Vehicle. If you are considering a trade of your business auto for another business auto, please call us first.

Tax Tip. If the tax basis of the old vehicle is significantly greater than the fair market value at the date of the trade (due to annual depreciation limits), a sale of the old auto (and a purchase of the new one) could produce a deductible tax loss that will be deferred if you trade. However, the sales tax implications of a sale, rather than a trade, must also be considered.

Hiring Children By Family Businesses Can Save Overall Taxes! There has long been a tax incentive for high-income owners of a family business to hire their children to work in the business. Generally, the parents could deduct their child's wages against their business income (which could be taxed as high as 35%), while the child would be taxed at rates as low as 10% (to the extent of child's unused standard deduction, the child's wages may avoid federal income taxes completely). Furthermore, if a child is under age 18 and working for a parent's sole proprietorship or a partnership where the only partners are the parents, the child's wages will be exempt from FICA tax while, at the same time, reducing the parents' self-employment (SECA) tax. Recent tax law changes have added additional incentives to hire children. For example:

- **Kiddie Tax.** Previously, children under age 18 were taxed on their unearned income (e.g., interest, dividends, and capital gains) at their parents' marginal tax rate if the unearned income exceeded a *threshold amount*. This rule is commonly referred to as the "kiddie tax." Over the last several years, Congress has expanded the *kiddie tax* to any child (who is not filing a joint return with a spouse) with "unearned income" in excess of the *threshold amount* ($1,900 for 2010) if: **1)**The child *has not attained age 18* by the *close of the tax year*; **OR 2)** The child *is age 18* (but not over age 18) by the *close of the tax year* AND the child's earned income does not exceed one-half the child's support; **OR 3)**The child is *age 19 through 23* by the *close of the tax year* AND the child is a full-time student AND the child's earned income does not exceed one-half the child's support.

  Tax Tip. Since a child's *earned income* is not taxed at the parents' rate, the expanded kiddie tax further encourages you to employ your child in your business and pay your child *reasonable* compensation. In addition, if your child is over age 17 and has wages (combined with other earned income) exceeding one-half of the child's support, the *new* kiddie tax rules will not apply to the child's unearned income.

  Tax Tip. By using this technique to avoid the kiddie tax rules, it would also open up tax planning opportunities for appreciated long-term capital gain property (e.g., stock) that you wish to sell. You could avoid paying the 15% capital gains tax (scheduled to go up to 20% in 2011) by first giving the stock to your child. Depending on your child's other income, your child could then sell the stock and all or a portion of the capital gain could be taxed as low as zero percent (scheduled to go up to 10% in 2011).

- **Expanded Refundable Credits.** Let's say your child is an unemployed single parent. Paying your child W-2 wages for working in your business could enable your child to receive recently-expanded refundable credits. For example, assume that your single child has a daughter who is her "qualifying child" for tax purposes. For 2010, your single child would only need: **1)** *earned income* of at least **$9,667** to get the full **$1,000** refundable *child credit*; **2)** *earned income* of at least **$6,452** to get the full **$400** refundable *making work pay credit*; and **3)** *earned income* of at least **$8,950** to get the full refundable **$3,043** *earned income credit.*

  Planning Alert! Thus, assuming your child meets the other requirements for these credits and does not have any other income, paying the child $10,000 of salary in 2010 could result in the child receiving $4,443 of refundable credits from the IRS.

  Caution! The child must actually work in your business and earn the wages paid.

- **Make Sure Childrens' Wages Are Reasonable!** If you employ your children, be sure to **1)** carefully document that the wages are reasonable for the work actually performed, **2)** pay the wages as part of the regular payroll, **3)** make sure the payroll checks are timely cashed and placed in the child's account, and **4)** comply with all laws relating to the employment of children.

The "Production Deduction." If your business generates "qualified production activities income" from manufacturing, construction, farming, ranching, engineering services, architectural services, software development, film production, production of sound recordings, etc., the business may qualify for a §199 *production deduction*. Generally, this deduction of **9% for 2010** (up from 6% in 2009) of the *qualifying income* cannot exceed 50% of the qualifying W-2 wages paid by your business.

- **Creating W-2 Wages For Purposes Of The Production Deduction.** Since the production deduction may not exceed 50% of W-2 wages paid to employees, the deduction is lost if there are no wages paid with respect to a qualifying business. Many farmers and small businesses reporting qualifying production activities income on Schedule F or Schedule C have paid no W-2 wages during 2010. However, in many of these businesses, a spouse has worked in the business but has not been paid.

  Tax Tip. One strategy to obtain a production deduction is to pay the spouse *reasonable* wages **on or before December 31, 2010.**

  Planning Alert! This strategy will generally be beneficial only where the additional FICA tax paid on the amounts paid to the spouse are offset by an equal reduction in the proprietor's or farmers's self-employed SECA tax liability. Therefore, the strategy is generally most beneficial when the self-employed income of the proprietor or farmer is $106,800 or less (i.e., the SECA wage base for 2010) before the payment of the spouse's salary. These calculations can be complicated. Please call us and we will help you determine whether or not the payment of wages to your spouse is advisable.

Expenses Paid By Partners And Shareholders May Be Limited. It is not uncommon for a partner in a partnership to individually pay business expenses of the partnership. Historically, the IRS has ruled that a partner may deduct business expenses paid on behalf of the partnership only if there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership.

Tax Tip. If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that they will not be reimbursed by the partnership.

Planning Alert! The courts continue to hold that corporate shareholders may not deduct expenses they pay on behalf of their corporation unless they are required to incur the expenses as a part of their duties as an employee. Even if the expenses are deductible, the shareholders/employees must classify them as miscellaneous itemized deductions which are subject to the 2% reduction rule, and are not deductible at all for alternative minimum tax purposes. This applies to S corporations as well as C corporations.

Tax Tip. If business expenses paid by a shareholder for an S corporation or C corporation are reimbursed to the shareholder under a qualified *accountable plan*, the corporation can take a full deduction and the shareholder will exclude the reimbursement from taxable income.

Worker Classification Continues To Be A Hot Tax Issue. If you hire independent contractors to work in your business, you run some risk of the IRS later arguing that these workers should have been treated as your "employees." If successful, the IRS could impose an array of taxes and penalties on your business.

Tax Tip. Even if these independent contractors should have been treated as employees, the IRS says that you can avoid reclassification (and related penalties) if you have a "reasonable basis" for treating the workers as independent contractors. Here is one way you can satisfy this "reasonable basis" test: **1)** file all necessary 1099 forms for the workers on a timely basis; **2)** consistently treat all employees performing similar duties as independent contractors; **and 3)** before you hire the workers, obtain an opinion from a knowledgeable tax person that it is appropriate to treat the workers as independent contractors for tax purposes.

Planning Alert! The rules for determining whether a worker is an independent contractor or an employee are very complex. Please call our office if you need assistance with this determination.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. Please call us before implementing any planning ideas discussed in this letter, or if you need additional information. **Note:** The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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