CORDASCO
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Certified Public Accountants

2010

INCOME TAX DEVELOPMENTS

UPDATED NOVEMBER 15, 2010

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2010 NEW TAX LAW LETTER

Responding to a weak economy and its desire to overhaul the health care system, Congress passed three significant tax bills this year: **1)** The ***Hiring Incentives Act of 2010*** (HIRE Act) to address high unemployment; **2)** The ***Health Care Act of 2010*** (Health Care Act) to overhaul the health care industry (which also contains an array of tax provisions), and **3)** The ***Small Business Jobs Act of 2010*** (Jobs Act) to help spur the economy 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 individuals and businesses alike. Much of the tax relief is **available for 2010,** including: a credit to small employers offering employee health insurance; tax incentives for employers that hire qualified unemployed workers; an increased refundable adoption credit; tax-free medical benefits to children who are not dependents; 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, under the *Health Care Act*, **starting in 2013,** higher-income taxpayers will be subject to a Medicare Surtax on "earned income," and a separate Medicare Surtax on "investment income."

> **Planning Alert!!** Following a trend it has embraced for over a decade, Congress failed to make many of these tax incentives permanent. Several key provisions expire ***at the end of 2010*****,** and several others ***expire in 2011.*** Consequently, **you may need to act quickly to obtain maximum benefits from these new provisions!**

In light of these significant changes, we are sending you this letter to keep you abreast of the major legislative tax developments that we believe have the greatest impact on our clients.

> **Planning Alert!!** We highlight only *selected* provisions of the new tax legislation. If you have heard or read about any tax development not discussed in this letter, feel free to call our office. This letter also contains planning ideas. However, you cannot properly evaluate a particular planning strategy without calculating your 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 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 THE HEALTH CARE, HIRE, AND JOBS ACTS

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* are effective **as early as 2010,** and other key tax changes **become effective in 2011.** Therefore, individuals and businesses 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.**

In light of the temporary nature of many of these tax incentives, and the phased-in effective dates of others, it is extremely important that you pay special attention to the **effective date** and **sunset date** (if applicable) for each provision, which we **highlight prominently** in each segment. To help you identify the items that may be of most interest to you, we have divided this letter between the new tax provisions that impact primarily **"individuals"** versus those that relate largely to **"businesses."** We also present these provisions in the order they become effective (starting with 2010), to help you determine which suggested actions are most urgent.

SELECTED PROVISIONS IMPACTING PRIMARILY *INDIVIDUAL* TAXPAYERS

PROVISIONS EFFECTIVE IN 2010

Self-Employed Individuals May Deduct Health Insurance 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, previously, 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 that would otherwise be lost. 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.

Planning Alert!! If you are an "employee" (instead of being self-employed) and *you pay your own* health insurance premiums, these payments will still be treated as "itemized deductions" and will not reduce the FICA tax on your W-2 earnings. However, as has been the case in the past, health insurance premiums paid by your employer are excluded from your W-2 earnings and are also exempt from FICA tax.

Rules For Cell Phones Relaxed. Prior to 2010, cell phones generally had limitations on deductions and restrictions on excluding the value of employer-provided cell phones from the employee's taxable compensation, unless a detailed log of the cell phone's business and personal use was maintained. **Effective for tax years beginning after December 31, 2009,** the *Jobs Act* removes cell phones and similar telecommunications equipment (including PDAs and Blackberry devices) from these restrictive documentation rules.

Planning Alert!! Although the rigid documentation requirements have been eliminated, employees and self-employed individuals still need to show that the phone is used for business.

Tax Tip. These new relaxed documentation rules will also make it easier for a self-employed individual or an employee to deduct the cost of a cell phone.

Tax-Free Medical Benefits Extended To Children Under Age 27. **Effective March 30, 2010,** the *Health Care Act* allows tax-free reimbursements from an employer-provided health plan to any child of an employee **who is not age 27** *as of the end of the tax year*. This exclusion applies even if the taxpayer cannot claim the child as a dependent for tax purposes.

> **Planning Alert!!** The IRS says that cafeteria plans may need to be amended to allow reimbursements to employees' children who have not reached age 27 by the end of the year. However, the IRS also says that in order to be effective back to March 30, 2010, the plan amendment **must be made no later than December 31, 2010.**
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> **Tax Tip.** If you are self employed, you are generally allowed an "above-the-line" deduction (i.e., a deduction not restricted by the "itemized deduction" rules) for health insurance premiums that you pay for yourself, your spouse, and your dependent children. With this change, you are now allowed this deduction for health insurance premiums you pay for your child who is *under 27 by the end of the year*, whether or not the child qualifies as your tax dependent.

Adoption Credit Increased And Made Refundable For 2010 And 2011. For 2009, an individual was generally entitled to an adoption tax credit for qualifying adoption expenses of up to $12,150 per *eligible child*, provided that the taxpayer's modified adjusted gross income (MAGI) did not exceed certain income phase-out thresholds. **For tax years beginning in 2010 or 2011,** the *Health Care Act* makes two significant changes: **1)** the maximum adoption tax credit is **increased to $13,170**, and **2)** the credit becomes *"refundable"* (this generally means that, to the extent the credit exceeds your income taxes before the credit, the IRS will send you a check for the excess). The credit also reduces your alternative minimum tax (AMT). **For 2010,** the adoption credit is phased-out as your modified adjusted gross income increases from **$182,520 to $222,520** (whether you're married filing a joint return, or single).

> **Planning Alert!!** You are generally not allowed to take the credit if you are married but do not file a joint return (i.e., you file as *married filing separately*). If you are adopting a child jointly with a person who is not your spouse, you and the other adopting parent may not take an aggregate credit that exceeds $13,170 (for 2010). However, the IRS says that you and the other parent may allocate the credit (maximum $13,170) between the two of you "in any way you both agree."
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> **Tax Tip.** Generally, for domestic adoptions, you are allowed the adoption credit in the tax year *following the year* the qualifying adoption expense is "paid." However, the credit is allowed for adoption expenses paid in the same tax year that the adoption is finalized. Thus, qualified expenses for a domestic adoption paid **by December 31, 2010** will generally generate a refundable credit **in 2011.** However, by **finalizing the adoption on or before December 31, 2010,** you can generate a refundable credit **in 2010.** If you are involved in an adoption and want more information on this expanded tax credit, please call our office.
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> **Caution!** Starting **in 2010,** the IRS is requiring you to file a copy of the adoption decree (if the adoption is final) or certain other documentation (if the adoption is not final) along with your tax return for the year you claim the credit.

Group Health Plans Covering Dependents Must Continue Coverage Until Age 26. The *Health Care Act* requires that group health plans that are otherwise covering dependent children must continue to make dependent coverage available for an adult child until the child reaches age 26, **effective for plan years beginning after September 22, 2010.**

> **Tax Tip.** Although this new requirement is not a "tax" law change, it may impact certain tax-planning opportunities. For example, if your modified AGI for 2010 exceeds $180,000 on a joint return (or exceeds $90,000 if filing single), you are not entitled to the American Opportunity Tax Credit (formerly the HOPE Credit) of up to $2,500 for the college tuition that you pay for your dependent children. The IRS says that, in that situation, your child can instead claim the credit if you elect not to claim that child as a dependent on your return (even if your child otherwise qualifies as your dependent). It has been reported that some insurance carriers have refused to provide family coverage to the insured's child, unless the child was actually claimed as a dependent on the taxpayer's tax return. Once this new requirement is fully effective, an insurance company that provides family coverage would be required to cover your child until age 26, even if you elect not to claim the child as your dependent.

"Qualified Small Business Stock" Exclusion *Temporarily* Increased From 75% To 100%. Starting in 1993, Congress granted special rules for taxing gain on the sale of "qualified small business stock" (defined below). Congress liberalized these rules last year, and has temporarily liberalized them again under the *Jobs Act.* If you sell *qualified small business stock* (QSBS) acquired prior to February 18, 2009, you can exclude 50% of the gain from your gross income. The remaining 50% of the gain is taxed at a maximum rate of 28%. Therefore, the regular tax rate on the entire gain is 14% (50% x 14%). If you sell your QSBS that you acquired after February 17, 2009 and before September 28, 2010, the 50% exclusion is increased to 75%. Under the *Jobs Act*, if you sell 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). In other words, no regular tax or alternative minimum tax is imposed on the sale of this stock if it is held for at least five years.

- ***Qualified Small Business Stock* (QSBS).** 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.

  > **Planning Alert!!** Businesses engaged in a professional service, banking, hotel, motel, restaurant, or farming activity generally *do not* qualify. Also, to qualify, you must have purchased the stock directly from the issuing corporation.

  > **Planning Alert!!** QSBS does not qualify for any gain exclusion unless it first satisfies a 5-year holding period. Thus, taxpayers who **acquire qualifying stock after September 27, 2010 through December 31, 2010,** must still hold the stock for more than 5 years to qualify for the 100% gain exclusion. Unless Congress extends this provision beyond 2010, QSBS **acquired after December 31, 2010** will generally revert back to the 50% gain exclusion rule and the gain will no longer be exempt from the alternative minimum tax. If you are considering investing in a small business, we would be glad to help you evaluate whether structuring your investment as QSBS will work to your overall tax advantage.

  > **Caution!** 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). Don't forget, to qualify you must purchase the stock directly from the corporation that is issuing the stock or an underwriter of the stock (stock purchased from other third parties does not qualify).

Partial Relief From Penalties For Failure To Disclose Certain Tax Information. Taxpayers who invest in certain *designated tax shelters* are required to file Form 8886 with their tax returns disclosing that they have invested in a tax shelter. Failure to disclose these investments can result in penalties of up to $100,000 for individuals and up to $200,000 for others. In certain situations, these penalties may far exceed the tax benefits the taxpayer could have possibly received from the investment. The *Jobs Act* places a cap on these **penalties assessed after 2006.** With this new cap, the penalty is generally limited to 75% of the reduction in tax reported on the investor's income tax return as a result of participation in the transaction, or that would result if the transaction were respected for federal tax purposes.

> **Tax Tip.** Taxpayers who have previously paid this penalty in excess of the cap (for any penalty **assessed after 2006),** should seek a refund of that excess. **Please call us if you need additional details.**

PROVISIONS EFFECTIVE IN 2011

Tax Rates Begin Rising In 2011. Unless Congress changes current law, individuals 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%.

> **Caution!** Starting **in 2011,** current law also provides for a return of the provisions phasing out *itemized deductions* and *personal exemptions* for higher-income taxpayers (these phase-outs **do not apply for 2010).** Consequently, **starting in 2011,** for taxpayers who are affected by these phase-out limits, the *effective* top income tax rates will be even higher than the *actual* top statutory rates described above. Furthermore, **starting in 2013,** higher-income taxpayers will be subject to a new .9% Medicare Surtax on their wages and self-employed income and a 3.8% Medicare Surtax on their investment income (discussed in more detail below).

Reimbursements Of Over-The-Counter Drugs No Longer Tax Free. Before the *Health Care Act*, taxpayers were allowed tax-free reimbursements for most *nonprescription* drugs and medicines from a health savings account (HSA), health flexible spending arrangement (FSA), health reimbursement arrangement (HRA), Archer medical savings account (MSA), or other qualified employer health plans. **Effective for expenses incurred after 2010,** reimbursements for drugs and medicines will be tax free *only for* a prescribed drug or insulin.

> **Planning Alert!!** If you have been using a tax-favored reimbursement arrangement to pay for your over-the-counter medications (e.g., to treat a chronic medical problem such as allergies or asthma), these reimbursements will generally be taxable **starting in 2011.** However, the IRS says that a taxpayer can continue to receive tax-free reimbursements of these over-the-counter drugs and medicines by obtaining a written or electronic prescription that is issued by an individual who is legally authorized to issue a prescription.
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> **Caution!** The IRS has also warned that debit cards generally may not be used for the purchase of over-the-counter drugs **after 2010,** unless a prescription is submitted to substantiate that the drug is a prescribed drug. However, in order to give debit card issuers a bit of extra time to re-program their computer systems, the IRS announced that it would allow over-the-counter drug purchases with debit cards **through January 15, 2011.**
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> **Tax Tip.** The IRS has stated that you may receive tax-free reimbursements **after 2010** for non-prescription drugs **that you purchased on or before December 31, 2010.**

Penalty For Non-Qualifying HSA Or MSA Distributions Increased To 20%. Generally, distributions for qualifying medical expenses from a *health savings account* (HSA) or *Archer Medical Saving Account* (MSA) are tax free. However, prior to the *Health Care Act*, distributions from an HSA before age 65 that are not for the reimbursement of qualifying medical expenses, are taxable, and are also subject to a 10% penalty (15% for an MSA). **Effective for distributions from an HSA after 2010,** the penalty for distributions made from an HSA prior to age 65 which are not used for qualified medical expenses is increased from 10% to 20% (for an MSA the increase is from 15% to 20%).

> **Tax Tip!** The penalty will not apply if the owner of the HSA or MSA is at least age 65 (eligible for Medicare coverage) on the date of the distribution.
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> **Planning Alert!!** Distributions from HSAs and MSAs **after 2010** for over-the-counter drugs without a prescription will not only be taxable, but will also trigger a **20% penalty.**

New Law Clarifies Tax Treatment Of "Partial" Pay Out Option By Nonqualified Annuity Contracts. If you receive annuity payments from your tax-deferred, nonqualified annuity contract (i.e., held outside of a qualified retirement plan or IRA), a portion of each payment is generally excluded from income based on an "exclusion ratio." The *exclusion ratio* is generally your investment in the entire annuity contract divided by the annuity's expected return. Under current law, there is no clear guidance as to how you would be taxed if you chose to take annuity payments from only a *portion* of your entire annuity contract (sometimes referred to as "partial annuitization"). **For amounts received in tax years beginning after 2010,** the *Jobs Act* permits you to receive *a part of* the annuity in the form of a stream of annuity payments, provided that the annuity payments are for a period of *at least* 10 years, or during one or more lives.

> **Tax Tip.** Under current rules, the IRS will authorize the partial annuitization of a single annuity contract only if the owner goes through a complex process that involves exchanging the single annuity contract for two contracts, waiting a period of time, and then annuitizing one of the new contracts. This welcomed change will allow the individual to receive annuity payments from a portion of his or her contract in one step, thus, making it much easier to annuitize *a portion* of the annuity contract while allowing the remaining amount to grow tax-deferred.

PROVISIONS EFFECTIVE IN 2013

Additional .9% Medicare Surtax On *Earned Income* Of Higher-Income Taxpayers. Payroll taxes imposed on your W-2 earnings include both a Social Security tax and a separate Medicare tax. Under current law, the overall Medicare tax rate is 2.9% (1.45% imposed on the employee and an additional 1.45% imposed on the employer). If you are self employed, you must pay the entire 2.9% Medicare tax on your income from self employment. However, as a self-employed taxpayer, you are allowed to deduct one-half (1.45%) of your Medicare tax as an "above-the-line" deduction. Although the *Health Care Act* does not increase your Social Security taxes, it does increase the Medicare taxes for higher-income taxpayers. **Generally, effective for wages and self-employed earnings received after 2012** that exceed certain thresholds, the *Health Care Act* imposes **an additional .9% Medicare Surtax.** This surtax applies to the amount by which the sum of your *W-2 wages* and your *self-employed earnings* **exceeds $250,000** if you are **married filing a joint return (exceeds $200,000 if you are single).**

> **Note!** For married individuals filing a joint return, the .9% Medicare Surtax will apply to the extent *the sum of* both spouses' W-2 earnings and the self-employed earnings exceed the $250,000 threshold. Also, if you are self-employed, you will not be entitled to take an "income" tax deduction for any portion of the .9% surtax imposed on your self-employed income.

New 3.8% Medicare Surtax On *Net Investment* Income. 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." **Starting in 2013,** a new 3.8% Medicare Surtax is imposed on the *net investment income* (e.g., interest, dividends, annuities, royalties, rents, and capital gains less applicable expenses) of *certain 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, $125,000 if married filing separately). **For example**, for individuals filing a joint return, the 3.8% Medicare Surtax will be imposed upon the lesser of **1)** modified adjusted gross income (MAGI) in excess of $250,000, or **2)** net investment income. Trusts and estates that have *net investment income* in excess of certain threshold amounts will also be required to pay the 3.8% Medicare Surtax, unless the income is timely distributed to beneficiaries. However, if the income is timely distributed, the beneficiary of the trust or estate may be subject to the Medicare Surtax if the beneficiary's MAGI exceeds the $250,000/$200,000 thresholds.

- **Net Investment Income.** Generally, "net investment income" includes (net of allocable deductions) interest, dividends, annuities, royalties, rents, gain from the sale of property (e.g., capital gains), and operating income from a business that trades in financial instruments or commodities. It 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 Surtax). 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.

- **Investment Income *Exempt* From The Surtax.** The following types of income are not subject to the 3.8% Medicare Surtax: tax-exempt bond interest; gain on the sale of a principal residence otherwise excluded under the home-sale exclusion rules; and distributions from qualified plans (e.g., IRAs, §403(b) annuities, etc.).

Planning Alert!! Taxable distributions from qualified plans, traditional IRAs, etc. will increase your MAGI which could, in turn, push you over the $250,000 (joint return) or $200,000 (single return) thresholds, subjecting your net investment income to the 3.8% Medicare Surtax.

- **Observations And Planning Considerations.** The following are a few observations and planning considerations relating to the new Medicare Surtax:

- **S Corporation Shareholders And Partners in Partnerships Should Evaluate Passive Activity Classification.** The income of an S corporation or partnership taxed to a high-income shareholder or partner who do not materially participate in the business could be subject to the 3.8% Medicare Surtax on the pass-through income. To avoid the surtax, 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).

  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.

- ***Qualified*** **Real Estate Professionals.** Although rental income from leased real estate is generally subject to the 3.8% surtax, a "qualified real estate professional" may be able to avoid the surtax on the rental income. Generally, a *qualified real estate professional* is a taxpayer who **1)** performs more than 750 hours of services during the year in real property trades or businesses, and **2)** more than 50% of the personal services performed in all of the taxpayer's trades or businesses during the year are performed in real property trades or businesses. Thus, if a *qualified real estate professional* "materially participates" (e.g., works more than 500 hours) in a real estate rental activity, it would appear that the rental income would not be "investment income," and would therefore be exempt from the 3.8% surtax.

- **Consider Roth IRA Conversions.** Since tax-free distributions from a Roth IRA do not increase your MAGI and thus will not increase your exposure to the Medicare Surtax, this should be factored into any analysis of whether you should convert your existing IRA to a Roth IRA. However, if the conversion occurs after 2012, the income triggered by the conversion increases your MAGI and therefore your potential exposure to the Medicare Surtax. Thus, by converting to a Roth **prior to 2013,** you may avoid any Medicare Surtax that would otherwise apply because of the conversion.

  Planning Alert!! Whether you should convert your traditional IRA to a Roth IRA can be an exceedingly complicated issue, and this new Medicare Surtax makes the decision even more complex. Please call our firm if you need help in deciding whether or not to convert to a Roth IRA.

- **Tax-Exempt Income Becomes More Valuable.** Investing in products that produce tax-exempt income will gain more importance. For example, tax exempt municipal bond interest will potentially provide higher income taxpayers with a double tax benefit: **1)** the interest will not be included in the taxpayer's MAGI thus reducing the chance that the taxpayer will exceed the income thresholds for the 3.8% Medicare Surtax, and **2)** the tax-exempt interest itself is exempt from the Medicare Surtax.

- **Additional Benefits For Contributions To Qualified Retirement Plans.** By maximizing your deductible contributions to qualified retirement plans (e.g., traditional IRAs, §401(k)s, SEPs, etc.), you will potentially receive a double tax benefit: **1)** your contributions will reduce your MAGI and reduce your chance of exceeding the income thresholds that would expose your current net investment income to the Medicare Surtax, and **2)** the retirement plan distributions that you receive when you retire will be exempt from the 3.8% Surtax.

- **Recognizing Gains On Investments Held More Than One Year In 2010.** With the scheduled increase in the maximum long-term capital gains rates from 15% to 20% **in 2011,** and the imposition of the new 3.8% Medicare Surtax on capital gains starting **in 2013,** timing your sales of stocks, bonds, or other securities has become much more complicated. High-income taxpayers may save taxes by selling their appreciated long-term capital investments **that have peaked in value** in 2010, instead of waiting until 2011 or later. Likewise, overall tax savings may occur if these taxpayers postpone selling investments producing a capital loss until 2011 or later, so that those losses can shelter capital gains that otherwise would be subject to the higher 20% capital gains rate and the 3.8% Medicare Surtax.

  Caution! Always consider the economics of a sale or exchange first!

- **Distributing Investment Income From Trust or Estate.** A trust or estate can avoid the 3.8% Surtax by making timely distributions of investment income to the beneficiaries of the trust or estate. Distributions will avoid the 3.8% Surtax altogether, where the beneficiaries have MAGI below the above-listed thresholds and are, therefore, not subject to the Surtax.

Deduction Threshold For Medical Expenses Raised From 7.5% To 10% Of AGI. Under current law, individuals are generally allowed an itemized deduction for unreimbursed medical expenses (including un-reimbursed health insurance premiums), but only to the extent that the expenses exceed 7.5% of adjusted gross income (10% for alternative minimum tax purposes). **Starting in 2013,** the *Health Care Act* generally increases the threshold for claiming an itemized deduction for unreimbursed medical expenses from 7.5% of adjusted gross income (AGI) to 10% of AGI. **Exception For Seniors. Through 2016,** if either the taxpayer or the taxpayer's spouse is **age 65 or older** before the close of the tax year, the increased 10% of AGI threshold will not apply.

> **Planning Alert!!** Since the alternative minimum tax (AMT) treatment of the itemized deduction for medical expenses is not changed, medical expenses will continue to be deductible for AMT purposes only to the extent that they exceed 10 percent of AGI, even if the taxpayer (or the taxpayer's spouse) is age 65 or older before the close of the tax year.

Annual Contributions To *Health* FSAs Will Be Capped At $2,500. Employer-sponsored cafeteria plans are one of the most popular tax-free fringe benefits offered to employees. Under these plans, employees can generally select certain tax-free benefits or taxable cash payments. Benefits provided under a cafeteria plan may be funded through employer contributions, employee salary reductions, or a combination of both. One common option under these plans is a *health care flexible spending arrangement* (Health FSA). These Health FSAs have become especially popular because they allow an employee to lower income taxes by paying for common medical expenses with before-tax dollars. Under current law, there is no limit (except as imposed by the plan itself) on the amount which an employee can elect to contribute to a health FSA through salary reductions. **Starting in 2013,** cafeteria plans will be required to cap the annual salary reduction contribution to a health FSA at $2,500. The $2,500 cap will be adjusted for inflation after 2013.

PROVISIONS EFFECTIVE IN 2014

Penalty For Failing To Carry Health Insurance. Beginning in 2014, the *Health Care Act* provides a penalty for individuals who do not have "minimum essential health coverage." The penalty will be paid with an individual's income tax return. Certain individuals may be granted an exemption from this penalty, such as: individuals having financial hardship or religious objections; American Indians; those without coverage for less than three months; aliens not lawfully present in the U.S.; incarcerated individuals; those for whom the lowest cost plan option exceeds 8% of household income; individuals with incomes below the tax filing threshold, and individuals residing outside of the U.S. Although the penalty will be assessed through the Internal Revenue Code and will be treated as additional tax owed, the failure to pay the penalty will not be subject to liens, seizures, or criminal or civil penalties. Instead, the IRS will be able to offset tax refund owed the noncompliant taxpayer.

> **Tax Tip.** Starting in 2014, the Health Care Act also provides for a *refundable* health insurance *premium assistance credit* to encourage low and middle income individuals to purchase health insurance.

SELECTED PROVISIONS IMPACTING PRIMARILY *BUSINESS* TAXPAYERS

PROVISIONS FIRST EFFECTIVE IN 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.**
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> **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.
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  > **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 Up To $250,000 Of *"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. (**Note!** Off-the-shelf software also qualifies if placed-in-service for *tax years beginning before 2012*). The *Jobs Act temporarily* allows taxpayers to "elect" to treat qualified "real" property as §179 property, provided that it 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.

Planning Alert!! It appears that "qualified real property" is not *automatically* included in the definition of §179 property, but is included only if you affirmatively "elect" to include it.

- ***Qualified Real Property*** includes property within any of the following three categories:

1) **Qualified Leasehold Improvement Property.** *"Qualified leasehold improvement property"* is generally any capital improvement to an interior portion of a building that is used for nonresidential commercial purposes, provided that **a)** the improvement is made under or pursuant to a lease either by the lessee, sublessee or lessor of that interior building portion; **b)** the interior building portion is to be occupied exclusively by the lessee or sublessee; **and c)** the improvement is placed-in-service **more than 3 years** after the date the building was first placed-in-service.

   Planning Alert!! *Qualified leasehold improvements* **doe not include** any improvement for which the expenditure is attributable to: the enlargement of the building; any elevator or escalator; any structural component benefitting a common area; or the internal structural framework of the building.

   Caution! Leasehold improvements made to property leased between certain *related persons* **will not qualify.**

2) **Qualified Retail Improvement Property.** *Qualified retail improvement property"* generally includes improvements **a)** made to the interior portion of a building used for nonresidential commercial purposes (whether or not the building is under a lease), **b)** placed-in-service **more than 3 years after** the building was **first** placed-in-service, and **c)** made to a building, the interior portion of which is open to the general public **for the sale of tangible personal property.**

   Planning Alert!! The following capital expenditures will not qualify: improvements that enlarge the building; any elevator or escalator; any structural component benefitting a common area; and any cost relating to the internal structural framework of the building.

3) **Qualified Restaurant Property.** *"Qualified restaurant property*" generally includes any building or improvement to a 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.

   Tax Tip. If a newly-constructed or newly-acquired (old or new) qualifying restaurant building is **placed into service in 2010 or 2011,** the *entire* cost of the building will qualify.

- **Overall Dollar Caps For §179 Deductions (Including "Qualified Real Property").** 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). **For example,** let's assume that in 2010 your calendar-year business places in service $600,000 of "qualified real property" (e.g., a restaurant building) and $300,000 of traditional §179 property (e.g., business equipment). Let's also assume that for 2010 you elected to deduct the maximum $250,000 of the cost of the *qualified real property*. Assuming that you were not restricted by the *taxable income limitation* (previously discussed), you would be entitled to deduct no more than $250,000 of the cost of the traditional §179 property (e.g., business equipment). Alternatively, let's assume that you elected to deduct only $200,000 of the cost of the *qualified real property.* In that case, you would be able to deduct up to $300,000 of the cost of the traditional §179 property.

- **$2 Million Phase-Out Threshold.** As mentioned earlier, the maximum §179 deduction is reduced by the amount by which the total §179 property acquisitions exceeds $2,000,000. Thus, for 2010 and 2011, once your §179 purchases exceed $2,500,000, the §179 deduction is completely phased out.

  Planning Alert!! It appears that if you "elect" to treat your recently-acquired *qualified real property* as §179 property, the *entire* cost of all of your *qualified real property* purchased in the current year will be applied to your $2 million phase-out threshold. Thus, if you have purchased traditional §179 property (e.g., business equipment, vehicles, etc.) but the cost of your *qualified real property* will put you well over the $2 million threshold, you might qualify for a larger §179 deduction overall by ***not electing*** to treat your *qualified real property* as §179 property (thus removing the real property from the $2 million phase-out).

- **Taxable Income Limitation.** The §179 deduction for *qualified real property* is also limited to the amount of the taxpayer's business taxable income (computed without the §179 deduction). However, unlike the §179 deduction for traditional §179 property, the §179 deduction for *qualified real property* in excess of the taxpayer's business taxable income **cannot be carried over to a tax year that begins after 2011.**

  Planning Alert!! This limitation essentially means that , for 2010, if the §179 deduction for *qualified real property* exceeds the taxpayer's 2010 taxable income, the excess can be carried over **only to 2011.** In addition, any such excess that occurs in 2011 **cannot be carried over at all** and, instead, must be added back to the depreciable basis of the *qualified real property*.

  Tax Tip. You may amend a prior year's return and change a previous §179 election, or make an initial §179 election on the prior return, if later events establish that overall taxes can be saved by making that change.

  Planning Alert!! If you are 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."

  Tax Tip. If the "qualified retail" or "qualified restaurant" improvements (described previously) are being made to a building under a commercial lease, it is possible that the improvements might also qualify as a "qualified leasehold improvement." If so, **for 2010,** these improvements may not only qualify for the temporary §179 deduction, but might also qualify for the *50% first-year bonus depreciation* deduction (discussed below).

Caution! 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 following the terrorist attacks of 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.** To meet the placed-in-service requirement for 2010, property must be ready and available for use **by December 31, 2010.** Also, the §179 deduction (discussed above) must be taken before the 50% bonus depreciation.

Tax Tip. There is no alternative minimum tax (AMT) on the excess depreciation taken because of the 50% bonus depreciation. Also, the §179 deduction and the 50% bonus depreciation deduction are not prorated if the property is placed-in-service at the end of 2010.

- **Qualifying 50% Bonus Depreciation Property.** Generally, the 50% bonus depreciation deduction applies only to *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.

- **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.

- **Special Rule For Long-Term Contractors.** Generally, taxpayers that report taxable income on long-term contracts using the "percentage of completion method" of accounting must recognize each year a percentage of the estimated revenue from the contract based on a completion percentage. The *completion percentage* is determined by comparing the costs allocated to the contract through the end of the current tax year, as a percentage of the estimated total costs under the contract. Thus, a taxpayer who deducts 50% bonus depreciation on property used in long-term contract projects that are reporting income using the *percentage of completion* method, would normally be required to report more income from the contract for the year the bonus depreciation deduction is taken. **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.

Bonus Depreciation For Passenger Automobiles. 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 ***used more than 50% in business*** 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.

> **Planning Alert!!** To qualify for the additional bonus depreciation, the vehicle must be purchased new and used *more than 50% in business* for 2010.

- **Vehicles Used Less Than 100% Business.** The depreciation limits discussed above must be reduced proportionately if your business use of a vehicle is less than 100%. For example, assume you are self-employed and you buy a new $30,000 passenger car which you use 60% for business and 40% for personal in the first year. Your first year depreciation dollar limit for 2010 would be $6,636 ($11,060 x 60%).

  > **Caution.** If you wait until early 2011 to purchase the same vehicle and the first year cap is the same for 2011 as for 2010, your first year limit would be only $1,836 ($3,060 x 60%).

- **Maximize And Maintain Business Use Percentage.** If you purchase the business vehicle late in 2010, be sure to use it as much as possible for business through **December 31, 2010,** and keep your personal use to a minimum. This will maximize your business percentage for 2010, and could dramatically increase your 2010 depreciation deduction.

  > **Planning Alert!!** If you purchase your new vehicle in 2010 and use it more than 50% business, you are generally allowed to take all or a portion of the additional $8,000 first year depreciation deduction. However, if after 2010, your business use percentage drops to 50% or below, you may be required to bring into income a significant portion of the depreciation taken in 2010. Therefore, it is imperative that the business use of the vehicle exceeds 50%, not only for 2010, but also for subsequent years.

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). For example, for a *new* SUV weighing over 6,000 lbs used entirely for business and **placed-in-service in 2010: 1)** up to $25,000 of the cost can be deducted immediately under section 179, **2)** 50% of the remaining balance can be claimed as bonus depreciation, and **3)** 20% of what's left can generally be taken as regular MACRS depreciation for the first year. Thus, generally for a $50,000 new SUV placed-in-service in 2010, $40,000 could be written off in 2010 (assuming 100% business use). On the other hand, pickup trucks with loaded vehicle weights over 6,000 lbs are *not* subject to the $25,000 limit imposed on SUVs, if the truck bed is at least six feet long.

> **Planning Alert!!** You are allowed the §179 deduction and the 50% bonus depreciation deduction only if you use the SUV or truck ***more than 50% business*** in the year you place it in service. As pointed out with regard to other business vehicles in the previous segment, if you take the §179 deduction and/or the 50% bonus depreciation deduction on an SUV or truck weighing over 6,000 lbs, and your business use percentage later drops to 50% or below, you may be required to bring into income a significant portion of the depreciation and §179 deduction taken in previous years. Therefore, you should make sure that the business use of the vehicle exceeds 50% for subsequent years.

Tax Incentives To Hire The Unemployed. The *HIRE Act* provides employers that hire qualified unemployed workers with temporary payroll tax relief, as well as a tax credit if the employee is retained for at least 52 weeks. Any 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 worker's Social Security taxes on *wages paid* to the employee from **March 19, 2010 through December 31, 2010.** This exemption will not impact the *qualified unemployed worker's* social security benefits. In addition, for each qualifying worker retained for at least 52 **consecutive** weeks, the employer will get an *additional* "income tax" credit, *up to $1,000 per worker*, when the employer files its 2011 income tax returns.

- **Qualified Unemployed Worker.** Generally, a new hire who began employment **after February 3, 2010** and **before January 1, 2011** will qualify if the 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 discussed in the below) under penalties of perjury 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).

  > **Planning Alert!!** The IRS has issued new **Form W-11** ("*Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit*") that may be used as the affidavit signed by the new employee certifying that he or she satisfies the 40-hour/60-day requirement discussed above. You can download a copy of this form from the IRS website at www.irs.gov. The IRS says that this form must be executed by the employee before the employer may claim the payroll tax exemption and the new hire retention credit. However, the employer is not required to file Form W-11 with the IRS, it only needs to be retained in the employer's files.
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  > **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 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.

IRS Provides Answers To Commonly-Asked Questions. Many employers have posed questions based on various fact patterns to the IRS to help them determine whether a new hire qualifies. The following are responses the IRS has posted on its website (assuming that the new employee satisfies the 40-hour/60-day requirement and is not related to the employer). A new hire will still qualify even if the employee was: **1)** hired to replace another employee previously laid off for lack of work; **2)** rehired where that same employee was previously laid off for lack of work; **3)** rehired after being placed on furlough, standby status, or temporary layoff as long as the previous employment status was terminated and then reestablished; **4)** hired to replace a worker who voluntarily quit work or was terminated for gross misconduct or poor performance; **5)** hired for part-time work; **6)** a recent high school or college graduate; **7)** a minor (there is no minimum age requirement); or **8)** "self-employed" (but was not an "employee") for more than 40 hours within the previous 60 days.

- **Workers "Related To the Employer" Do Not Qualify.** Generally, an employee is "related to a qualified employer" and therefore, will not qualify for the payroll tax exemption or the $1,000 tax credit (discussed below), if the employee is a member of a broad range of family relatives of the employer (including a more than 50% owner of the employer).

- **Maximum Tax Benefit.** Because the Social Security tax only applies to the first $106,800 of wages paid in 2010, the maximum payroll tax forgiven for any one qualifying employee is $6,621.60 ($106,800 x 6.2%).

  Planning Alert!! In order to determine the true savings produced by the payroll tax exemption, we must factor in the employer's income tax rate since the payroll taxes would otherwise be deductible if paid. **For example,** for a corporation with an effective income tax rate (Federal and State) of 40%, the maximum after-tax savings for any one employee would be $3,972.96 ($6,621.60 X 60%) since the employer's portion of the Social Security tax would otherwise be deductible for income tax purposes.

- **Qualifying Employers.** Taxable businesses, tax-exempt businesses, and public colleges and universities qualify for the exemption.

  Planning Alert!! Federal, state, and local government employers (other than public colleges and universities) and household employers ***do not*** qualify.

- **Claiming The 6.2% Payroll Tax Exemption.** The payroll tax exemption is generally claimed on Form 941 ("Employer's QUARTERLY Federal Tax Return") beginning with the **second quarter of 2010.**

  Planning Alert!! The IRS has revised Form 941 for use beginning with the second calendar quarter of 2010, and has released the revised form's new instructions.

  Planning Alert!! If you failed to reduce your payroll taxes for a qualifying employee on Form 941 for the second, third or fourth quarter of 2010, you may file Form 941-X to obtain a refund of the excess taxes paid.

- **Qualified Unemployed Workers Who Also Qualify For The "Work Opportunity Tax Credit."** It is possible that hiring a *qualified unemployed worker* could also qualify the employer for the *Work Opportunity Tax Credit* (WOTC). The WOTC is a nonrefundable credit allowed to employers that hire employees from qualified targeted groups (e.g., certain low income individuals, disabled veterans, unemployed veterans, summer youth, unemployable youth, ex felons). For more detailed information regarding the types of workers that will qualify an employer for the WOTC, please consult the instructions to the latest IRS **Form 8850** ("Pre-Screening Notice and Certification Request For the Work Opportunity Credit"), which can be obtained from the IRS website at www.IRS.gov. Generally, wages paid to a qualified unemployed worker cannot also be used to qualify the employer for the WOTC. However, an employer that wishes to claim the WOTC with respect to that qualified unemployed worker may elect out of the payroll tax exemption with respect to wages paid to that qualified employee.

  Tax Tip. If the tax benefit of the WOTC is greater than the tax benefit of the payroll tax exemption, the employer should elect out of the exemption and choose the WOTC instead. For example, if an employer paid $20,000 of wages to a newly-hired employee who qualified for a maximum WOTC of $2,400, and also qualified for the payroll tax exemption, the employer would get a larger benefit by taking the WOTC of $2,400 rather than the payroll tax reduction of $1,240 ($20,000 x 6.2%). The IRS says that the employer may elect out of the payroll tax exemption in favor of the WOTC on an employee-by-employee basis.

  Planning Alert!! Employers may not be able to determine whether the FICA exemption or the WOTC provides a larger tax benefit until the end of 2010, after the employer has the information to tally the total wages paid to the employee from March 19, 2010 through December 31, 2010. If the WOTC turns out to be more beneficial, the IRS says that the employer may elect out of the FICA exemption filing a Form 941-X and paying the 6.2% payroll tax. Then the employer may take the more beneficial WOTC on its 2010 income tax return.

- **FICA Exemption And §45B FICA Tax Credit On Tips May Be Available For Same Employee.** Under current law, a business that employs individuals in connection with providing food or beverages for consumption (e.g., a restaurant's wait staff) generally qualifies for a FICA Tax Credit under §45B (the §45B FICA Tax Credit) for the employer's share of FICA (social security and Medicare) taxes paid on tips in excess of $5.15 per hour (i.e., the minimum wage per hour **that existed on January 1, 2007).** The IRS says at its website that an employer can claim both the FICA exemption and the §45B FICA Tax Credit if the employer has tipped employees who are also "qualified unemployed workers."

  Planning Alert!! An employer that applies the FICA exemption with respect to a qualified employee will be entitled to a smaller §45B FICA Tax Credit because the employer will pay only Medicare tax (and no Social Security tax) on the employee's tips.

Retention Credit (Up To $1,000). An employer qualifies for the "retention credit" if the employer hires a *qualified unemployed worker* (i.e., a worker whose wages qualify for the exemption from FICA taxes described above) who: **1)** continues to be employed by the employer for at least 52 consecutive weeks, and **2)** receives wages during the last 26 weeks of that 52-week period that are at least 80% of the wages received during the first 26 weeks. The amount of the **credit is the lesser of $1,000 or 6.2% of wages** (as defined for income tax withholding purposes) paid by the employer to the qualified retained employee during the 52-consecutive-week period. **Note!** The credit will be $1,000 where the retained worker's wages during the 52-consecutive-week-period exceed $16,129.03.

Tax Tip. The IRS has confirmed that the *retention credit* is allowed even if an employer elects to forgo the payroll tax exemption for an otherwise qualifying employee in order to take the Work Opportunity Tax Credit (WOTC).

Planning Alert!! It appears that the employer could lose the retention credit if, for example, the worker is paid significant overtime during the first 26-week period of employment but not during the last 26 weeks, causing the employee's compensation for the last 26 weeks to drop below the 80% threshold.

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% of the cost of qualifying employee health insurance. **For tax years beginning after 2013,** the maximum credit is 50% of the employer's cost of qualifying employee health coverage.

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. After reading the following requirements for the credit, if you think that your business may qualify, please call our firm and we will help you determine whether your business qualifies and the amount of credit you can expect.

The credit is only available to an "eligible small employer" (ESE), whether formed as a regular "C" corporation, "S" corporation, partnership, LLC, or sole proprietorship. An *ESE* will generally receive no credit if it has **25 or more *full-time equivalent employees* (FTEs)** during the year, or if its **FTEs have *average annual wages* of $50,000 or more. To determine the *number of FTEs*,** the new law generally requires an employer to divide total employee hours worked for the year (by all *qualifying* full-time and part-time employees) by 2,080 hours (i.e., the number of hours in a 52-week year based on a 40-hour work week). **To determine the *average annual FTE wages,*** an employer generally divides the employer's aggregate wages paid to *qualifying* employees for the year by the number of FTEs. For purposes of each formula, there is a host of special rules that may exclude hours worked by certain employees, or that may exclude the compensation paid to certain employees. For instance, the formulas ***exclude*** hours worked by and compensation paid to certain owners (and members of the owners' family). The following are selected features of this credit that you should consider when evaluating whether your business qualifies:

- **Transition Rule For *2010 Only*.** Generally, to qualify for the credit, the employer must pay at least 50% of the cost of the employer-provided insurance for each employee who chooses to be covered. The employer must also pay the same percentage for each covered employee. **For 2010 only,** the IRS says that an employer will be deemed to satisfy these requirements if it pays at least 50% of the cost of a "single**"** coverage policy for each covered employee (including those employees who opt for family coverage).

- **Credit Not Allowed For Owners And Family Members.** The credit is not allowed for health insurance premiums paid for partners, sole proprietors, more than 2% shareholders of an S corporation, more than 5% owners of a regular C corporation, or a broad range of family members of these owners.

  Planning Alert! Wages paid to these employees are also ***excluded*** for purposes of determining the number of FTEs and the amount of average annual FTE wages.

- **Tax-Exempt Organizations Get "Refundable" Credit**. If a tax-exempt organization otherwise qualifies for the credit, the organization can get a *refundable* credit by filing a Form 990-T ("Exempt Organization Business Income Tax Return").

  Planning Alert!! The credit rate for qualifying tax-exempt employers **is 25%** (instead of 35%) for **2010 through 2013** (for 2014 and 2015, the credit rate for tax exempts will be 35% instead of 50%).

- **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.

- **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.

- **Avoiding The FTE And FTE Wages Phase-Out Thresholds.** The health insurance credit phases out as the number of FTEs increases from 10 to 15, and/or the average FTE wages increases from $25,000 to $50,000. If you find that your business needs additional work hours but it is also approaching these phase-out thresholds, consider hiring additional family members of the owners of the employer. Owners' family members are generally excluded altogether from the FTE and FTE wages computations. Alternatively, your business could possibly avoid the phase-out thresholds by engaging "independent contractors" to perform the additional work.

Planning Alert!! Classifying workers as "independent contractors" can be extremely risky and costly if there is a possibility that the IRS could successfully re-classify the workers as "employees." Worker classification continues to be a hot audit issue.

"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,* **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. In addition, the *Jobs Act* allows all **"eligible small business credits" determined in tax years beginning in 2010 (and the carrybacks of those credits)** to offset the taxpayer's AMT.

- **"Eligible Small Business Credit."** An eligible small business credit is a general business credit generated in the **first tax year beginning in 2010** by any taxpayer that: **1)** 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)** has $50 million or less in average annual gross receipts for the prior three years.

  Planning Alert!! Credits determined with respect to a partnership or S corporation are **not** treated as *eligible small business* credits by a partner or shareholder unless the partner or shareholder also meets the gross receipts test for the taxable year.

- **5-Year Carryback For *One Year Only*.** For calendar-year taxpayers, this provision will **not be available after December 31, 2010.** Consequently, calendar-year businesses that wish to take advantage of this temporary 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.**

  Planning Alert!! This temporary provision is particularly beneficial to businesses that are generating negligible taxable income in 2010, but paid taxes on profits it generated during the preceding 5 years.

- **2010 Business Credits May Be Carried Back To Years Before Credit Was Available.** Generally, when Congress creates a new business credit, the credit cannot be carried back to a tax year before the new credit is effective. For example, as discussed in the preceding segment, the *Health Care Act* created a new 35% credit for employers that provide qualified health insurance **effective for tax years beginning in 2010.** Normally, an employer with a health insurance credit in 2010 that cannot fully utilize the credit, could not carry the credit to any year before 2010. However, any *eligible small business credit* (which should include the new health insurance credit generated by an *eligible small business*) generated in 2010 can be carried back to the preceding 5 years.

  Tax Tip. This could help many struggling businesses get immediate tax relief for providing qualifying employee health insurance to employees.

Up-Front Deduction For Business Start-Up Expenses Increased *For 2010 Only*. If you start a new business, you are generally allowed to deduct all or a portion of your start-up expenses in the year you begin business operations. "Start-up expenses" are generally business expenses incurred before you begin active business operations. For tax years beginning **before 2010,** the first $5,000 of start-up expenses was deductible up-front in the tax year business operations began. However, the $5,000 immediate deduction was reduced by each dollar the total start-up expenditures exceeded $50,000. Any start-up expenses exceeding the amount deductible up-front are amortized over 180 months beginning with the month in which the trade or business began. **For tax years beginning in 2010,** the *Jobs Act* increases the up-front deduction for start-up expenses to $10,000 (up from $5,000), and the phase-out threshold begins at $60,000 (up from $50,000). Thus, if the start-up expenses for your business that **begins operations in 2010** do not exceed $60,000, you will be able to deduct the first $10,000 immediately, and any excess may be amortized over 180 months beginning with the month in which the trade or business begins.

> **Caution!** There are similar rules for deducting the "organizational costs" of a newly-formed corporation, partnership, or limited liability company (LLC). Unlike the deductions for *start-up expenses*, Congress **did not expand** the rules for deducting *organizational costs*. The maximum up-front deduction for "organizational costs" remains at $5,000.

Businesses With Calendar Years Must Begin Operations By *December 31, 2010* To Get Enhanced Write-Off. 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!**

> **Planning Alert!!** If you, as a shareholder of your corporation or a partner in your partnership, pay these expenditures out of your personal funds, make sure you properly document the expenses to the corporation or partnership and have the corporation or partnership reimburse you. Otherwise, these deductions could be lost.

New Law Expands Roth Account Options For Employer-Sponsored Retirement Plans. In 1997, Congress enacted legislation that created the Roth IRA. Starting in 2006, employers were able to offer employees a Roth account within a §401(k) plan or a 403(b) plan. **Effective for tax years beginning after 2010,** the *Jobs Act* authorizes governmental §457(b) plans to also offer a Roth account within the plan. In addition, **after September 27, 2010,** the Jobs Act allows §401(k) and §403(b) plans that offer a Roth account option to permit participants to transfer their pre-tax account balances into a designated Roth account within the plan. Governmental §457 plans that offer a Roth account option may permit participants to transfer their pre-tax account balances into a designated Roth account within the plan **after 2010.** The amount transferred to the designated Roth account will generally be includible in the participant's taxable income. If the transfer is made **in 2010,** the participant will include the amount transferred to the Roth in income ratably in 2011 and 2012, unless the participant elects to include the income entirely in 2010.

> **Tax Tip.** This will allow participants in a §401(k), §403(b), or §457 plan who want to convert to a Roth, to retain the funds within the employer-sponsored plan, instead of having to transfer the funds to an outside Roth IRA.
>
> **Planning Alert!!** The plan must be amended to allow transfers to a designated Roth account. However, Congress has requested that the IRS allow employers to offer this option to employees for 2010 and amend the plan later.

New 10% Excise Tax On Indoor Tanning Services. The Health Care Act imposes a new 10% excise tax on customers of indoor tanning salons, **for services performed after June 30, 2010.** The tax is imposed on the full amount of the charge for the service and is imposed regardless of who pays the ultimate cost of the service. Although the tax is imposed on the patron of the indoor tanning salon, like a retail sales tax, the salon will actually be required to collect the tax and pay it over to the IRS. This excise tax will not apply to phototherapy services performed by licensed medical professionals.

> **Tax Tip.** The tanning salon pays the tax quarterly by filing Form 720 ("Quarterly Federal Excise Tax Return").

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.

SELECTED PROVISIONS EFFECTIVE IN 2011

Certain Owners Of Rental Property Required To File Form 1099s For Rental Expense Payments. Under current law, if your business pays $600 or more to a service provider, you are generally required to file a Form 1099 with the IRS reporting the amount of your payments. However, under current law, if your rental real estate activity is not considered to be a "trade or business," you are generally not subject to this reporting requirement. **For payments made after 2010,** the *Jobs Act* requires persons receiving rental income from real estate to file a Form 1099 for payments of $600 or more made to those providing services in connection with the rental property (e.g., plumber, painter, repair person). Certain taxpayers will be exempt from this reporting rule, such as: **1)** individuals who receive no more than a nominal amount of rent (as will be determined by the IRS), **2)** any individual (including active members of the military or intelligence community) who is renting out his or her principal residence on a temporary basis, and **3)** any other individual where the IRS determines that this reporting requirement would cause undue hardship.

> **Planning Alert!!** It is anticipated that the IRS will provide additional guidance on these exceptions before the reporting requirements are effective.

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 creates no immediate taxation. 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. This built-in gains tax can also be triggered by an income recognition event other than a *sale*. For example, the collection of accounts receivables, which arose before the S election, by a cash-basis S corporation can trigger the tax. Last year, Congress temporarily reduced the10-Year Recognition Period to *7 years* for built-in gains recognized in tax years beginning in 2009 or 2010. The *Jobs Act* has again *temporarily* reduced the original10-Year Recognition Period *to 5 years* **for tax years beginning in 2011.** For example, if a Converted S Corporation sells a built-in gain asset during its tax year **beginning in 2011,** there will generally be no *built-in gains tax* if the S election was **first effective January 1, 2006,** or earlier.

> **Tax Tip.** If a calendar-year C corporation originally converted to an S corporation **effective January 1st of 2004, 2005, or 2006,** and the owners are considering selling the corporation's *built-in gain* assets owned on the date of the S election, the corporation would need to wait **until 2011** to sell the corporate assets without built-in gains tax exposure.

New *Simple* Cafeteria Plan For Small Employers. Employer-sponsored cafeteria plans offer a menu of nontaxable benefits to participating employees. To qualify for this tax-favored status, cafeteria plans cannot discriminate in favor of highly-compensated participants or key employees. Smaller businesses sometimes find it difficult to justify providing a classic cafeteria plan to employees because the nondiscrimination requirements often diminish the benefits enjoyed by owner-employees. To address this situation, **for plan years beginning after 2010,** the *Health Care Act* creates a "simple cafeteria plan" that provides *eligible small employers* a safe harbor from the normal nondiscrimination requirements, if certain eligibility and participation rules are met. An **"eligible small employer"** is generally any employer that, during **either of the two preceding years,** employed an average of 100 or fewer employees.

> **Tax Tip.** This change is intended to create additional incentives for small employers to offer cafeteria plan benefits to employees. Please call our firm if you need additional details.

SELECTED **PROVISIONS 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.

Form 1099 Required For Payments Of $600 Or More To *Corporations*. Generally, any business that makes 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*. Under the *Health Care Act*, **effective for payments made after 2011,** this new Form 1099 reporting rule will generally apply to payments aggregating $600 or more to corporations as well as others. However, reporting is not required for payments to tax-exempt corporations.

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.

SELECTED **PROVISIONS EFFECTIVE IN 2013**

Employer's Deduction For Medicare Part D Payments To Retirees Reduced by Subsidy. If your business provides a *qualified retiree prescription drug plan*, it is entitled to a special federal subsidy of a percentage of the *allowable* retiree drug costs under the plan. A "qualified retiree prescription drug plan" is generally employment-based retiree health coverage that has an actuarial value at least equal to the Medicare Part D standard plan for the risk pool, and that meets certain other disclosure and record-keeping requirements. This federal subsidy is excluded from taxable income. However, under current law, an employer is allowed a full tax deduction for its cost of the qualified retirement prescription plan, unreduced by the tax-free subsidy from the federal government. **For tax years beginning after 2012,** the *Health Care Act* will require employers to reduce their business deduction for the retiree prescription drug plan by the federal subsidy. Thus, the federal subsidy will still be tax free, but the employer's tax deduction for the plan's cost will be reduced by the subsidy.

Compensation Deduction For Health Insurance Companies Limited To $500,000. Generally, under the *Health Care Act*, health insurance providers will not be able to deduct *current* annual compensation paid to any single officer, director, or employee in excess of $500,000, **paid in tax years beginning after 2012.**

> **Planning Alert!!** For *deferred* compensation arrangements, the limit applies to compensation for **tax years beginning after 2012,** that is attributable to services performed in a **tax year beginning after 2009.**

SELECTED **PROVISIONS EFFECTIVE IN 2014**

New Penalty For Larger Employers That Fail To Provide Adequate Employee Health Coverage. The *Health Care Act*, **starting in 2014**, will generally require certain larger employers to either offer and contribute to their employees' *qualified* health insurance coverage, or pay a penalty. This penalty will generally *not apply* to any employer that employed on average *less than 50* full-time employees during the preceding calendar year.

> **Planning Alert!!** This new so-called *play-or-pay* penalty contains a host of technical provisions, which are far too lengthy to address in this letter. Please call our firm if you would like additional information.

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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