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Client Letter & Update – Spring 2010

April 28, 2010

Dear Clients & Friends:

In addition to our quarterly newsletters, we provide our clients with updates we feel are important. These updates relate to tax, accounting and various business topics. This document may seem long, but I highly recommend you scan it for items that apply to you and your business. Give us a call with any questions as the below is just an overview or summary of topics.

VERTICAL ADVISORS NEW WEBSITE:

Our website at www.verticaladvisors.com has been updated. It has a new look and feel. In addition, there are a couple of areas that we feel are important to our clients. Check out the Resources tab which has the following items under it.

- **Podcasts.** We have created Podcasts on hot topics dealing with privately held companies. Some of the recent Podcasts are:
    - Business loans for privately held businesses
    - The bankers view point of the financial crisis
    - Tax & Legal Issues with Short Sales and Foreclosures
    - Our goal is to post two podcasts per month. Look for HR issues coming soon.
    - The new site also allows you to share these podcasts with your friends and families.

  Let us know if there are any other topics you would like us to consider for future podcasts.

- **Tax News**, is a section which is updated each month on changing tax topics / laws

- **Articles** page which is an archive of our past newsletters.

- **Client Testimonials**, which is under the About Us tab. We would appreciate any client testimonials to add to our website. This is also a great way to create another link to your company. We have had many clients and contacts work with our clients.

- **LinkedIn** - Please add Peter DeGregori as a contact under LinkedIn. We will post our podcasts to LinkedIn.

- **Facebook** – Vertical Advisors will have a Facebook page coming soon. This will be just another way to keep our clients updated with tax, accounting and business issues.

- **Our Services** - Please make sure you review our services to see if there is something that you need help with and didn't know that we could help. For example, we provide the following assistance: (1) Retirement Planning, (2) Buying or selling a business, (3) Improving your internal accounting, (4) Training your accounting staff, (5) Assisting with bank loans, (6) Preparation of Compiled financial statements, (7) Recommendations and referrals to other professionals for estate planning, financial advisory, asset protection and much more. We will make sure that these other services blend with your business, tax and accounting structures.

2009 & 2010 Tax consideration: *Make sure you discuss with us if you haven't already about the possible tax benefits for 2009/2010 as discussed below.*

Federal Business

Work opportunity Credit

Employers can qualify for a tax credit known as the work opportunity tax credit that is worth as much as $2,400 for each eligible employee ($4,800 for certain veterans and $9,000 for employees who are "long-term family assistance recipients"). The credit is generally limited to eligible employees who begin work for the employer before Sept. 1, 2011. The credit is available on an elective basis for employers hiring individuals from one or more of 11 targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group. These groups are: (1) qualified members of families receiving assistance under the Temporary Assistance for Needy Families (TANF) program, (2) qualified veterans, (3) qualified ex-felons, (4) designated community residents, (5) vocational rehabilitation referrals, (6) qualified summer youth employees, (7) qualified members of families in the Supplemental Nutritional Assistance Program (SNAP), (8) qualified Supplemental Security Income recipients, (9) long-term family assistance recipients, (10) certain unemployed veterans or disconnected youth who begin work for the employer during 2009 or 2010 and (11) certain individuals hired before Aug. 28, 2009 to work in the Hurricane Katrina disaster area.

For each employee, there is also a minimum requirement that the employee has completed at least 120 hours of service for the employer.

Also, the credit isn't available for certain employees who are related to the employer or work more than 50% of the time outside of a trade or business of the employer (e.g., working as a maid in the employer's home). You should also be aware that there are some additional rules that, in limited circumstances, prohibit the credit or require an allocation of the credit.

Hiring Incentives to Restore Employment Act of 2010 (HIRE)

The President recently signed into law the "Hiring Incentives to Restore Employment Act of 2010" (the HIRE Act, P. L. 111-47, 03/18/2010). The centerpiece of this Act is a payroll tax holiday and up-to-$1,000 tax credit for businesses that hire unemployed workers. In addition to these new hiring incentives, the HIRE Act also includes a one-year extension of the enhanced small business expensing option under Code Sec. 179. Both of these provisions are extremely important to many businesses.

Payroll tax holiday and up-to-$1,000 credit for employers who hire unemployed workers.

To help stimulate the hiring of workers by the private sector, the new law exempts any private-sector employer that hires a worker who had been unemployed for at least 60 days from having to pay the employer's 6.2% share of the Social Security payroll tax on that employee for the remainder of 2010. A company could save a maximum of $6,621 if it hired an unemployed worker and paid that worker at least $106,800—the maximum amount of wages subject to Social Security taxes—by the end of the year. As an additional incentive, for any qualifying worker hired under this initiative that the employer keeps on payroll for a continuous 52 weeks, the employer is eligible for an additional non-refundable tax credit of up to $1,000 after the 52-week threshold is reached, to be taken on their 2011 tax return. In order to be eligible, the employee's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period.

Workers hired after the date of introduction of the legislation (Feb. 3, 2010) are eligible for the payroll tax forgiveness and the retention bonus, but only wages paid after March 18 receive the exemption for payroll taxes. Some additional features of the new hiring incentive include:

- The tax benefit of the new incentive is immediate. It puts money into a business' cash flow immediately, since the tax is simply not collected in the first place.
- The tax benefit generally applies only to private-sector employment, including nonprofit organizations—public sector jobs are generally not eligible for either benefit. However, employment by a public higher education institution qualifies.
- There is no minimum weekly number of hours that the new employee must work for the employer to be eligible, and there is no limit on the dollar amount of payroll taxes per employer that may be forgiven.
- For workers that would otherwise be eligible for the Work Opportunity Tax Credit (i.e., another type of employment tax credit), the employer must select one benefit or the other for 2010. <u>There is no double dipping.</u>
- <u>An employer can't claim the new tax breaks for hiring family members</u>.
- A worker who replaces another employee who performed the same job for the employer isn't eligible for the benefit, unless the prior employee left the job voluntarily or for cause.
- For the hiring to qualify, the new hire must sign an affidavit, under penalties of perjury, stating that he or she hasn't been employed for more than 40 hours during the 60-day period ending on the date the employment begins.
- The incentive isn't biased towards either low-wage or high-wage workers. Under the measure, a business saves 6.2% on both a $40,000 worker and a $90,000 worker.
- The payroll tax holiday doesn't apply with respect to wages paid during the first calendar quarter of 2010, but the amount by which the Social Security payroll tax would have been reduced under the payroll tax holiday provision during the first calendar quarter is applied against the tax imposed on the employer for the second calendar quarter of 2010.
- The Act creates a similar new set of rules allowing a payroll tax holiday for railroad retirement tax purposes.
- The credit for retaining qualifying new hires is the lesser of $1,000 or 6.2% of the wages paid by the taxpayer to the retained worker during the 52-consecutive-week period. Thus, the credit for a retained worker will be $1,000 if, disregarding rounding, the retained worker's wages during the 52-consecutive-week period exceed $16,129.03. However, the credit isn't available for pay not treated as wages under the Code (e.g., remuneration paid to domestic workers).

Reporting the payroll credit:
New Form W-11, Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit, will be used by employers to confirm that new employees are qualified employees under the act. The form requires the new employee to declare, under penalties of perjury, that he or she is unemployed or has not worked for anyone for more than 40 hours during the 60-day period ending on the date employment with the new employer starts. The form also requires the employee to supply his or her name, Social Security number, first date of employment and the name of the employer.

According to the form instructions, instead of Form W-11, another similar statement can be used, but it must contain all the information on Form W-11, and the employee must sign it under penalties of perjury.

Employers must collect affidavits from each new employee in order for the employee to count as a qualified employee for purposes of the payroll tax credit and the employee retention credit. However, the employer should not send the affidavits to the IRS, but should retain them in its records.

Extension of enhanced small business expensing. (IRC Section 179) The new law gives a one-year lease on life to enhanced expensing rules, which allow qualifying businesses the option to currently deduct the cost of business machinery and equipment, instead of recovering it via depreciation over a number of years. For tax years beginning in 2010, the maximum amount that a business may expense is \$250,000, and the expensing election begins to phase out when a business buys more than \$800,000 of expensing-eligible assets. These dollar limits are the same as those that were in effect for 2008 and 2009. Had the HIRE Recovery Act not been passed and signed into law, these dollar limits would have dropped this year to \$134,000 and \$530,000 respectively.

Domestic Production Activity Deduction

This isn't new for 2009, but we wanted to remind our readers. IRC section 199 —enacted to help offset the repeal of a tax break for U.S. exporters—provides a deduction for many U.S. businesses that's allowed for both regular tax and alternative minimum tax (AMT) purposes. The deduction doesn't have an official name. It's been called, among other things, "the U.S. production activities deduction," the "domestic production activities deduction" (DPAD), and the "domestic manufacturing deduction" (DMD). For simplicity's sake, we're calling it the Code Sec. 199 deduction.

IRC section 199 deduction is allowed to all taxpayers—individuals, C corporations, farming cooperatives, estates, trusts, and their beneficiaries. The deduction is allowed to partners and the owners of S corporations (not to partnerships or the S corporations themselves), and may be passed through by farming cooperatives to their patrons. And, despite the deduction's history, it's fully available to taxpayers who don't export.

IRC section 199 deduction equals a percentage of the net income from eligible activities—6% for 2007-2009, 9% after 2009. However, the amount of the deduction for any tax year may not exceed the taxpayer's taxable income or, in the case of individuals, the taxpayer's adjusted gross income. When fully phased in, the deduction is designed to be economically equivalent to a 3% reduction in the tax rate on eligible activities conducted in the U.S. This means that if the tax rate on the business income from an eligible activity would normally be, say, 36%, the Code Sec. 199 deduction would reduce it (when fully phased in) to 33%. The reduction is smaller before 2010.

IRC section 199 deduction equals a percentage of the net income from eligible activities. Among the more common eligible activities are:

- the manufacture, production, or growth of tangible personal property, in whole or in significant part within the U.S.;
- the construction of real property in the U.S.; and
- the performance of engineering or architectural services in the U.S. in connection with real property construction projects in the U.S.

Purely sales activities aren't eligible for the deduction, nor are purely service activities, except for construction, engineering, and architectural services.

A broad range of activities qualifies as eligible manufacturing or production activities. The taxpayer's raw materials and finished products may be brand new, or may be made out of scrap, salvage, or junk material. Manufacturing or producing components used by another party in later manufacturing or production activities are eligible activities, as are manufacturing or producing finished items from components manufactured or produced by others.

The processing and preparation of food products for sale at wholesale is an eligible “production” activity, but the preparation of food and beverages for sale at retail is not.

Generally, the taxpayer must own the property that it's “manufacturing or producing.” The manufacture or production of property under contract for someone else who owns the property isn't an eligible activity. (There are exceptions for some federal government contractors—and this requirement doesn't apply to construction, architecture, or engineering businesses.)

Construction activities are eligible for the IRC section 199 deduction, but only if the construction is of real property performed in the U.S. The real property may consist of residential or commercial buildings, permanent structures (like docks and wharves), permanent land improvements (like swimming pools and parking lots), oil and gas wells, platforms, and pipelines, and infrastructure (like roads, sewers, sidewalks, and power lines). Real property doesn't include machinery unless it's a “structural component”—for an example, an elevator. Examples of businesses conducting eligible construction activities are residential remodelers, commercial and institutional building construction contractors, foundation, structure, and building exterior contractors, structural steel and precast concrete contractors, electrical, plumbing, heating, and air-conditioning contractors.

Eligible construction activities don't include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction.

Construction includes “substantial renovation,” but not decoration (or redecoration).

Engineering and architectural services are eligible for the IRC section 199 deduction, but only if they're performed in the U.S. for real property construction projects in the U.S. Eligible engineering services include consultation, investigation, evaluation, planning, design, and supervision of construction. Eligible architectural services include consultation, planning, aesthetic and structural design, and supervision of construction.

There's a lot more to the Code Sec. 199 deduction—for example, determining whether your particular business activities are eligible for the deduction, how to compute the net income from activities that are eligible, and how to determine the amount of the deduction when you've got income from both eligible and ineligible activities. The statutory rules are complicated, and IRS has issued voluminous—and equally complicated—guidance on those rules. If you would like to discuss whether Code Sec. 199 applies to you, and, if so, how best to take advantage of it, please do not hesitate to call.

Cost Segregation:
When a taxpayer purchases residential or commercial real estate, the cost basis is allocated between land and building. Land is not depreciable, but the building is. However, the building is depreciated over 27.5 or 39 years depending on if it is residential or commercial. If the taxpayer could use more depreciation to reduce income taxes, then the taxpayer may want to consider a method to increase their depreciation. This method is called Cost Segregation. Cost Segregation is typically done by someone that has an engineering back ground. The project goal is to reallocate tax basis from the building to personal assets, like plumbing, sewer, lighting, cabinetry, HVAC, equipment, etc. Reallocating building tax basis to these types of assets shortens the depreciable life and thus increases depreciation. However, careful consideration and consultation with your tax advisor should be done to determine if the taxpayer can in fact use the extra depreciation. Please contact us to evaluate your options with Cost Segregation.

Leasehold Improvements – Favorable Depreciation:
Whether you are a landlord or a tenant, some of the leasehold improvements that you make (within the window period described below) qualify for a favorable depreciation rule that doesn't apply to most other improvements to real property.

Specifically, for improvements that are "qualified leasehold improvement property" placed in service after October 22, 2004 and before January 1, 2010, depreciation deductions are allowed over a 15-year period. This treatment provides considerable relief from the general rule that depreciation deductions for non-residential buildings, or improvements to the buildings, are allowed over a 39-year period.

Many, but not all, improvements made under a lease meet the requirements for being qualified leasehold improvement property. These requirements include, but aren't limited to, the requirements that the improvements not enlarge the building, not be attributable to internal structural framework and not be placed in service three years or sooner after the building was first placed in service. We are available to help you determine whether any improvements that you have in mind meet the requirements. Also, we can help you identify improvements that, although attached to the building, are, for depreciation purposes, considered to be machinery or equipment and, thus, qualify for depreciation periods considerably shorter than 15 years.

Current Tax News

Officers can be held personally liable for Company Payroll Taxes:
The district court for the Middle District of North Carolina in Frohnaple, 105 AFTR 2d 2010-1294, granted summary judgment to the U.S., holding that a company president was liable for a trust fund recovery penalty (payroll taxes). The United States Treasury is very serious when it comes to payroll taxes. Some companies try to use this money which is owed to the federal and state government as a line of credit and sometimes get to a point of not being able to pay it back. Numerous cases go against the officers of a corporation in these situations. This can also be the case with state taxes and even sales tax. So, keep this in mind.

Pension Credit:
If you start a pension plan, you can take a credit of up to $500 a year for each of the first three years of the plan. The credit is for 50% of certain start up costs you incur in each of those years. Those costs include the expenses you incur in establishing and administering the plan, as well as the cost of any retirement planning education programs you sponsor for your employees. Thus, if you spend $1,200 this year in establishing a plan, and $1,100 in the next two years on administration and employee education, you would be eligible for a $500 credit against your taxes in each of those three years.

You must meet several requirements to qualify for this credit:

- you must have no more than 100 employees who received at least $5,000 of compensation in the year before you start the plan (i.e., you can have more than 100 employees, as long as no more than 100 of them earned at least $5,000);

- you must have at least one employee participate in the plan who meets the definition of a "nonhighly compensated employee"—generally someone who makes $110,000 (as adjusted for inflation for 2009) or less a year and who is not an owner of the company; and

- you cannot have had a pension plan during the three tax year's right before the year in which you start your plan.

If you had a pension plan in the last couple of years, you may want to consider waiting three years from the time the plan was terminated before starting a new plan so that you qualify for the credit. As an example, if you had a plan that was terminated in 2008, you would have to wait until 2012 to start a new plan and qualify for the credit.

There are several types of plans you can establish for your employees and still qualify for the credit. For example, you could start a pension, profit sharing, or an annuity plan, among other choices. If you are interested in pursuing this further, please call me.

Net Operating Loss (NOL) – Carry Back

Depending on your situation, the carry back of an NOL or unused general business credit opens up refund opportunities. With the recent recession, some companies incurred losses, and thus a NOL carry back may make things a little easier to receive a large refund. Contact us so we can review this situation with you.

You can use an NOL sustained in one year to reduce your taxable income in another year. You can do this by carrying the loss back to a year before the year in which the NOL occurred. If you paid tax for that earlier year, you may get a tax refund. Or, you can carry the loss forward to reduce taxable income in a later year.

Carry back periods. Except as discussed below, you can carry an NOL back two years. Thus, an NOL arising in 2009 can be carried back to 2007.

You can carry back an unused general business credit one year. An unused general business credit arising in 2009 can be carried back to 2008.

Small business NOLs for 2008. Eligible small businesses may elect a three-, four-, or five-year carry back period for NOLs for tax years ending in 2008 (or, if the taxpayer so elects, NOLs for tax years beginning in 2008), instead of the general two-year carry back period. An "eligible small business" that may elect the increased carry back is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) whose average annual gross receipts (reduced by returns and allowances) for 2006-2008 are $15 million or less.

Extended carry back period for 2008 or 2009 NOLs. Most taxpayers (not just small businesses) may elect a three-, four-, or five-year carry back period for an "applicable NOL" (i.e., an NOL for a tax year beginning or ending in either 2008 or 2009), instead of the general two-year carry back period. The amount of the NOL that can be carried back to the fifth tax year before the loss year may not be more than

50% of the taxpayer's taxable income for that fifth preceding tax year (determined without taking into account any NOL for the loss year or for any later year). The amount of the NOL otherwise carried to tax years after the fifth preceding tax year is adjusted to take this 50% limitation into account. An extended carry back period election for a 2008 or 2009 NOL can't be revoked, and must be made by the return due date (including extensions) for the taxpayer's last tax year beginning in 2009. Generally, the election may be made for only one tax year. However, small businesses that have already elected an extended carry back for a 2008 NOL (discussed above) may also elect to extend the carry back for NOLs from 2009. If the election is made for a 2008 or 2009 NOL, then the deduction attributable to the NOL for alternative minimum tax (AMT) purposes—the alternative tax NOL (ATNOL) deduction—may be used to offset up to 100% (rather than only 90%) of AMT income. The extended carry back period election isn't available if the taxpayer received certain financial assistance from the federal government.

Specified liability losses. An NOL attributable to a "specified liability loss"—i.e., a product liability loss and/or losses attributable to certain deferred statutory liabilities—may be carried back 10 years. A specified liability loss arising in 2009 may be carried back to 1999.

Eligible losses. An NOL attributable to an "eligible loss" may be carried back three years. Thus, an NOL attributable to an eligible loss arising in 2009 may be carried back to 2006.

For individuals, eligible losses are losses arising from a casualty, theft, or disaster.

For taxpayers that are small businesses or are engaged in the trade or business of farming, eligible losses are losses attributable to federally declared disasters. A "small business" for this purpose is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) whose average annual gross receipts for the three-tax-year period ending before the loss year are $5 million or less.

Disaster losses. Effective for 2008 and 2009 only, NOLs due to a disaster casualty deduction may be carried back five years and may be allowed against the AMT in the five-year carry back period.

Farming losses. Farming losses—i.e., NOLs attributable to the income and deductions of a farming business, but not in excess of the taxpayer's NOL for the year—may be carried back five years, regardless of whether the loss was incurred in a disaster area. Thus, farming losses arising in 2009 may be carried back to 2004. Taxpayers can elect to forego the five-year carry back period for the farming NOL, in which case the normal two-year NOL carry back period applies.

Election to forego NOL carry back. A taxpayer may elect not to carry back an NOL at all and instead only carry it forward over the allowed carry forward period (see below). Once the election is made for a tax year, it's irrevocable for that year. There is no similar election to forego the carry back of an unused business credit.

Carry forward period. If NOLs and general business credits aren't used up after having been carried back (or if the taxpayer elected to forego the NOL carry back), the balance can be carried forward up to 20 years before they expire. Of course, a dollar of tax saved 20 years from now is worth much less than a dollar of tax recovered today by a carry back. A carry forward that arose before 1998 expires after 15 years.

Please call if you wish to discuss the NOL/general business credit carryover rules further.

Federal Individual

(Before you get excited, please review the phase out calculations)

Making Work Pay credit. The new law provides an individual tax credit in the amount of 6.2% of earned income not to exceed $400 for single returns and $800 for joint returns in 2009 and 2010. The credit is phased out at adjusted gross income (AGI) in excess of $75,000 ($150,000 for married couples filing jointly). The credit can be claimed as a reduction in the amount of income tax that is withheld from a paycheck, or through a credit on a tax return. Under the credit, workers can expect to see perhaps $13 a week less withheld from their paychecks starting around June. Next year, the extra take-home pay will go down to around $7.70 per week.

Economic recovery payment. The new law provides for a one-time payment of $250 to retirees, disabled individuals and Social Security beneficiaries and SSI recipients receiving benefits from the Social Security Administration and Railroad Retirement beneficiaries, and to veterans receiving disability compensation and pension benefits from the U.S. Department of Veterans' Affairs. The one-time payment is a reduction to any allowable Making Work Pay credit.

Unemployment compensation exclusion. A provision temporarily suspends federal income tax on the first $2,400 of unemployment benefits received by a recipient in 2009.

Expanded and revised higher education tax credit. The new law creates a $2,500 higher education tax credit that is available for the first four years of college. The credit is based on 100% of the first $2,000 of tuition and related expenses (including books) paid during the tax year and 25% of the next $2,000 of tuition and related expenses paid during the tax year, subject to a phase-out for AGI in excess of $80,000 ($160,000 for married couples filing jointly). 40% of the credit is refundable. The new credit temporarily replaces the Hope credit.

Computers as an education expense. A provision permits computers and computer technology to qualify as qualified education expenses in 529 education plans for tax years beginning in 2009 and 2010.

Qualified Tuition Program – 529 Plans
If you have a child (or a grandchild) who is going to attend college in the future you have probably heard about qualified tuition programs, also known as 529 plans (for the Internal Revenue Code section that provides for them), which allow prepayment of higher education costs on a tax-favored basis. I am writing regarding a provision in the recently enacted "American Recovery and Reinvestment Act of 2009" (the Act) which enhances the flexibility of 529 plans.

Under 529 plan rules, distributions from the program are tax-free if they don't exceed the student's qualified higher education expenses. These include tuition, fees, books, supplies, room and board (if the student is enrolled at least half-time), and required equipment. Under pre-Act rules, the cost of a computer doesn't qualify as an eligible expense unless the computer is required by the college or by a specific degree program or course. The new law changes that rule to allow money from 529 plans to be used to purchase computers and related technology. The change applies for 2009 and 2010**.**

Expanded credit for first-time home buyers. Last year, Congress provided taxpayers with a refundable tax credit that was equivalent to an interest-free loan equal to 10% of the purchase of a home (up to $7,500) by first-time home buyers. The provision applied to homes purchased on or after April 9, 2008 and before July 1, 2009. Taxpayers receiving this tax credit were required to repay any amount received under this provision back to the government over 15 years in equal installments (or earlier if the home was sold). The credit phases out for taxpayers with AGI in excess of $75,000 ($150,000 in the case of a joint return). The new law enhances the credit by eliminating the repayment obligation for taxpayers that purchase homes on or after January 1, 2009. It also extends the credit through the end of November 2009, and bumps up the maximum value of the credit from $7,500 to $8,000.

Congress also expanded and extension in the Worker, Homeownership and Business Assistance Act of 2009. It extended the following item.

> Extending deadlines for purchasing and closing on a home. Under the 2009 Assistance Act, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010 and close on the home by June 30, 2010. For qualifying purchases in 2010, taxpayers have the option of claiming the credit on either their 2009 or 2010 return.

Authorizing the credit for long-time homeowners buying a replacement principal residence. For the first time, long-time homeowners who buy a replacement principal residence may also claim a homebuyer credit of up to $6,500 (up to $3,250 for a married individual filing separately). They must have lived in the same principal residence for any five-consecutive-year period during the eight-year period that ended on the date the replacement home is purchased. One key point is that the replacement home must be a principal residence—vacation homes aren't eligible.
Raising the income limitations for homeowners claiming the credit. People with higher incomes can now qualify for the credit. The new law raises the income limits for homes purchased after November 6, 2009. The credit phases out for individual taxpayers with modified adjusted gross income (MAGI) between $125,000 and $145,000 or between $225,000 and $245,000 for joint filers. The pre-2009 Assistance Act MAGI phase-outs of $75,000 to $95,000 or $150,000 to $170,000 for joint filers still apply to purchases on or before November 6, 2009.

Providing additional homebuyer liberalizations for service members. The 2009 Assistance Act ensures that recapture of the credit will not apply to service members (including members of the U.S. uniformed services, Foreign Service, and intelligence community) who dispose of a principal residence or cease using a home as a principal residence after December 1, 2008, in connection with Government orders received by the individual or the individual's spouse for qualified official extended duty service. Additionally, in the case of service members serving outside the United States for at least 90 days during the period beginning after December 31, 2008, and ending before May 1, 2010, the credit is extended for one year. This means that the purchase must occur before May 1, 2011 (or July 1, 2011, for taxpayers with binding contracts). This change will allow service members stationed overseas to take advantage of the credit when they return.

However, the 2009 Assistance Act also adds new restrictions on the first-time homebuyer tax credit by:

- Imposing an $800,000 purchase-price limitation. For purchases after November 6, 2009, the credit cannot be claimed for buying a residence for more than $800,000.

- There is no phase-out mechanism. A purchase price that exceeds the $800,000 threshold by even a single dollar will cause the loss of the entire credit.

- Requiring a minimum age of 18 to claim the credit.

- Prohibiting dependents from claiming the credit.

- Denying the credit for purchases from parties related to the taxpayer's spouse.

- Requiring taxpayers to attach a signed copy of their settlement statement to their return.

Giving IRS the authority to automatically assess tax and begin collection proceedings in cases where they suspect fraud (thus shortening the time it takes for IRS to collect additional tax through the normal deficiency procedures). This IRS authority (called "math error authority") is retroactive to April 9, 2008, thus giving IRS the ability to quickly address any erroneous refund claims that have been previously filed.

Nonbusiness Energy Property Credit
Unlike past efforts by Congress to use taxes to spur energy efficiency by homeowners, provisions in the recently enacted "American Recovery and Reinvestment Act of 2009" (the Act) are substantial. These include an increased credit of 30% of the cost of residential energy-efficient improvements such as more efficient furnaces, heat pumps and air conditioners, as well as energy-tight windows and more insulation, and a tripling of the maximum credit for a household to $1,500.

Background.

Individual taxpayers are allowed a personal tax credit, known as the nonbusiness energy property credit, for energy efficient improvements to a dwelling unit in the U.S. owned and used by the taxpayer as the taxpayer's principal residence. Under pre-Act law, this credit was equal to the sum of:

(1) 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements (i.e., building envelope components meeting certain requirements) installed during the tax year, and
(2) the amount of residential energy property expenditures (i.e., $50 for each advanced main air circulating fan, $150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and $300 for qualified energy efficient property, including heat pumps, water heaters, and central air conditioners) paid or incurred by the taxpayer during the tax year.

Under pre-Act law, the credit was subject to a lifetime cap. The total credit for all tax years couldn't exceed $500, no more than $200 of which could be for expenditures on windows.

The credit was also set to expire at the end of 2009

New law.

The new legislation modifies and extends the nonbusiness energy property credit in the following ways:

- the 10% credit rate is increased to 30%;

- the dollar limitations on residential energy property expenditures have been eliminated;

- instead, all energy property that was previously eligible for the $50, $150, and $300 credits is instead eligible for a 30% credit;

- the $500 lifetime cap ($200 for windows) is eliminated and replaced with an aggregate $1,500 cap for 2009 and 2010; and

- the credit is extended for one year, through Dec. 31, 2010.

Casualty Loss
Taxpayers who experience certain types of major personal casualties may be able to recoup some of their losses through tax savings.

An itemized deduction may be available for personal losses from fires, storms, car accidents, and similar "sudden, unexpected, or unusual" events. Losses from theft are included as well.

The deduction is only available for physical damage or loss to your property. Thus, if you are in an automobile accident and pay for the damage done to the other driver's car, the cost does not qualify. Similarly, if you're injured in the accident, your medical bills do not qualify as part of your casualty loss (although they may result in a medical expense deduction).

Figuring the loss. The loss is not always the decline in economic value you suffer. It's measured as the lesser of (a) the drop in value and (b) your basis in the property (usually, your cost).

Example: Dan bought an antique vase for $500 which rose in value to $3,000. It was damaged in a fire after which it was worth only $1,000. For tax purposes, the casualty loss is only $500, even though the economic loss was $2,000 ($3,000 − $1,000). The lesser of cost ($500) and drop in value ($2,000) is used.

It may be difficult to establish these elements. If you have your original receipt, you can show your cost. In some cases, appraisals will be needed to establish pre– and post–loss values. Sometimes, repair costs can be used as a measure of drop in value.

Limitations on the deduction. The loss figure must be reduced by three amounts. In many cases, these reductions result in no deduction being available.

First, to the extent you are insured, you must reduce your loss by your reimbursement. However, you shouldn't fail to file an insurance claim in the hope of increasing your deduction. If you do, the IRS will reduce your loss by the insurance reimbursement you could have received.

Next, for each casualty, you must reduce your loss amount by $100 ($500 for 2009 only). Note that this reduction is per "event," not per item damaged. Thus, if a storm knocks over a tree that damages your car and home, you have three property losses (tree, car, and house) and only one reduction. Casualty losses from Hurricanes Katrina, Rita, and Wilma, and Kansas and Midwestern disaster area losses, are not subject to the reduction.

Third, after combining all your losses under the above guidelines, you must reduce them by 10% of adjusted gross income (AGI). Only the loss amount above this "floor" can be deducted.

This final limitation is often the one that wipes out the deduction. For example, if your AGI is $75,000, your losses (determined as described above) are only deductible to the extent they exceed $7,500 (10% of $75,000). The 10%-of-AGI limit on casualty losses is waived for federally declared disasters in 2008 and 2009. Casualty losses from Hurricanes Katrina, Rita, and Wilma, and Kansas and Midwestern disaster area losses, aren't subject to the 10% of AGI floor.

Short Sales / Foreclosures:
Due to the housing market, taxpayers are finding that it makes financial sense to consider a short sale of foreclosure. We suggest that before a taxpayer concludes one of these transactions, that they understand any tax effect.

- Typically a purchase money loan is non-recourse, which means that the owners are not personally liable. However, each state is different so make sure you check with legal counsel. If the taxpayer enters into a short sale or foreclosure, there is no cancellation of debt (COD). However, there will still be a gain / loss calculation on the sale of the home. Typically in a non-recourse situation, the sales price is the greater of the sales price or the total debt outstanding.
- Typically when an owner refinances, the debt becomes recourse, meaning that the lender could go after the owners. If the taxpayer has recourse debt and enters into a short sale or foreclosure, then there will typically be COD. However, there are laws available to exempt some or all of the COD income. There is also going to be a gain or loss on the sale of the home also. Again, each state has different laws regarding non-recourse and recourse, and even if the taxpayer has recourse debt, the lender may still decide to not pursue the owner. However, a tax calculation should be done, so contact us if you have entered into one of these transactions or if you are considering it.
- We also have a Podcast on our website discussing this topic. *We suggest you listen to it if you are contemplating a short sale or foreclosure.*
- <u>Also note that we have clients that are Strategic Default Specialist (Short Sale / Foreclosure specialist), so contact us if you need a referral</u>.

Primary Residence Mortgage Interest Deduction:
Taxpayers are only able to deduct interest on a qualified loan up to $1 million dollars. This includes vacation homes also. This does not include rental properties. In addition, a taxpayer can deduct mortgage interest on a Home Equity Line of Credit (HELOC) up to $100,000.

Remember that points on a purchase are amortized over the life of the loan. However, if you sell the home or refinance it, the remaining points can be written off. Generally, prepayment penalties that a taxpayer pays to terminate an old mortgage are treated as deductible mortgage interest and deductible in the year of payment.

Also, if you have mortgage interest which exceeds the deductible amount, contact us to determine if you can deduct it another way.

Deduction for losses in Ponzi schemes or fraudulent losses
IRS has announced special relief for victims of Bernard Madoff's Ponzi scheme (and for investors in other similar fraudulent schemes). Because Madoff's scheme continued for years, many investors are faced not only with the loss of their original investments, but also with having paid taxes on "phantom income," based on fraudulent statements sent by Madoff's firm to investors over a number of years.

The first question IRS answers—generally positively for investors—is exactly how the loss from the investment will be treated for tax purposes. If the loss was considered a capital loss, which is often the case when a taxpayer loses money on an investment in stocks or securities, individual taxpayers would be limited to offsetting the loss against their capital gains, plus an additional $3,000 allowed as a deduction against ordinary income. Although the excess loss can be carried forward indefinitely, it would do little for losses of the magnitude incurred by the typical Madoff investor. So it was good news for investors when IRS announced that investors can take an ordinary loss deduction and the deduction isn't subject to the 2% of adjusted gross income (AGI) limit on miscellaneous itemized deductions, the income-based limitation on itemized deductions, or the 10% of AGI limitation on the deduction for casualty losses.

When the deduction is taken. Taxpayers can deduct the loss in the year the theft was discovered, which was 2008 for Madoff investors. This deduction can be taken if the loss isn't covered by a claim for reimbursement or other recovery that has a reasonable chance of occurring. If there is a reasonable chance of recovery, the taxpayer must either reduce the deduction by that amount or, alternatively, make a special election under a 2009 revenue procedure, which is discussed farther below. If, after reducing the deduction, the taxpayer actually recovers less than the reduction in a later year, he or she can take an additional deduction in the year the recovery amount is ascertained. And a taxpayer is required to include in income any amount recovered greater than the amount anticipated at the time of taking the deduction.

The amount of the deduction. According to IRS, the amount of the theft loss is determined by adding to the amount of the initial investment any additional investments and any amounts the taxpayer reported as income and reinvested, minus any amounts withdrawn over the years and any reimbursements or likely recovery.

Here's an example. Assume A invested $500,000 with Madoff's scheme in 2002, reported $40,000 of income on the investment each year in 2003, 2004, 2005, 2006, and 2007, all of which ($200,000) he reinvested. A made no withdrawals over the years, and has filed a claim for reimbursement with the Securities Investor Protection Corporation (SIPC). A is likely to recover $500,000, which is the most any investor can recover from SIPC (subject to a $100,000 cash maximum). His ordinary loss deduction for 2008 is $200,000.

There is an alternative way to calculate the loss under an elective provision, which is described below.

Net operating losses. Taxpayers with losses from Madoff's fraud may have loss deductions in excess of their income for 2008. Under the general rules for net operating losses (NOLs), the losses can be carried back two years and forward 20 years. For casualty or theft losses, the carry back is increased to three years. For 2008 and 2009 NOLs, most taxpayers can elect a three-, four- or five-year carry back period (instead of two years). In addition, a special increased carry back period election is available for small businesses, but only for 2008 NOLs. The interaction of the NOL rules with the rules for other deductions and credits is complex; if you have a potential NOL, you need tax advice before choosing a carry back period.

Safe-harbor relief. Some investors will qualify for elective relief under Rev. Proc. 2009-20, 2009-14 IRB 735. The amount of the investment that qualifies for relief under the revenue procedure is the same as it is under the rules described above. But the amount to be deducted is 95% of the qualified investment if the investor doesn't pursue any potential third party recovery or 75% of the qualified investment if the investor is pursuing or intends to pursue a third party recovery. These amounts must be reduced by any actual recovery or potential SIPC recovery. The biggest advantage of this method is that the deduction isn't further reduced by a potential direct or third party recovery (although further deductions or income from losses or recoveries occurring in later years are covered by the rules above). The safe harbor can be elected only by investors who invested directly with Madoff (or in a similar fraudulent scheme).

To qualify for relief under Rev. Proc. 2009-20 , investors must file Form 4684, Casualties and Thefts, marked “Revenue Procedure 2009-20,” with the tax return for the year in which the theft was discovered. Appendix A of Rev. Proc. 2009-20 contains a worksheet for calculating the amount of the theft loss and a statement that must be signed by the investor and submitted with Form 4684. We expect that this can be done on extension.

State tax treatment. Each state may treat these losses differently. New York, for example, has announced that it will recognize the safe harbor under Rev. Proc. 2009-20 for purposes of determining the amount of

New York state itemized deductions for the theft loss. However, itemized deductions in New York are reduced for taxpayers with income in excess of certain thresholds (that is also the case for federal income tax purposes, but the IRS has explicitly accepted these losses from those reductions). And the NOL provisions permitted for federal purposes aren't permitted for New York because the state allows NOL deductions only for losses attributable to a business, trade, profession, or occupation carried on in New York. The losses from a Ponzi-like fraudulent investment arrangement generally won't qualify.

Principal Residence Gain Exclusion

Many of you know that a taxpayer can exclude $250,000 if single or $500,000 of gain on the sale of their primary residence assuming the primary residence qualifies. The general qualification is that the primary residence was used as the primary residence for two out of five years. <u>Before the changes made by the Housing Assistance Act of 2008, an individual could exclude gain from the sale or exchange of a vacation home that had been converted into a principal residence as long as that individual met the two year ownership and use tests for the residence.</u>

However, for sales and exchanges after Dec. 31, 2008, the $250,000/$500,000 exclusion does not apply to any gain from the sale or exchange of a residence that is allocated (under the rules discussed below) to periods of “nonqualified use” (defined below). In other words, any gain allocated to periods of “nonqualified use” is ineligible for the exclusion and is included in the taxpayer's gross income. For this purpose, gain is allocated to periods of nonqualified use based on the ratio of years of use as a principal residence to the total time of ownership.

Here's a simple example of how these rules work. Assume that a single individual (H) realizes a gain of $300,000 from a sale of a residence (with a basis of $700,000) for $1,000,000. H has owned the residence for ten years and has three years of “nonqualified use” of the residence after 2008. In that case, 30% (i.e. three-tenths) of H's realized gain of $300,000 ($1,000,000 − $700,000) or $90,000 (30% × $300,000) is gain allocated to periods of nonqualified use and is ineligible for the exclusion of gain. Thus, only $210,000 ($300,000 − $90,000) of H's realized gain ($300,000) is eligible for the exclusion and H has to include the $90,000 of gain allocated to periods of nonqualified use in his gross income.

A period of nonqualified use is any period during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or a former spouse. For example, use of a residence as a rental property or as a vacation home is a period of nonqualified use. However, the following circumstances are exceptions to the definition of a period of nonqualified use:

- any period preceding Jan. 1, 2009,
- portions of certain periods in the five-year testing (i.e., ownership and use) period that are after the last date that the taxpayer (or his spouse) used the property as a principal residence,
- a temporary absence (not exceeding an aggregate period of two years) due to change of employment, health conditions, or any other unforeseen circumstances that IRS specifies, or
- certain periods in which a taxpayer or his spouse is serving on qualified official extended duty as a member of the uniformed services, a member of the Foreign Service, or an employee of the intelligence community.

These rules also have to be coordinated with the rules denying the exclusion with respect to any gain attributable to post-May 6, '97 depreciation.

Since the application of these rules can be quite complex, please let me know if you need assistance in determining how the rules might apply to your circumstances.

Gift tax exclusion:
The amount of the exclusion for 2010 is $13,000. The exclusion covers gifts an individual makes to each donee each year. Thus, a taxpayer with three children can transfer a total of $39,000 to them every year free of federal gift taxes. If the only gifts made during a year are excluded in this fashion, there is no need to file a federal gift tax return. If annual gifts exceed $13,000, the exclusion covers the first $13,000 and only the excess is taxable. Further, even taxable gifts may result in no gift tax liability thanks to the unified credit (discussed below). (Note, this discussion is not relevant to gifts made by a donor to his spouse because these gifts are gift tax-free under separate marital deduction rules.)

Gift-splitting by married taxpayers. If the donor of the gift is married, gifts to donees made during a year can be treated as split between the husband and wife, even if the cash or gift property is actually given to a donee by only one of them. By gift-splitting, therefore, up to $26,000 a year can be transferred to each donee by a married couple because their two annual exclusions are available. Thus, for example, a married couple with three married children can transfer a total of $156,000 each year to their children and the children's spouses ($26,000 for each of six donees).

Where gift-splitting is involved, both spouses must consent to it. Consent should be indicated on the gift tax return (or returns) the spouses file. IRS prefers that both spouses indicate their consent on each return filed. (Because more than $13,000 is being transferred by a spouse, a gift tax return (or returns) will have to be filed, even if the $26,000 exclusion covers total gifts. Gift and estate tax issues can be complex, so contact us if you have any questions.

Tax Audits and Supporting deductions:
We have seen an increase in IRS and State audits and unfortunately, they have been much more aggressive. I also just read an article in the WSJ on April 12, 2010, which was titled, “How to FIGHT the IRS”. I have never seen such a large article in the WSJ regarding IRS audits, so naturally I read it. The summary of the article was that the Federal government has a HUGE deficit (*we know*), so the IRS plans on auditing more taxpayers. The article first says that the taxpayer should just pay the tax on an audit because typically the cost to fight it isn’t worth it. However, it states if the area of tax law is complicated and you feel you are correct, then hire a good tax advisor and spend some money. Anyway, what does all this mean to the taxpayer? Well, in dealing with some recent audits, the IRS is really focusing on substantiation of expenses. They have the right to ask for substantiation, which is back up, support or the receipts. However, we don’t feel you have to keep every receipt, but let us give you some quick thoughts. For businesses, have your bank send you copies of canceled checks, or better yet, down load them onto your server and keep them for four years. Use business credit cards versus personal, and keep the monthly or annual statements also on digital format. Make sure you document in your calendar or in your accounting system the purpose of the expense, especially for travel, meals and entertainment, and mileage. If you have an automobile that is titled in your personal name and the business is paying for it, please make sure you discuss with us about having the property rights assigned to the Company or transfer title.

Having these items for an audit will make the audit go much easier and one shouldn’t end up paying a lot of extra tax which wasn’t necessary. Also consider something my tax professor told me, “pigs get fat, but hogs get slaughtered, so don’t be a hog”. Make sure you are not taking a business expense for a personal expense. Do not comingle personal expenses with business activities.
Make sure you consider any personal benefit before expensing 100% of the cost. Make sure you spend a little extra time to document items. It is easier to review documents now than trying to remember two years later. When in doubt, call your tax advisor.

Real Estate Professional is still under IRS scrutiny so make sure you have all the support you need and your log book. If you have a specific question about real estate professional, review our podcast with Jason Hartman on the topic or contact us.

State(s) Tax Discussion: We discussed federal tax items above, now let's not forget about state taxes.

State Credits:

Various states have authorized some sort of job / employment credit. Enterprise credits have been around for awhile, but usually change. Enterprise credits are provided to businesses that are located in a certain area(s) of the state in which the state wants to revitalize. We have listed a few below. If you have specific questions about your state, please contact us.

State	Investment Credits	Enterprise Credits	New Job Credits	Fuel Tax Credits	Other Credits
AL	Y	Y	Y	N	Y
AK	Y	N	N	N	Y
AZ	Y	Y	Y	N	Y
AR	Y	Y	Y	N	Y
CA	Y	Y	Y	N	Y
CO	Y	Y	Y	N	Y
CT	Y	Y	Y	N	Y
DE	Y	Y	Y	N	Y
DC	N	N	Y	N	Y
FL	Y	Y	Y	N	Y
GA	Y	N	Y	N	Y
HI	Y	Y	N	Y	Y
ID	Y	N	Y	N	Y
IL	Y	Y	Y	N	Y
IN	Y	Y	Y	Y	Y
IA	Y	Y	Y	Y	Y
KS	Y	Y	Y	N	Y
KY	Y	Y	Y	N	Y
LA	Y	Y	Y	Y	Y
ME	Y	Y	Y	N	Y
MD	N	Y	Y	N	Y
MA	Y	Y	Y	N	Y
MI	Y	Y	Y	N	Y
MN	N	N	Y	N	Y
MS	Y	N	N	N	Y
MO	Y	Y	Y	N	Y
MT	Y	N	Y	N	Y
NE	Y	Y	Y	N	Y
NH	Y	Y	Y	N	Y
NJ	Y	Y	Y	N	Y
NM	N	Y	Y	N	Y
NY	Y	Y	Y	N	Y
NC	Y	Y	Y	N	Y
ND	Y	N	Y	N	Y
OH	N	N	Y	N	Y

OK	Y	Y	Y	N	Y
OR	Y	Y	Y	N	Y
PA	Y	Y	Y	N	Y
RI	Y	Y	Y	N	Y
SC	Y	Y	Y	N	Y
TN	Y	Y	Y	N	Y
UT	N	Y	Y	Y	Y
VT	Y	N	N	N	Y
VA	Y	Y	Y	N	Y
WV	Y	N	Y	N	Y
WI	Y	Y	N	N	Y

California New Job Credit

Will You Qualify for the New Jobs Credit?

Newly enacted state law, ABX3 **15** (Assembly Budget Committee, Stats. 2009 Third Extraordinary Session, Ch. 10) allows a potential income tax credit of $3,000 to a qualified taxpayer for each additional full-time employee hired. The total amount of the credit available to taxpayers is capped at $400 million.

This credit will not be subject to the 50 percent limitation for business credits in 2009. This credit does have an eight year carryover provision.

The credit must be claimed on a timely-filed original return received by us before the cut-off date. This cut-off date is defined as the last day of the calendar quarter within which we estimate the $400 million limit will be reached. The cut-off date has not yet been determined.

This credit is allowed for taxable years beginning on or after January 1, 2009.

An employer qualifies for the credit if both apply:

- They employed a total of 20 or fewer employees on the last day of the preceding taxable year (for Calendar taxpayers this would be December 31, 2009).
- They have a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year.

We would like to address some of the questions we have been receiving regarding this credit.

If a taxpayer starts a new business in 2009, will they qualify for this credit?

For taxpayers who start doing business in California during the current taxable year, the number of qualified full-time employees employed in the preceding year would generally be zero, unless certain special rules apply.

Does the employee have to work for the taxpayer the entire year?

No. Taxpayers who hired employees throughout the year can qualify for this credit. The credit is, however, limited by being prorated on an annual full-time equivalent basis for employees employed less than one full year. This is done by taking the total number of hours each less-than-full year employee work (not more than 2000 hours for each employee) and dividing by 2000. Salaried employees are based on weeks worked. So if your client, who otherwise meets the requirements for this credit, hired a new employee in June and that employee worked 1,000 hours, your client could qualify for a $1500 credit.

Can the taxpayer claim this credit on their fiscal 2009 return?

This credit is only allowed for taxable years beginning on January 1, 2009, which means taxpayers that file for fiscal year 2009 will have to wait to see if there is any credit left available to claim on their returns filed for years ending in 2010.

What if the taxpayer converts their business from a partnership to an S corporation? Would the S corporation be consider a new business or need to count the employees the partnership had in 2008 as prior year employees?

The answer to your question will depend on the facts and circumstances of each taxpayer; certain special rules apply. But if the client just changed the business form, they would need to count the partnership employees as prior year employees.

A **new** credit, Form 3527, New Jobs Credit has recently been developed and is now available. For more information about this credit, go to ftb.ca.gov and search for new jobs tax credit.

Florida: Florida has enterprise job credits for corporations.

Washington: Washington State has enterprise job credits.

New tax law / legislation

This is our current explanation, but the law may change. Accordingly, check with us and / or our website about any updates. As this is very new law, the application of the law is going to be very specific to each taxpayers facts and circumstances.

Tax changes affecting individuals in the 2010 health reform legislation

Individual mandate. The new law contains an "individual mandate"—a requirement that U.S. citizens and legal residents have qualifying health coverage or be subject to a tax penalty. Under the new law, those without qualifying health coverage will pay a tax penalty of the greater of: (a) $695 per year, up to a maximum of three times that amount ($2,085) per family, or (b) 2.5% of household income over the threshold amount of income required for income tax return filing. The penalty will be phased in according to the following schedule: $95 in 2014, $325 in 2015, and $695 in 2016 for the flat fee or 1.0% of taxable income in 2014, 2.0% of taxable income in 2015, and 2.5% of taxable income in 2016. Beginning after 2016, the penalty will be increased annually by a cost-of-living adjustment. Exemptions will be granted for financial hardship, 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, those with incomes below the tax filing threshold (in 2010 the threshold for taxpayers under age 65 is $9,350 for singles and $18,700 for couples), and those residing outside of the U.S.

Premium assistance tax credits for purchasing health insurance. The centerpiece of the health care legislation is its provision of tax credits to low and middle income individuals and families for the purchase of health insurance. For tax years ending after 2013, the new law creates a refundable tax credit (the “premium assistance credit”) for eligible individuals and families who purchase health insurance through an Exchange. The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an Exchange. Under the provision, an eligible individual enrolls in a plan offered through an Exchange and reports his or her income to the Exchange. Based on the information provided to the Exchange, the individual receives a premium assistance credit based on income and IRS pays the premium assistance credit amount directly to the insurance plan in which the individual is enrolled. The individual then pays to the plan in which he or she is enrolled the dollar difference between the premium assistance credit amount and the total premium charged for the plan. For employed individuals who purchase health insurance through an Exchange, the premium payments are made through payroll deductions.

The premium assistance credit will be available for individuals and families with incomes up to 400% of the federal poverty level ($43,320 for an individual or $88,200 for a family of four, using 2009 poverty level figures) that are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage. The credits will be available on a sliding scale basis. The amount of the credit will be based on the percentage of income the cost of premiums represents, rising from 2% of income for those at 100% of the federal poverty level for the family size involved to 9.5% of income for those at 400% of the federal poverty level for the family size involved.

Higher Medicare taxes on high-income taxpayers. High-income taxpayers will be hit with a double whammy: a tax increase on wages and a new levy on investments.

Higher Medicare payroll tax on wages. The Medicare payroll tax is the primary source of financing for Medicare's hospital insurance trust fund, which pays hospital bills for beneficiaries who are 65 and older or disabled. Under current law, wages are subject to a 2.9% Medicare payroll tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes). Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling ($106,800 for 2010), the Medicare tax is levied on all of a worker's wages without limit.

Under the provisions of the new law, which take effect in 2013, most taxpayers will continue to pay the 1.45% Medicare hospital insurance tax, but single people earning more than $200,000 and married couples earning more than $250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts. Employers will collect the extra 0.9% on wages exceeding $200,000 just as they would withhold Medicare taxes and remit them to the IRS. Companies won't be responsible for determining whether a worker's combined income with his or her spouse makes them subject to the tax. Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Self-employed persons will pay 3.8% on earnings over the threshold. Married couples with combined incomes approaching $250,000 will have to keep tabs on both spouses' pay to avoid an unexpected tax bill. It should also be noted that the $200,000/$250,000 thresholds are not indexed for inflation, so it is likely that more and more people will be subject to the higher taxes in coming years.

Medicare payroll tax extended to investments. Under current law, the Medicare payroll tax only applies to wages. Beginning in 2013, a Medicare tax will, for the first time, be applied to investment income. A new 3.8% tax will be imposed on net investment income of single taxpayers with adjusted gross income (AGI) above $200,000 and joint filers with AGI over $250,000 (unindexed). Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Net investment income is reduced by properly allocable deductions to such income. However, the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans. Also, the new tax will apply only to income in excess of the $200,000/$250,000 thresholds. So if a couple earns $200,000 in wages and $100,000 in capital gains, $50,000 will be subject to the new tax. Because the new tax on investment income won't take effect for three years, which leaves more time for Congress and IRS to tinker with it. So we can expect lots of refinements and "clarifications" between now and when the tax is actually rolled out in 2013.

Floor on medical expenses deduction rose from 7.5% of AGI to 10%. Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses for regular income tax purposes only to the extent that those expenses exceed 7.5% of the taxpayer's AGI. The new law raises the floor beneath itemized medical expense deductions from 7.5% of AGI to 10%, effective for tax years beginning after Dec. 31, 2012. The AGI floor for individuals age 65 and older (and their spouses) will remain unchanged at 7.5% through 2016.

Limit on reimbursement of over-the-counter medications from HRAs, HSAs, FSAs, and MSAs. The new law excludes the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account (HRA) or health flexible savings accounts (FSAs) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer Medical Savings Account (MSA), effective for tax years beginning after Dec. 31, 2010.

Increased penalties on nonqualified distributions from HSAs and Archer MSAs. The new law increases the tax on distributions from an HSA or an Archer MSA that are not used for qualified medical expenses to 20% (from 10% for HSAs and from 15% for Archer MSAs) of the disbursed amount, effective for distributions made after Dec. 31, 2010.

Health flexible spending arrangements (FSAs) are limited to $2,500. An FSA is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses. Under current law, there is no limit on the amount of contributions to an FSA. Under the new law, however, allowable contributions to health FSAs will capped at $2,500 per year, effective for tax years beginning after Dec. 31, 2012. The dollar amount will be indexed for inflation after 2013.

Dependent coverage in employer health plans. Effective on Mar. 23, 2010, the new law extends the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the tax year. This change is also intended to apply to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such a child. A parallel change is made for VEBAs and 401(h) accounts. Also, self-employed individuals are permitted to take a deduction for the health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year.

Excise tax on indoor tanning services. The new law imposes a 10% excise tax on indoor tanning services. The tax, which will be paid by the individual on whom the tanning services are performed, but collected and remitted by the person receiving payment for the tanning services, will take effect July 1, 2010.

Liberalized adoption credit and adoption assistance rules. For tax years beginning after Dec. 31, 2009, the adoption tax credit are increased by $1,000, made refundable and extended through 2011. The adoption assistance exclusion is also increased by $1,000.

Tax changes affecting small business in the 2010 health reform legislation

For owners of small businesses and their workers, the recently enacted health reform legislation has some key provisions to pay attention to. The major ones include: tax credits; excise taxes; and penalties. But whether a business will be affected by them depends on a variety of factors, such as the number of employees the business has. I'm writing to give you an overview of the provisions in the new law with the biggest impact on small business. Please call our office for details of how the new changes may affect your specific business.

Tax credits to certain small employers that provide insurance. The new law provides small employers with a tax credit (i.e., a dollar-for-dollar reduction in tax) for nonelective contributions to purchase health insurance for their employees. The credit can offset an employer's regular tax or its alternative minimum tax (AMT) liability.

Small business employers eligible for the credit. To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than 25 full-time equivalent employees (“FTEs”), and the employees must have annual full-time equivalent wages that average no more than $50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000.

Years the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage purchased from an insurance company licensed under state law. For tax years beginning after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange and is only available for two years. The maximum two-year coverage period does not take into account any tax years beginning in years before 2014. Thus, an eligible small employer could potentially qualify for this credit for six tax years, four years under the first phase and two years under the second phase.

Calculating the amount of the credit. For tax years beginning in 2010, 2011, 2012, or 2013, the credit is generally 35% (50% for tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums. The credit phases out as firm-size and average wages increase. Tax-exempt small businesses meeting these requirements are eligible for payroll tax credits of up to 25% for tax years beginning in 2010, 2011, 2012, or 2013 (35% in tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums.

Special rules. The employer is entitled to an ordinary and necessary business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an eligible small employer pays 100% of the cost of its employees' health insurance coverage and the amount of the tax credit is 50% of that cost (i.e., in tax years beginning after 2013), the employer can claim a deduction for the other 50% of the premium cost.

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, and five percent owners of the employer are not treated as employees for purposes of this credit. Any employee with respect to a self-employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals and the individual is not taken into account in determining the number of full-time equivalent employees or average full-time equivalent wages.

Most small businesses exempted from penalties for not offering coverage to their employees. Although the new law imposes penalties on certain businesses for not providing coverage to their employees (so-called “pay or play”), most small businesses won't have to worry about this provision because employers with fewer than 50 employees aren't subject to the “pay or play” penalty. For businesses with at least 50 employees, the possible penalties vary depending on whether or not the employer offers health insurance to its employees. If it does not offer coverage and it has at least one full-time employee who receives a premium tax credit, the business will be assessed a fee of $2,000 per full-time employee, excluding the first 30 employees from the assessment. So, for example, an employer with 51 employees who doesn't offer health insurance to his employees will be subject to a penalty of $42,000 ($2,000 multiplied by 21). Employers with at least 50 employees that offer coverage but have at least one full-time employee receiving a premium tax credit (also allowed under the new law) will pay $3,000 for each employee receiving a premium credit (capped at the amount of the penalty that the employer would have been assessed for a failure to provide coverage, or $2,000 multiplied by the number of its full-time employees in excess of 30). These provisions take effect Jan. 1, 2014.

The “Cadillac tax” on high-cost health plans. The new law places an excise tax on high-cost employer-sponsored health coverage (often referred to as “Cadillac” health plans). This is a 40% excise tax on insurance companies, based on premiums that exceed certain amounts. The tax is not on employers themselves unless they are self-funded (this typically occurs at larger firms). However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

Here are the specifics: The new tax, which applies for tax years beginning after Dec. 31, 2017, places a 40% nondeductible excise tax on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds $10,200 for single coverage and $27,500 for family coverage. An additional threshold amount of $1,650 for single coverage and $3,450 for family coverage will apply for retired individuals age 55 and older and for plans that cover employees engaged in high risk professions. The tax will apply to self-insured plans and plans sold in the group market, but not to plans sold in the individual market (except for coverage eligible for the deduction for self-employed individuals). Stand-alone dental and vision plans will be disregarded in applying the tax. The dollar amount thresholds will be automatically increased if the inflation rate for group medical premiums between 2010 and 2018 is higher than the Congressional Budget Office (CBO) estimates in 2010. Employers with age and gender demographics that result in higher premiums can value the coverage provided to employees using the rates that would apply using a national risk pool. The excise tax will be levied at the insurer level. Employers will be required to aggregate the coverage subject to the limit and issue information returns for insurers indicating the amount subject to the excise tax.
We hope this information is helpful. We expect many things to change and we will try to keep you up to date on relevant changes. If you would like more details about these provisions or any other aspect of the new law, please do not hesitate to call.

Warmest Regards,

Peter DeGregori, CPA, MST
Partner

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