

2011/2012 Tax Update & Important Reminders

TABLE OF CONTENTS

WAGES, SOCIAL SECURITY & OTHER INCOME	Pages 2-6
<i>Social Security Taxes & Benefits (pp.2-5)</i>	
<i>Capital Gains & Losses (p.5)</i>	
<i>Debt Forgiveness & Foreclosures (pp. 5 - 6)</i>	
CREDITS AND DEDUCTIONS	Pages 7-10
<i>Personal Tax Credits (p. 7)</i>	
<i>Itemized Deductions (pp.7-10)</i>	
EDUCATION PLANNING	Pages 11- 15
<i>Credits (pp. 11-12)</i>	
<i>Deductions (pp. 12-13)</i>	
<i>Contributions (pp. 13-15)</i>	
RETIREMENT SAVINGS	Pages 16-19
<i>Traditional and Roth IRAs (pp. 16-17)</i>	
<i>Conversion from Traditional IRA to Roth IRA (p. 18)</i>	
<i>Other Retirement Plans (pp.18-19)</i>	
BUSINESS UPDATES & REMINDERS	Pages 20-30
<i>Payroll Issues (pp. 20-21)</i>	
<i>Schedule C (Sole Proprietors and Single Member LLCs) (pp. 21-23)</i>	
<i>Independent Contractor VS Employee (pp. 24-25)</i>	
<i>Health Insurance Tax Credit for Small Employers (pp. 25 - 26)</i>	
<i>Employer Provided Education Assistance (p. 26)</i>	
<i>Domestic Production Activities Deduction (DPAD) (p.27)</i>	
<i>Business Credits (pp. 27-29)</i>	
<i>Depreciation Update (pp. 29-30)</i>	



WAGES, SOCIAL SECURITY & OTHER INCOME

REDUCTION OF SOCIAL SECURITY TAX – 2011

Ever since the economic downturn really took hold in 2008, government has tried several tactics to put more take home pay in the hands of the taxpayer, hoping that would encourage folks to spend more money, which in turn would stimulate the economy:

- 2008 – Recovery Rebate Credit
- 2009 – Making Work Pay Credit
- 2010 – Making Work Pay Credit

For 2011, employees received instead a Social Security Tax reduction equal to 2% of their taxable wages. This “tax vacation” is due to expire at the end of 2011. If it is not extended, wage earners should be prepared for a 2% decrease in their take home pay come January 2012.

SOCIAL SECURITY

Taxation of Benefits

Up to 85% of Social Security benefits may be taxable to a retiree dependent on how much they collect in other taxable revenue in a particular year. For example, if increased withdrawals are taken from a pension plan or the taxpayer cashes in on some stock that has appreciated in value, the taxes due on those amounts are not only taxed, but more of their Social Security benefits may become taxable with the overall increase in revenue.

Income is calculated as ½ of the Social Security benefits plus taxable pensions, wages, interest, dividends and other taxable income, as well as tax-exempt interest. The following chart displays the % taxed depending on the income and the filing status of the taxpayer.

Filing Status	% Taxed	Income Threshold
Single, HOH, QW, MFS Apart All Year	Up to 50%	\$25,001 - \$34,000
MFJ	Up to 50%	\$32,001 - \$44,000
Single, HOH, QW, MFS Apart All Year	Up to 85%	Over \$34,000
MFJ	Up to 85%	Over \$44,000
MFS Lived With Spouse	Up to 85%	0

Social Security Benefits Based on Earnings & Age of Retirement

Many people approaching retirement age wonder when they should start drawing Social Security Benefits. Three factors to consider:

1. Will you want to continue working after starting to receive benefits?
2. How much will you need to comfortably retire?
3. When will you die?

The third factor – when will you die – is not exactly facetious, although none of us really knows the answer to that question. The issue is that there is a break-even point for those who retire at the traditional retirement age of 65 as compared to those who draw Social Security starting at age 62. That break-even point is **age 80**. If you live to be 80 or older, you may be better off in the long run to wait until Social Security’s full retirement age (66) before beginning to take benefits.

The first two questions are more realistic to answer. If you “retire” before age 66 but you want to continue working, there is a limit on how much money you can make before Social Security benefits must be paid back, as illustrated below:

Retirement Earnings	2011
For any year in which an individual does not attain full retirement age , but is at least 62	\$14,160 per year \$1,180 per month
For the year in which an individual attains full retirement age (66) and only for those full months prior to actually reaching that age	\$37,680 per year \$3,140 per month

Social Security checks do not automatically stop if a retiree exceeds earning limits; instead, checks are reduced by a formula applied to the excess earnings.

The second question above pertains to the decreased benefits paid if you retire earlier than age 66. Will you have enough money to cover your monthly expenses if you decide to retire early? The chart below shows the % of full benefits you stand to receive depending on your date of birth and the date you begin taking benefits.

Normal Retirement Age to Receive Full Retirement Benefits						
Year of Birth	Normal Retirement Age	Benefit as a Percentage (%) of PIA (Primary Insurance Amount) Starting at Age:				
		62	65	66	67	70
1937 or prior	65	80.00	100.00	106.50	113.00	132.50
1938	65:and 2 mos	79.17	98.89	105.42	111.92	131.42
1939	65:and 4 mos	78.33	97.78	104.67	111.67	132.67
1940	65:and 6 mos	77.50	96.67	103.50	110.50	131.50
1941	65:and 8 mos	76.67	95.56	102.5	110.00	132.50
1942	65:and 10 mo	75.83	94.44	101.25	108.75	131.25
1943 – 1954	66	75.00	93.33	100.00	108.00	132.00
1955	66:and 2 mos	74.16	92.22	98.89	106.67	130.67
1956	66:and 4 mos	73.34	91.11	97.78	105.33	129.33
1957	66:and 6 mos	72.50	90.00	96.67	104.00	128.00
1958	66:and 8 mos	71.67	88.89	95.56	102.67	126.67
1959	66:and 10 mo	70.83	87.78	94.44	101.33	125.33
1960 +	67	70.00	86.67	93.33	100.00	124.00

WARNING: Once you start taking Social Security Benefits, you can't change your mind. The "do-over" is done. The "do-over" used to be possible if someone was willing to stop their payments and repay all cumulative past payments in order to start getting higher benefits at a later age. No more.

CAPITAL GAINS (AND LOSSES)

New for This Year and for the Near Future

1. The lower capital gains rate structure was extended for 2011 and 2012; however, **in 2013**, capital gains will again be taxed at **20%**, unless the law is changed before then.
2. Brokers are now required to report basis for any securities sold during the year. As a result, IRS has added a new Form 8949 and has revised the Schedule D. A separate 8949 will need to be completed showing short term and long term stock sales separately. In addition, a separate schedule will be required for each of these three possibilities:
 - a. The Form 1099-B shows the basis for the shares sold
 - b. The Form 1099-B does not show the basis for the shares sold
 - c. The Form 1099-B was not received
3. In **2013**, investors will begin making Medicare tax payments on net investment income, if their income is higher than \$250,000.

Planning Strategies

- If you are planning on selling anything that has a capital gain, it would be a good idea to do so before the end of 2012.
- If you are so inclined, donate appreciated stocks to charity by 12/31/12.
- Gift appreciated stock to relatives who can sell it and pay less tax.

DEBT FORGIVENESS & FORECLOSURES

With the economic downturn and the housing crisis, it's no wonder that the number of people going through bankruptcy and losing their homes is at an all-time high. Taxpayers need to understand what happens from a tax standpoint if debt is forgiven or not. To understand it better, we need to look at consumer debt (credit cards) and secured debt (loans on homes, boats, etc.) as separate.

Consumer Debt

Generally, consumer debt is not secured by any property. If a taxpayer stops making payments on credit cards or other consumer debt, the creditor may try to negotiate what they will accept in payment and/or take the debtor to court to recoup their loss. If the debtor and creditor accept a negotiated settlement, the taxpayer can expect to receive a Form 1099-C, which reports the amount of debt that was cancelled. The amount cancelled is considered to be income to the taxpayer and is usually taxable, **UNLESS the taxpayer is going through bankruptcy or is insolvent** immediately before the cancellation. Proof of insolvency is required.

Secured Debt

Secured debt is "recourse" debt. In other words, the taxpayer is personally liable for the debt and the property used to secure the debt can be re-claimed or repossessed by the creditor. If that happens, then there still may be cancellation of debt, if the debt is greater than the fair market value of the property. In that case, the 1099-C would show the fair market value of the property and the amount of debt canceled.

A different form, Form 1099-A, is used by the lender to indicate that the property has been acquired through foreclosure, deed-in-lieu or abandonment. At that point, the creditor has not indicated that the debt has been cancelled and could still pursue the creditor for the difference between fair market value and what was still owed, **EXCEPT in the case of a principal residence**. There are other exceptions to that rule, such as farm debt, real property business indebtedness and forgiveness of student loans.

It's possible for a creditor to issue a 1099-A in one year and a 1099-C in a subsequent year, depending on the circumstances.

CREDITS AND DEDUCTIONS

PERSONAL TAX CREDITS

Various credits were extended, but just for a year or two. Other credits will expire after this year and/or have some changes for 2011/2012.

1. First-time and Long-Time Homebuyer Credits – Although these credits are no longer available for most taxpayers, Service Members on qualified extended duty had an additional year to enter into a binding contract (April 30, 2011) and close on the home (June 30, 2011).
2. Earned Income Credit – This credit is not paid in advance anymore.
3. Child Tax Credit – The child tax credit of \$1,000 per qualifying child was extended through 2012.
4. Adoption Credit and/or Exclusion – There are two types of tax incentives available for qualifying taxpayers. The first is a tax credit and the other is an exclusion for those taxpayers whose employer paid for the adoption. The credit is used to offset the costs of adoption. The maximum credit and exclusion is \$13,360. The phase-out threshold increased to \$185,210 for 2011 and the credit is completely phased out at \$225,210.
5. Qualified Plug-in Electric Vehicle Credit – This credit is due to **expire on December 31, 2011**. With the Chevy Volt and the Nissan Leaf recently coming on the market, there are some good choices for someone who wants to purchase a “commuter car”. The maximum credit is \$7,500.
6. Personal Energy Credit – This nonrefundable credit (maximum \$500) is equal to up to 10% of the cost of energy efficient improvements made to the taxpayer’s principal residence and is due to **expire on December 31, 2011**.
7. Residential Energy Efficient Property Credit – The cost of certain qualified energy property expenditures can be offset by this 30% credit (unlimited). Qualified properties include solar electric, solar water heating, fuel cells, small wind, and geothermal heat pumps. Expiration is not until December 31, 2016.

ITEMIZED DEDUCTIONS

For 2011 taxes, itemized deductions are not phased out for higher income taxpayers. Some of the categories of itemized deductions are described below.

Medical Deductions (IRS Pub. 502) – only expenses in excess of **7.5% of AGI** (10% for Alternative Minimum Tax purposes) are deductible. Deductible

expenses are out-of-pocket costs (not reimbursed or covered by insurance) and include:

- Medical
- Dental
- Vision
- Treatment of Mental/Emotional Conditions
- Transportation necessary for medical care
- Long-term care services
- Insurance premiums
- Prescriptions (but **not** over-the-counter medicines, unless you have a prescription from a doctor for them)
- Capital expenditures – as long as the special equipment or improvement to the home is medically necessary; in the case of home improvement, the deduction is allowed for the cost of the improvement minus the increase in the value of the property
- Long-term care insurance premiums (limited depending on age)

Note to divorced taxpayers that have dependent children: Both parents can deduct the medical expenses they paid, regardless of custody or which parent claims the children as dependents.

Home Mortgage Interest (IRS Pub 936) – Interest that arises from a loan secured by the taxpayer's primary and one secondary residence, for which the taxpayer is legally liable, **may** be deductible. There are many limitations, dependent on various factors, including:

- If the debt is a home equity line of credit, whether the debt is used to buy, build or improve a residence or used for something else (i.e. paying off other debt)
- If the debt is refinanced home acquisition debt in excess of the balance of the old mortgage

All information about mortgage interest loans must be revealed in order to determine any restrictions on the deductibility of the interest, both for regular tax and Alternative Minimum Tax (AMT) purposes.

Charitable Deductions (IRS Pub 526) – One of the most important changes that has occurred in recent years is the requirement for careful recordkeeping when it comes to claiming charitable deductions. Clearly, the IRS suspects that some people’s donations are not legitimate. Here are the updated requirements:

- Cash Donations – Taxpayers must have a statement from the charity showing the name of the charity, the date of the contribution, and the amount given. If the cash donation is less than \$250, a bank record (i.e. cancelled check) is acceptable in lieu of a letter from the charity.
- Non-Cash Donations – A receipt from the charity showing the name of the charity and the date of the donation is required, accompanied by an itemized list of items donated.

The **new rules on non-cash donations** expand the requirements further:

1. Deductions may not be taken for donations of used clothing and household items that are not in “good used condition or better”. For more information on the value of donated clothing and household items, go to www.SalvationArmyUSA.org.
2. When donations of cars, boats and airplanes exceed \$500 in value, three methods are used to determine what the deduction should be:
 - if the donation is sold by the charity without any significant intervening use or material improvement, the deduction is limited to the gross proceeds realized by the charity
 - if the charity intends to make significant use or materially improve the vehicle, the deduction is generally the fair market value (FMV)
 - if the charity sells the vehicle substantially below FMV to needy or disadvantaged people as part of the charity’s purpose, the deduction is generally the FMV
3. A contemporaneous written acknowledgement from the charity is required certifying which of the three methods was used (see above) and must be attached to the tax return; a VIN is required as well.
4. If the donation of the vehicle is valued between \$250 and \$500, donors should receive a Form 1098-C from the charity to be included with the tax return.
5. For non-cash charitable contributions valued **at greater than \$5,000**, a qualified appraiser must issue a written statement declaring the value of the donation, which will need to be attached to the tax return. The appraisal

must be done within 60 days prior to making the gift and not later than the return's due date.

Charitable donations must be made only to **qualified organizations**. To find out whether an organization qualifies for charitable contributions, go to www.irs.gov and check for the organization on IRS Publication 78, "Cumulative List of Organizations".

You may not deduct contributions made:

- To a specific individual
- To a non-qualified organization
- From which you receive a benefit
- Of your time or services
- If they provide a chance to win a prize (i.e. a raffle)

Miscellaneous Deductions (IRS Pub 529) – most miscellaneous deductions are limited by a threshold of 2% of AGI. Those include:

- Unreimbursed employee expenses
- Tax preparation fees and filing costs
- Appraisal fees for a casualty loss or charitable contributions
- Legal fees for tax advice, to collect alimony or related to keeping your job
- Investment fees
- Hobby expenses (up to the total of hobby income)
- Repayment of taxable social security benefits or unemployment compensation (if more than \$3,000, this item is not subject to the 2% of AGI limitation)

Deductions that are not subject to the 2% of AGI limitation include:

- Impairment related work expenses
- Certain casualty or theft losses
- Gambling losses (to the extent of gambling income)



EDUCATION PLANNING

As you are no doubt aware, the cost of post-secondary education is increasing at a rapid pace. Whether you are a parent or a grandparent, planning ahead for a child's education is the best way to stave off long-term debt. And, the sooner the better!

Here are some college facts for the 2010-2011 school year provided by www.collegeboard.com:

- Average annual four-year private college tuition and fees is \$27,293
- Average annual four-year public in-state college tuition and fees is \$7,605
- Average annual two-year public college tuition and fees is \$2,731
- The average annual surcharge for out-of-state tuition is \$11,990
- Room, board, books, supplies, transportation, and personal expenses add an annual average of more than \$12,000 to the above numbers for students living away from home
- Financial aid is a key component in paying for higher education

CREDITS

There are two credits available to help offset the cost of education. They have a few things in common:

1. the institution providing the education must be accredited
2. they must offer credit toward a degree or certificate
3. they must accept Pell grants, student loans & student aid
4. none of them are allowed for taxpayers that are married filing separately (MFS)
5. the expenses must be out-of-pocket; any scholarships and/or grants cannot apply towards the cost of attending
6. a taxpayer cannot take more than one credit for the same student in the same tax year, but if the taxpayer is claiming more than one child as a dependent, they could still end up with more than one credit

American Opportunity Credit

Up to \$2,500 per student is allowed; 40% of the credit is refundable. It is calculated by taking 100% of the first \$2,000 of qualified higher education expenses (QHEE) and 25% of the next \$2,000.

This credit covers tuition, fees and course materials for the first four years of post-secondary education. The student needs to be enrolled for at least one academic period and be at least a half-time student.

The credit phases out for MFJ and Surviving Spouse between \$160,000 and \$180,000, and between \$80,000 - \$90,000 for those filing single or head-of-household.

Lifetime Learning Credit

Up to \$2,000 is allowed for each eligible taxpayer (not student) per year, calculated by taking 20% of up to \$10,000 in QHEE. None of the credit is refundable.

This credit is available to be used for undergraduate, graduate or professional courses. There is no restriction on whether or not the program leads to a college degree and no restriction for how many hours are spent in school. Phase-outs are \$102,000 - \$122,000 for MFJ and Surviving Spouse, and \$51,000 - \$61,000 for single filers and head-of-household.

Planning Opportunity! If the parents' income is too high to take either of the credits, they should arrange for their child to make the payments and take the credit, assuming that he/she has enough taxable income to benefit.

DEDUCTIONS

Higher Education Expense Deduction (HEED)

This deduction lowers taxable income by a percentage of QHEE. The deduction is limited based upon the taxpayer's adjusted gross income (AGI) and the filing status:

Filing Status	AGI Limits	Deduction Allowed
Single, Head of Household	Up to \$65,000	\$4,000
Single, Head of Household	\$65,0001 - \$80,000	\$2,000
MFJ and Surviving Spouse	Up to \$130,000	\$4,000
MJF and Surviving Spouse	\$130,001 - \$160,000	\$2,000

Restrictions on Use of the Deduction:

- not allowed if the taxpayer is claiming Married Filing Separately
- not available when either of the two credits are claimed in the same year for the same student

Student Loan Interest Deduction

An individual can deduct interest paid on any qualified education loan. The deduction lowers taxable income and is phased out for MFJ and Surviving Spouse between \$120,000 and \$150,000, and for Single and HOH between \$60,000 and \$75,000. The maximum deductible per taxpayer is \$2,500.

CONTRIBUTIONS

Those who can put money away before their children start attending college can choose between a few programs:

1. Education Savings Bonds – *interest is excluded when cashed in to pay QHEE; subject to AGI phase-out*
2. Coverdell Education Savings Accounts – *education IRA; contribute up to \$2,000 per year per child; subject to AGI phase-out*
3. Traditional and Roth IRA Distributions – *10% penalty for early withdrawal is not assessed if used for QHEE*
4. Qualified Tuition Programs (529 Plans) – *prepaid tuition plans (see below)*

The Qualified Tuition Program (QTP) is also known as the 529 Plan, in reference to the Internal Revenue Code 529. In addition to covering costs of tuition, the cost of room and board also qualifies. 529 Plans are sponsored by states and/or institutions. They are not federal plans. As a result, programs offered vary state to state.

Essentially, these plans allow the taxpayer to pay for future tuition costs in today's dollars on behalf of a designated beneficiary, providing a "hedge" against tuition inflation. Only the 529 Plan administrators may make investment decisions, not the contributor. Therefore, it's very important to research what's available in your state.

Advantages of the 529 Plan:

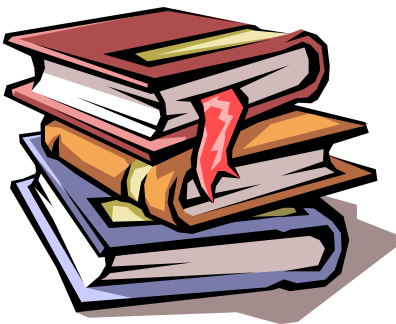
- The contributor retains control over the assets until distributions are made to beneficiaries
- The contributor retains control of when and how much is distributed
- The contributor can change the beneficiary(s)
- Contributions are considered gifts and are eligible for the \$13,000 annual gift tax exclusion
- Large contributions are permitted
- There is no AGI phase-out hindering participation
- Most states allow nonresidents to contribute to their plans
- Distributions are excluded from the income of the beneficiary and the contributor, if used for QHEE
- Most 529 Plans have no time limit on withdrawal; unused funds can be rolled over to another beneficiary that is a member of the first beneficiary's family
- Funds contributed by grandparents who are account owners on the Plan do **not** show up as an asset of the student for financial aid purposes

Planning Opportunity for Residents of Oregon: Oregon allows an income tax deduction for up to \$4,240 MFJ and \$2,120 Single or Head of Household for contributions to Oregon's 529 Plan. If an educational expense is coming up, put funds in a 529 Plan a week before it's due and then pull it out tax free and get the tax deduction on the Oregon return.

For more information on education costs, credits, deductions, exclusions, student aid and student loans:

- Books
 - *A Professional's Guide to College Planning* by Raymond D. Loewe
 - *Family Guide to College Savings* by Joseph F. Hurley
- Government
 - www.fafsa.gov – qualifying for grants, aid and loans
 - www.studentaid.ed.gov – financial aid and scholarship searches

- www.salliemae.com – Sallie Mae Signature Student Loan Information; (888)272-5543
- www.loanconsolidation.ed.gov – list of lenders and their discounts
- (800)4-FED-AID to request “The Student Guide” and “Direct Loans”
- IRS Publication 970, “Tax Benefits for Education”
- Saving for College / 529 Plan Information
 - www.savingforcollege.com – all the information you need to know about 529 plans
 - www.collegesavings.org – College Savings Plan Network; general information about saving for college
- College and Scholarships Searches
 - www.collegeboard.com – comprehensive sites for financial aid calculators, college searches and other financial aid information
 - www.fastweb.com – free, searchable scholarship database that locates sources of financial aid suitable to the student (see Top 10 Admission Tips)
 - www.collegeview.com – search engine of over 3,500 colleges, virtual campus tours
 - www.scholarshipexperts.com – scholarship searches
 - www.collegefirstaid.com – help with finding funding



RETIREMENT SAVINGS

TRADITIONAL AND ROTH IRA'S

Contributions

- Contributions need to be made by the due date of the tax return (April 15th), without extension
- Contribution limit remains at \$5,000 per year, with an additional \$1,000 allowed for those age 50 and older
- Traditional IRA contributions are tax deductible for individuals earning below certain thresholds. The chart below illustrates the phase-out for 2011 and 2012:
 - Contributions by individuals earning in excess of the limits would not be deductible
 - Phase-out changes for those who are enrolled in some other retirement plan at work ❶
 - Even if otherwise deductible, the taxpayer can choose to **designate** the traditional IRA contribution as non-deductible.

Phase-Out Limits for Traditional IRA Contributions		
Deductible IRA Phase-Out	2011	2012
Joint filer – plan participant ❶	\$90,000 - \$110,000	\$92,000 - \$112,000
Joint filer – not a plan participant, but married to a plan participant	\$169,000 - \$179,000	\$173,000 - \$183,000
Single/HOH plan participant ❶	\$56,000 - \$66,000	\$58,000 - \$68,000
MFS – lived with spouse during the year	\$0 - \$10,000	\$0 - \$10,000

- Roth IRA contributions are never tax deductible, but also have income limits and phase-outs. In addition, there are also phase-out limits restricting who can participate, as shown below:

Phase-Out Limits for Roth IRA Contributions		
Filing Status	2011	2012
MFJ	\$169,000 - \$179,000	\$173,000 - \$183,000
Single/HOH	\$107,000 - \$122,000	\$110,000 - \$125,000
MFS – lived with spouse during the year	\$0 - \$10,000	\$0 - \$10,000

Record Keeping – Traditional IRAs

Because contributions to a traditional IRA are sometimes deductible and sometimes not deductible, the taxpayer must keep accurate records of all contributions to each and every traditional IRA account, noting which are deductible and which are non-deductible. The non-deductible contributions are considered “basis” in the IRA, which means that they will not be taxed when distributions are taken.

Traditional IRA vs. Roth IRA

Many people have heard that converting to a Roth IRA might be a good move. That all depends on your current situation and in the foreseeable future. Here’s a comparison of advantages/disadvantages of the Roth:

Roth IRA Advantages

- More people can contribute because the phase-out amounts are more liberal and there is no problem with having another retirement plan
- Earnings and qualified distributions are tax-free
- Taxpayers can keep contributing to a Roth IRA after age 70½
- Taxpayers do not ever need to take required minimum distributions

Roth IRA Disadvantages

- If a Roth IRA loses money, the loss is reported as a miscellaneous deduction subject to 2% of income limit. That deduction is not allowed until all Roth IRA accounts have been distributed
- You don’t get a deduction upon contribution to the Roth
- If you convert to a Roth, all contributions and earnings are taxable in the year of conversion

Conversion of Traditional IRA to Roth IRA

You should get expert advice before converting Traditional IRA account contributions to a Roth IRA account. Here are a few things you should consider before doing a conversion:

1. Converting is considered a distribution and the converted funds are taxable in the year of conversion (except for non-deductible contributions).
2. Conversion must be done by the due date of the return; however, an extension will also extend the due date of the conversion.
3. The converted funds can be re-characterized (that is, converted back to a traditional IRA) if done timely.
4. You should set up a new Roth account for each and every conversion, in order to track basis in the investment.
5. Do a conversion early in the year, so that you have time to re-characterize before the end of the year if that is necessary.
6. Conversions that are withdrawn before a five-year period may be subject to a 10% penalty.

OTHER RETIREMENT PLANS

There are a plethora of other retirement plans – too many, in fact, to go into all of them here. However, here is a chart that you can use to compare and contrast one to the other.

2011 PENSION PLAN COMPARABILITY TABLE

Plan Characteristic	Money Purchase	Profit Sharing	401(k)	Traditional or Roth IRA	SIMPLE IRA	SEP
Maximum deductible plan deposit per code	Lesser of \$49,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)	Lesser of \$49,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)	Lesser of \$49,000 or 25% of compensation 415 IRC Sec. (Also see limits, below)	N/A	Employee amount + lesser of 3% of compensation or employee deposit	Lesser of \$49,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)
Maximum <i>employee</i> deposit	N/A	N/A	Lesser of \$16,500 or 100% of compensation	Lesser of \$5,000 or 100% of compensation	Lesser of \$11,500 or 100% of compensation	N/A

Age 50 and older catch-up contribution (over and above otherwise allowable maximum)	N/A	N/A	\$5,500	\$1,000	\$2,500	N/A
Form 5500 required?	Yes	Yes	Yes	No	No	No
Other qualified plans allowed?	Yes	Yes	Yes	See AGI Limits	No	Yes
Mandatory employer contributions	Yes	No	No	N/A	Yes	No
Minimum age/service	Age 21, up to 2 years	Age 21, up to 2 years	Age 21, up to 2 years, but employee deferrals allowed after 1 year	N/A	All earning more than \$5,000 in any prior 2 years and expecting \$5,000 in current year	Age 21, any 3 of last 5 years, and earning more than \$550 in current year
Top-heavy rules apply?	Yes	Yes	Yes	No	No	Yes
Nondiscrimination rules apply?	Yes	Yes	Yes	No	No	No
IRC Sec. 415 limits apply?	Yes	Yes	Yes	N/A	No	Yes
Participant loans allowed?	Yes	Yes	Yes	No	No	No
Vesting?	Yes—graduated	Yes—graduated	Yes—graduated, 100% immediate for employee contributions	Yes-100% immediate	Yes-100% immediate	Yes-100% immediate
Last day to establish	December 31 of current year	December 31 of current year	December 31 of current year	April 15 of following year	October 1 — current year	Due Date plus extension
Last day for employer to deposit	Due Date plus extension	Due Date plus extension	Due Date plus extension	April 15 of following year	Due Date plus extension	Due Date plus extension

Compensation Limit for defined contribution plans is \$245,000 for 2011, maximum \$49,000 deductible contribution for 2011.

Compensation limit for defined benefit plans is \$195,000 for 2011. ERISA rules require deferral deposits by the 15th of the following month (SIMPLE is not an ERISA plan, must be deposited by the 30th).

BUSINESS UPDATES & REMINDERS

PAYROLL ISSUES

1. Federal Unemployment Tax

For the second half of 2011, the rate of Federal Unemployment taxes was reduced from .8% to .6%. Actually, the difference (.2%) was a surcharge that was supposed to be temporary but which has lasted for 35 years!

2. New EFTPS Filing Requirements

Employers are no longer allowed to make deposits of payroll taxes using payment coupons. All deposits must be made electronically through the Electronic Federal Tax Payment System (EFTPS).

3. Payroll Compliance Checklist – to assist businesses of 25 employees or more in preventing payroll problems

- a. Is there a W-4 and I-9 on file?
- b. Is the employee handbook up to date?
- c. Do I complete performance appraisals and reviews consistently for all employees?
- d. Do I have current compliance posters on display in my business?
- e. Do I know how to handle a sexual harassment claim?
- f. Do I have procedures to train a new employee or discharge an employee?
- g. Is there a safety manual and do I comply with safety standards?
- h. Am I sure of the payroll tax deposit due dates and do I have procedures to ensure they are met?
- i. Do I periodically check my software for correctness? (refer to IRS Circular E)
- j. Have I properly classified my employees as exempt or non-exempt under the Fair Labor Standards Act?
- k. Am I sure employee Social Security numbers are correct? (check by going to www.ssa.gov/employer/ssnvspamphlet.htm)
- l. Do I have any third party sick pay claims? (refer to IRS Pub 15-A)

4. Hiring Family Members – a self-employed individual cannot be an employee of himself; however, family members can be hired and paid through the business if there is a legitimate employer-employee relationship. Here is a 10-point checklist to establish the legitimacy of that relationship:

	Yes	No
1. Is there a written employment contract between the parties?	_____	_____
2. Are time records kept at the time of work performance?	_____	_____
3. Is there a written job description?	_____	_____
4. Is the employee paid periodically?	_____	_____
5. Is there an I-9 on file for the employee?	_____	_____
6. Is there a W-4 on file for the employee?	_____	_____
7. Are payroll tax returns filed regularly?	_____	_____
8. Are W-2s issued?	_____	_____
9. Does the employee deposit the check in his/her own account?	_____	_____
10. Are wages comparable to fair market wages for equivalent work?	_____	_____

NOTE: Any box checked "No" indicates a questionable deduction.

5. **Penalties on Bad Social Security Numbers** – A listing of missing or invalid SSNs may be provided to you upon request. The IRS can charge employers a penalty of up to \$100.00 for each return or Form W-2 that has a missing or incorrect SSN. An SSN is invalid if:
- a. It is all ones (111-11-1111) or all threes (333-33-3333)
 - b. It is 123-45-6789
 - c. The first three digits are 000, 666. 900-999
 - d. The middle digits are 00
 - e. The last four digits are 0000

For more information, visit the SSA website at
www.ssa.gov/employer/ssnvhighgroup.htm

SCHEDULE C FILERS (Sole Proprietors and Single Member LLCs)

IRS continues to focus on Schedule C as a source of the "tax gap". They believe that \$148 billion (43%) of the tax gap is due to unreported income earned by sole proprietors, which in turn causes unpaid self-employment tax.

The deductibility of business expenses is always among the ten most litigated tax issues. Generally, a business expense is **only deductible if the expense is ordinary, necessary and reasonable in amount.**

- "Ordinary": *normal, customary or usual for this type of business*
- "Necessary": *appropriate and helpful (does not mean that the expense is required to be vital to the business in this context)*
- "Reasonable": *depending on the facts and circumstances of each situation, the expense is within reasonable limits*

Like many other deductions, business expense deductions are not allowed unless they are substantiated. Substantiation consists of proving that the taxpayer paid the expense (or charged it on a credit card) and that the expense is legitimate. Receipts, invoices and other supporting documentation is required. Those documents must be **contemporaneous** with when the expenses were incurred.

Bad debts are never deductible for a cash basis business, since they have never been included as income.

Typical Items Audited:

1. Hobby activity with no profit motive
2. Deposits of business income into personal accounts without reporting it
3. Co-mingling business and personal activity in one bank account
4. Taxpayer not materially participating in the business
5. Worker Classification – employee versus independent contractor
6. Entertainment expenses
7. Start-up expenses
8. Expensing of capital items (furniture, equipment, vehicles)
9. Drastic changes in income
10. Unlikely business expenses
11. Large "miscellaneous" or "other expenses"
12. Round numbers

Business or Hobby?

A trade or business is an activity carried on with a **goal of making a profit**, even if the profit motive is not reasonable. Some type of economic activity must be conducted.

If an activity shows a profit in any three years out of a five-year period, it is presumed that the activity is a trade or business. The burden of proof is on the IRS at that point to prove otherwise. So, what if your business has not shown a profit in three out of five years? In that case, the burden of proof is on you to prove that there is a profit motive and that the activity is a trade or business.

Nine key factors are used to determine whether an activity is engaged in for profit:

1. The manner in which the taxpayer carries on the activity
 - a. Is the activity conducted in a businesslike manner?
 - b. Does the taxpayer maintain complete and accurate books?
 - c. Is the activity conducted in a similar manner to profitable activities of the same nature?
2. The expertise of the taxpayer or the taxpayer's advisors
 - a. Did the taxpayer adequately prepare for conducting the activity?
 - b. Did the taxpayer consult with experts? And did the taxpayer heed the advice of those experts?
3. The time and effort spent by the taxpayer in the activity
 - a. Is the taxpayer devoting substantial time to the activity? If not, does the taxpayer employ competent and qualified personnel?
 - b. Did the taxpayer withdraw from another occupation to devote more time to the activity?
4. Expected appreciation in asset values
 - a. Appreciation in land value
 - b. Appreciation in other assets greater than all losses
5. Success in other business activities – Has the taxpayer been successful in other business activities and/or previously converted similar businesses from being unprofitable to being profitable?
6. History of income or losses for the activity - Are the losses as a result of normal start-up costs?
7. History of any earned profits in relation to any losses – Has the taxpayer earned enough given the amount of the taxpayer's investment?
8. Financial status of the taxpayer
 - a. Are there losses that generate significant tax savings for the taxpayer?
 - b. Does the taxpayer rely on the income from the activity?
9. Element of personal pleasure or recreation – The fact that the taxpayer derives personal pleasure from engaging in an activity is not sufficient by itself to cause the activity to be classified as a hobby.

Self-Employment Tax

Self-employment (SE) tax is Social Security and Medicare tax for individuals who are:

- self-employed individuals or
- members or partners who receive compensation and are actively involved with the partnership

The rates charged on net earnings are 10.4% in 2011 for Social Security (up to \$106,800) and 2.9% for Medicare.

- For 2011, SE tax was decreased by 2%
- For **2010 only**, health insurance was deducted prior to calculating SE tax

INDEPENDENT CONTRACTOR OR EMPLOYEE?

The IRS asserts that the independent contractor versus employee issue is prevalent in the consulting industry. Areas of concern:

- A former employee comes back to a company as an independent consultant
- The consultant obtains a client for whom s/he does not have the resources to fulfill the contract, so the consultant forms "strategic alliances" with other individuals that can lead to an employee/employer relationship

There are three categories that encompass various factors that the IRS looks at to determine worker classification. They are:

1. Behavioral Control – Facts that show whether the business has a right to control how the worker performs the required task
2. Financial Control – Facts that show whether the business has the right to control the business aspects of the worker's job
3. Relationship of the Parties Involved – The substance of the relationship between the parties

The degree of importance of each factor varies depending upon the occupation and the actual context in which the services are performed.

If the IRS determines that an independent contractor should have been treated as an employee, there may be substantial back payroll taxes to pay, along with interest on top of that and a penalty of 1.5% of the individual's wages.

Some procedures to have in place that will help in case of an audit:

- Make sure there is a written contract on file that is:
 - Signed before the worker is hired
 - Clear about the specific business arrangements between the parties
 - Clear that the worker will not be treated as an employee for federal and state tax purposes
- Require independent contractors to submit competitive bids
- Don't provide fringe benefits to independent contractors
- Make sure the independent contractor carries their own workers' compensation insurance
- Avoid making advances or loans to independent contractors
- Keep vendor records separate from employee records
- Issue 1099s to independent contractors in a timely manner
- Have a file for each contractor that contains
 - Bids
 - Contracts
 - Form W-9
 - Workers' compensation insurance certificates

For more information, go to www.irs.gov and review IRS Pub. 1779, "Independent Contractor or Employee" brochure and to www.irs.gov/pub/irs-utl/emporind.pdf to look at IRS training materials pertinent to this subject.



SMALL EMPLOYER TAX CREDIT FOR EMPLOYEE HEALTH INSURANCE BENEFITS

This credit is intended to help more small businesses provide health coverage to workers. Businesses with **less than 25 full-time equivalent (FTE) workers** who pay **average annual wages of \$50,000 or less** are eligible for a credit

of **up to 35%** towards the cost of the insurance premiums. This credit is available for the years 2010 – 2013.

There are two other requirements to qualify:

1. The employer must pay at least 50% of the premiums for each employee
2. A uniform percentage must be paid for all employees

Some employees are excluded when coming up with the FTE and the average annual wage:

- Seasonal workers (unless they work for more than 120 days a year)
- Owners (including partners, sole proprietors, S-Corporation shareholders and 5% owners of the employer)
- Related employees (child, parents, siblings, etc.)

The full 35% credit is available to an employer with 10 or fewer FTE and whose annual average wage is less than \$25,000. The credit is reduced for employers with between 11 and 24 FTE with annual wages of between \$25,000 and \$50,000.

Different methods are allowed for calculation of FTE. The employer is allowed to use whichever method produces the best result.

For more information, go to www.irs.gov and search the database for Small Employer Tax Credit and IRS Notices 2010-44 and 2010-82.

EMPLOYER PROVIDED EDUCATION ASSISTANCE

Employers can exclude up to \$5,250 per year of qualified educational assistance paid or incurred by the employer. Educational expenses can include tuition, fees, books, supplies, and equipment. Graduate level courses qualify.

Education for the purpose of this exclusion is defined as any form of instruction or training that improves or develops an individual's capabilities, regardless of whether or not the education is job related or part of a degree program.

Education assistance programs may not discriminate in favor of highly compensated employees or the owner's family, and the benefits allowed for more-than-5% owners or their families cannot exceed 5% of the benefit.

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION (DPAD)

This deduction is available to businesses that have "domestic production gross receipts. These receipts can originate from any of three sources:

1. Lease, rental, license, sale or exchange of production property which was **manufactured, produced, grown or extracted** by the taxpayer
2. Any qualified film produced by the taxpayer
3. Electricity, natural gas, or potable water produced by the taxpayer

The activity must be carried on with continuity and regularity. Providing services alone does not qualify.

In brief, the deduction is calculated on net production income (after cost of goods sold and overhead). The applicable percentage for 2011 is 9%, but cannot exceed 50% of employee wages. Other restrictions apply.

Unless some action is taken by Congress, this deduction will sunset on December 31, 2011.

For more information and to determine whether your business qualifies, go to www.irs.gov and research Internal Revenue Code Section 199. There are a lot of good examples there. You may also contact our office for additional information.

BUSINESS CREDITS

There are a number of business tax credits available, many relating to energy improvements and hiring of disadvantaged workers. Two of the most popular hiring incentives are the Work Opportunity Credit and The HIRE Act.

1. The Work Opportunity Credit (WOTC) is available to employers who hire from specific targeted groups of people that have experienced difficulties in the past securing employment. Counties in 32 states nationwide qualify. The credits range from \$1,200 to \$9,000 per employee, depending on the situation. The WOTC **will expire at the end of 2011**, unless it is extended by Congress.
2. The Hiring Incentives to Restore Employment (HIRE) Act was signed into law 3/18/2010 and offers an up-to \$1,000 tax credit for businesses that hire unemployed workers. This credit is separated into two sections. The first

section is not in effect after 2010, but the **second section is still available through the end of 2011**. If an employee was **hired after February 3, 2010** from the designated group **and retained** for at least **52 weeks continuously**, there is an additional credit per qualifying worker (the lesser of \$1,000 or 6.2% of wages paid).

For more information on the WOTC, refer to IRS Publication 3991, and for HIRE, research information on IRC Section 38.

What follows is a complete list of the credits available and applicable reference information:

ENERGY RELATED CREDITS			
IRC Section	Credit Title	Form Number	IRS Pub
34	Credit for Federal Tax Paid on Fuels	4136	510
40(a), 38(b)	Alcohol and Biodiesel Fuel Credit	6478	510
40A	Biodiesel & Renewable Diesel Fuels Credit	8864	510
30(c)	Credit for Certain Other Qualified Electric Plug-in Vehicles	8834	535
30D	Qualified Plug-in Electric Drive Motor Vehicle	8936	535
45	Renewable Energy	8835	334
30B	Alternative Motor Vehicle Credit (Hybrid)	8910	334,463
30C	Alternative Fuel Refueling Property Credit	8911	334
48(a)	Energy Credit	3468	
45K	Nonconventional Source Fuel Credit	8907	
48B	Coal Gasification, Advanced Coal Project, Advanced Energy Project Credits	3468	
48C	Qualified Energy Manufacturing Project Credit	3800	
45L	Energy Efficient Home Credit (homebuilders)	8908	
45M	Energy Efficient Appliances (manufacturers)	8909	
45H	Low Sulfur Diesel Fuel Production	8896	
45Q	Carbon Dioxide Sequestration	8933	



EMPLOYMENT CREDITS			
IRC Section	Credit Title	Form Number	IRS Pub
51	Work Opportunity Credit	5884,8850	3991
45P	Differential Wages Credit	8932	
44	Disabled Access Credit	8826	907
45B	Employer Tip Credit	8846	15, 531
45E	Pension Startup Credit	8881	334
38	Retained Worker Credit (2 nd Phase of HIRE Act)	5884-B	
1396/1400H	Empowerment Zone and Renewal Community Credit	3800, 8844	954
45A	Indian Employment Credit	8845	954

Other Business Credits			
IRC Section	Credit Title	Form Number	IRS Pub
45D	New Markets Credit	3800, 8874	
45R	Small Employer Health Insurance Credit	8941	
41	Credit for Increasing Research Activities	6765	
42	Low Income Housing Credit	8586, 8609	334
47	Rehabilitation Credit	3468	

DEPRECIATION - Update

Bonus Depreciation – Extended bonus depreciation through 2012

- ✓ On new assets only
- ✓ 100% expensing in 2011 only (down to 50% in 2012)
- ✓ Must "elect out" of bonus depreciation

Section 179 Depreciation – Increased limits are extended through 2011 and real property has been added to the definition of Section 179 property (up to \$250,000)

- ✓ On new and used assets
- ✓ 100% expensing allowed
- ✓ Limited to \$500,000 in assets
- ✓ Limited to the taxable income from the business
- ✓ Business cannot have purchased more than \$2,000,000 in assets

Leasehold Improvements – 15 year depreciation is extended through 2011 only