tax IMPACT

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Congress delivers tax relief in the nick of time

After weeks of heated debate and controversy, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 on Dec. 17. And while some may be concerned about the cost of the act, just about everyone will benefit. Here are some of the key changes.

Income tax rates hold steady

The central feature of the Tax Relief act is a two-year extension of the "Bush tax cuts." Individual income tax rates ranging from 10% to 35% had been scheduled to return to their previous levels (from 15% to 39.6%) in 2011. The act extends the lower rates through Dec. 31, 2012.

It also increases alternative minimum tax (AMT) exemptions that would otherwise have decreased substantially for 2010 and 2011.

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Payroll taxes reduced

For 2011 only, the act reduces the employee's share of Social Security taxes from 6.2% to 4.2% on earnings up to the taxable wage base ($106,800 in 2011). So, for example, an employee who earns $100,000 this year will save $2,000 in payroll taxes.

The act also cuts the Social Security portion of self-employment taxes from 12.4% to 10.4%. (This doesn't reduce a self-employed individual's deduction for the employer's share of these taxes, however.)

Capital gains and dividends rates extended

The 15% tax rate for long-term capital gains and qualified dividends (0% for taxpayers in the 10% and 15% brackets) was scheduled to expire at the end of 2010. Without new legislation, the capital gains rate would have risen to 20% (10% for taxpayers in the 15% bracket) and qualified dividends would again have been taxed at ordinary-income rates as high as 39.6%. The act extends the lower rates through Dec. 31, 2012.

This means the pressure is off (for now) to cash in appreciated investments before rates go up. In addition, gifting appreciated securities to children (if not subject to the "kiddie tax") or other family members in the bottom two tax brackets continues to be a viable strategy.

Estate and gift tax changes

Without Congressional action, the estate tax would have come back in 2011 (after a one-year repeal) with a top rate of 55% and an exemption

amount of only $1 million. The Tax Relief act restores the federal estate tax, *retroactive to the beginning of 2010*, but reduces the top rate to 35% and increases the exemption to $5 million.

The act also revives the stepped-up basis rules that applied before 2010. Under those rules, inherited property generally receives a tax basis equal to the property's date-of-death fair market value, which allows the recipient to sell the property without triggering capital gains taxes other than for postdeath appreciation.

Gifts made in 2010 are still subject to gift tax at a top rate of 35%, with a $1 million lifetime exemption. For 2011 and 2012, however, the gift and estate taxes are "reunified" — both apply at a top rate of 35% with a combined $5 million exemption (indexed for inflation in 2012). The generation-skipping transfer (GST) tax exemption is increased to match the estate tax exemption, but the GST tax rate for 2010 is 0%, increasing to 35% for 2011 and 2012. There are other important changes as well:

Election for 2010. Under the estate tax repeal, modified carryover basis rules set the basis of most inherited property at the lesser of the deceased's basis or the property's fair market value. As a result, heirs selling appreciated assets would be liable for capital gains taxes, even if the appreciation occurred before they inherited the assets. Executors are allowed to allocate up to $1.3 million to increase the basis of estate assets plus an additional $3 million for assets left to a surviving spouse.

For people who died in 2010, the act gives their estates two options: 1) calculate estate taxes using the new 35% top rate and $5 million exemption (with a stepped-up basis for all estate assets), or 2) elect to apply the law as it existed before the act — that is, no estate tax but a modified carryover basis regime.

Portability. For 2011 and 2012, the act makes the estate tax exemption (but not the GST exemption) "portable" between spouses. So, if a husband dies this year with an estate worth $2 million (and an election is made on a timely filed estate tax return), his wife's exemption will include the husband's unused amount ($3 million) for a total exemption of $8 million.

Portability allows spouses to make the most of their exemptions without using trusts. But this provision is scheduled to expire at the end of 2012, which limits its value. And, after the death of the first spouse, a trust can allow appreciation to escape estate tax. For these reasons, a trust will likely still make sense in many situations.

Key business changes

The Small Business Jobs Act of 2010 (SBJA) extended 50% bonus depreciation, generally through Dec. 31, 2010. This provision allows

Extended tax breaks

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extends or expands several individual income tax breaks through 2012, including:

- Elimination of the personal exemption phaseout and itemized deduction limitation,
- A modified child tax credit,
- An increased dependent care credit, adoption credit and adoption assistance exclusion,
- "Marriage penalty" relief, and
- A variety of education incentives, including expanded Coverdell Education Savings Accounts, an expanded exclusion for employer-provided educational assistance and an expanded student loan interest deduction.

The act also extends, through 2011, these breaks that expired at the end of 2009:

- Deduction for state and local *sales* taxes in lieu of state and local *income* taxes,
- Higher education tuition deduction, and
- IRA direct charitable contribution.

Extended business tax breaks include the:

- R&D tax credit, which was renewed for 2010 and 2011,
- 100% gain exclusion for qualified small business stock held for five years or more, extended to stock acquired before Jan. 1, 2012,
- Work Opportunity tax credit, extended through 2011, and
- 15-year depreciation for qualified leasehold-improvement, restaurant and retail-improvement property, extended through 2011.

The act also extends a variety of energy incentives for businesses and individuals.

businesses to immediately write off 50% of the cost of certain capital expenditures, such as tangible property with a recovery period of 20 years or less, computer software, water utility property and qualified leasehold-improvement property.

The Tax Relief act increases bonus depreciation to 100%, generally for assets placed in service after Sept. 8, 2010, and before Jan. 1, 2012. Bonus depreciation drops to 50% in 2012 and is scheduled to disappear in 2013.

The SBJA also increased the maximum Section 179 expense deduction for fixed asset purchases to $500,000 for 2010 and 2011. In addition, the SBJA increased to $2 million the level of qualified property purchases at which the Sec. 179 deduction begins to phase out. Absent additional legislation, the deduction was scheduled to drop to $25,000, with a $200,000 phaseout threshold, in 2012. The Tax Relief act increases the 2012 figures to $125,000 and $500,000, respectively, both indexed for inflation.

If you acquired fixed assets in 2010 or plan to do so this year or next, review bonus depreciation and the Sec. 179 provisions to determine the most tax-efficient strategy for each year. Bonus depreciation is available regardless of expenditure level, but only for new property. Sec. 179 applies to both new and used property. State rules differ for bonus depreciation vs. Sec. 179 in certain states.

How do you spell relief?

In addition to the changes described above, the Tax Relief act temporarily extends many expiring provisions. (See "Extended tax breaks" above.) Consult your tax advisor to discuss what the act means for you and your business.

The home-office deduction: What you need to know

If you're one of the lucky ones who are able to get out of bed, eat breakfast and walk into their office without ever leaving home, good for you! But are you aware of the IRS's home-office deduction rules?

Passing the test

According to the IRS, your workspace must meet certain tests to qualify for the home-office deduction:

Exclusive trade or business use. You must have a specific area of your home used for only your trade or business. No personal use of the space is allowed.

Regular use. You must use the area regularly and on a continuous basis.

Principal place of business. The area must be your principal place of business or the place where you regularly meet or deal with customers. Using the space for administrative or management functions typically qualifies, too, even if a significant portion of your work is done in the field.

Your workspace doesn't have to be an actual office or even a separate room in your home — only a defined space used for business. In fact, you don't even have to use a portion of your home as an office. It can be any space, such as a storage facility or showroom, that you consistently use.

Moreover, any areas you use to store inventory, files or documents, such as a closet or basement, are also eligible for the deduction if you use the space regularly.

Determining what to deduct

You can potentially deduct 100% of expenses directly related to the home-office space, including your telephone line and utilities (if you have separate hookups), painting and repairs, and the cost of an insurance rider on your homeowner's policy.

You're also allowed to deduct a percentage of indirect expenses that pertain to your home office, such as mortgage interest and property taxes, as well as association fees or condominium assessments. And if you don't own your home, you can deduct some of your rent.

Other deductions include insurance premiums on the home, the cost of a security system, and bills for repairs, utilities, trash removal and general maintenance. Finally, you can depreciate the portion of the home used for business over a period of 39 years.

To determine the "home-office" portion of your residence, divide the square footage of your office by the square footage of your entire home. Then apply that percentage to each indirect cost to calculate the deduction you can claim.

Minding the details

If you're self-employed, the home-office deduction, plus all your other deductible business expenses, can't exceed your business income for the year. Any excess of expenses over income, however, can be applied in future years against self-employment income.

If you're not self-employed but work from home for an employer for a significant amount of time, you'll need to prove to the IRS that your home office is maintained for your employer's benefit and convenience, not your own.

Further, your home-office deduction will be counted as a miscellaneous itemized deduction on Schedule A, rather than on Schedule C, where self-employed business owners calculate their profit or loss. You can write off miscellaneous itemized deductions, but only if they exceed 2% of your adjusted gross income.

Regardless of whether you work for yourself or someone else, to withstand IRS scrutiny in case of an audit, keep pictures of your office in your tax file. Also retain records of utilities, mortgage interest, real estate taxes, rent, insurance, bills and receipts for maintenance and service, and other pertinent documents.

Crossing your t's and dotting your i's

Whether you're considering working out of your home or you've had a designated workspace in the home for years, make sure you learn and follow the IRS's rules on what you can and cannot deduct. Your tax advisor can answer any questions you may have. ◎

SBJA creates valuable tax-planning opportunities

On Sept. 27, President Obama signed the Small Business Jobs Act of 2010 (SBJA), which created $30 billion in funding for small business loans. It also provided several tax incentives for businesses — both large and small.

In light of these incentives, here are three actions you should consider in 2011:

1. Rid yourself of "built-in gain" property. If your company converted from a C corporation to an S corporation, the SBJA may provide you with an opportunity to dispose of certain assets without a tax penalty. Ordinarily, C corporations that convert to S status must hold appreciated assets for at least 10 years or face taxes on any gains. The act temporarily reduces the holding period to five years for assets disposed of in taxable years beginning in 2011.

2. Buy cell phones for your employees. Recognizing that cell phones and smart phones are no longer novel or expensive, the SBJA has eliminated their "listed property" designation. This change lifts the strict substantiation requirements and depreciation limits for these devices — making it easier for businesses to deduct the cost of phones they purchase for employees — and allows an employee to exclude the value of personal use from income if the phone is used predominantly for business.

3. Review your business credits. For businesses with average annual receipts of $50 million or less for the previous three years, the SBJA increases the carryback period for general business credits from one year to five years. This provision, which applies for both regular and alternative minimum tax purposes, offers qualifying businesses an opportunity to boost their cash flow by carrying back credits to years where they had tax liability so they can receive tax refunds.

These are just a few of the tax-saving opportunities created by the SBJA. Consult your tax advisor to discuss others that may be available to you.

tax TIPS

Defined value gifts limit tax exposure

If the IRS determines that you've undervalued assets transferred to loved ones, you can end up with unexpected gift or estate tax liabilities. One way to avoid these unpleasant surprises is to make "defined value" gifts.

Instead of transferring a specified percentage of a business or family limited partnership, for example, you transfer a specific *dollar* amount. If the IRS concludes that the transferred asset's value is higher than the amount you reported on your gift or estate tax return, the excess goes to an alternate beneficiary, such as your spouse or a charity.

Defined value clauses must be drafted carefully to ensure they'll withstand an IRS challenge and won't trigger additional tax liabilities. ◎

Check out charities before you donate

If you're considering gifts to small charities, be sure they're in good standing with the IRS before you get out your checkbook. Even the smallest are now required to file Form 990N — an "e-postcard" return. Those that fail to do so risk losing their tax-exempt status, which can endanger your charitable deductions. The IRS website contains a list of charities in danger of losing their exemption. This "List of Organizations At Risk of Automatic Revocation of Tax-Exempt Status" can be accessed by going to irs.gov and typing "List of Organizations" into the search box. ◎

No more paper payroll tax deposits

If your business still uses paper coupons to submit federal payroll tax deposits, you'll need to switch to the Electronic Federal Tax Payment System (EFTPS). In proposed regulations (which likely will have been made final by the time you're reading this), the IRS announced plans to discontinue the paper coupon system after Dec. 31, 2010.

EFTPS allows you to make deposits 24/7, either online or by telephone. You can schedule payments up to 120 days in advance to ensure you don't miss a deadline.

Certain businesses that pay a minimal amount of payroll taxes can continue to make payments with their returns instead of using EFTPS. For more information, contact your tax advisor or visit eftps.gov. ◎

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