

CPA Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*SM

Lower Taxes May Mean More Jobs



In some ways, the title of the Small Business Jobs Act of 2010 says it all. This new federal law aims to create jobs within the United States, with small companies acting as engines of growth. Among the multiple provisions of this act, several provide tax benefits for small businesses. The authors of the new law hope that lower taxes will make many small companies more profitable and thus more likely to add employees.

Equipment deductions

One provision of the new law expands Section 179 of the tax code, which allows small companies to buy business equipment and take a first-year tax deduction. Ordinarily, companies must depreciate the equipment they buy, thus spreading deductions over several years.

From 2008 through 2010, Congress passed a series of laws setting the maximum first-year “expensing” amount at \$250,000. Once annual equipment purchases topped \$800,000, companies would lose the tax benefits of expensing, dollar for dollar. In the Small Business Jobs Act of 2010, the \$250,000 expensing cap for 2010 was increased from \$250,000 to \$500,000, and the higher limit was set for 2011 as well. (Up to \$250,000 of the \$500,000 cap can be deducted for qualified real property, which includes leasehold improvements, such as renovations to a store or a restaurant.) For each of those two years, the phaseout threshold is now \$2 million.

Example 1: ABC Corp. spends \$450,000 on business equipment in 2011. It can immediately deduct \$450,000, which is under the \$500,000 cap.

Example 2: DEF Corp. spends \$1.1 million on business equipment in 2011. It can immediately deduct \$500,000, the amount of the cap. The company can depreciate the other \$600,000 of equipment purchases under standard IRS rules.

Example 3: GHI Corp. spends \$2.2 million on business equipment in 2011. The company’s expenditures are \$200,000 over the \$2 million phaseout threshold so

January 2011

What’s Inside

Special Report on the Small Business Jobs Act of 2010

- 1 Lower Taxes May Mean More Jobs
- 3 More Flexibility in Retirement Planning
- 4 Tax Calendar

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Well-Equipped Deductions

The upper limit on first-year tax deductions for equipment purchases, now set at \$500,000, was \$17,500 in 1996.

continued on page 2

Trusted Advice

Required Income

- ❖ A “taxable income limitation” test exists that applies to the deduction under Section 179 of the tax code. The amount of the Section 179 expense deduction, the first-year deduction for business equipment, can’t exceed the purchaser’s business income.
- ❖ For example, suppose PQR Corp. buys \$100,000 worth of equipment in 2011. The company is entitled a \$100,000 deduction this year, but only if it has at least \$100,000 of income.
- ❖ With C corporations, the corporation usually buys its own equipment. If the corporation “zeroes out” its income via salary and bonus payments to executives, there won’t be enough income to cover the Section 179 election.
- ❖ To use the Section 179 deduction, a company can pay less compensation to its executives and keep enough taxable income to be offset by the expensing deduction. In the case of PQR Corp., the company might pay a smaller bonus to its CEO and retain \$100,000 of profits, which can be offset by the Section 179 deduction.

its expensing election is reduced by \$200,000, from \$500,000 to \$300,000. The company can depreciate the other \$1.9 million of equipment purchases under standard IRS rules.

With the new law in place, if a company spends \$2.5 million or more on equipment this year, no expensing will be permitted.

Startup deductions

The new law also increases startup deductions allowed under Section 195 of the tax code. For 2010 and 2011, the ceiling on the deduction is raised from \$5,000 to \$10,000, and the phaseout threshold rises from \$50,000 to \$60,000. With this arrangement, new companies can deduct the lesser of (1) the amount of the startup expenses or (2) \$10,000, reduced by the amount by which the startup expenditures exceed \$60,000.

Example 4: MNO Corp. has startup expenses of \$63,000 in 2011. The company is \$3,000 over the \$60,000 threshold so it can deduct \$7,000 of its outlays: \$10,000 minus the excess \$3,000.

You incur startup costs when you’re investigating or creating a new business but have not actually begun operations. (Money spent to buy capital equipment doesn’t qualify.) Those costs might include market surveys, advertisements, travel to line up suppliers, consulting fees, and wages paid prior to opening the doors of a new business. Such outlays may be deductible in the year that you begin operations, under Section 195. Costs you can’t deduct right away can be amortized over 180 months, beginning in the month operations begin.

Built-in gains

Standard C corporations face many tax hurdles. They could owe corporate income taxes on profits, for example. The IRS might determine that a business owner’s compensation is

unreasonable and deny a deduction for the compensation to a C corporation.

To avoid such tax traps, small companies may elect to be S corporations rather than C corporations. To qualify for this election, S corporations must meet certain criteria: they can have no more than 100 shareholders and only one class of stock, for example. After making an S corporation election, business owners report company profits on their personal tax returns and the company owes no corporate tax.

Some C corporations elect S corporation status while holding appreciated assets. In the past, a 10-year rule had been in effect—if holdover assets with built-in gain were sold within 10 years of a switch to S corporation status, the company would owe tax on the built-in gain at the highest corporate tax rate, which is now 35%. The American Recovery and Reinvestment Act of 2009 shortened that 10-year holding period to seven years for 2009 and 2010. The new Small Business Jobs Act further reduces the holding period to five years for dispositions of assets with built-in gain in 2011.

With this new provision, companies that have made the C-to-S switch won’t owe corporate income tax in 2011 on the built-in gain of appreciated assets sold after five years from the conversion.

Self-employment health insurance

For several years, self-employed individuals have been able to deduct 100% of the cost of health insurance for themselves and family members. However, that deduction does not reduce the amount of self-employment income subject to self-employment (Medicare and Social Security) tax. Under the new law, self-employed individuals can deduct

health insurance premiums when calculating earned income subject to self-employment tax for tax years beginning in calendar year 2010.

Example 5: Joan Barnes is a self-employed Web designer. In 2009, she reported earned income of \$90,000. Joan paid \$8,000 in health insurance premiums in 2009, which she deducted from her gross income; nevertheless, she paid Social Security and Medicare tax on \$90,000 of earnings.

Assume that Joan had the same earned income and health insurance premiums in 2010. Again, she will deduct that \$8,000 deduction from her gross income on her tax return. For 2010, though, she will owe Medicare and Social Security tax only on \$82,000 of earned income: \$90,000 of earnings minus \$8,000 in health insurance costs.

Cell phones

The tax code considers certain types of assets to be “listed property.” The list includes items such as cars, motorcycles, cameras, and computers—in essence, assets that a business might provide to

employees but that also can provide a nonbusiness personal benefit. Employees with listed property must keep records to show business use versus personal use.

When cell phones were introduced, they were relatively expensive; employer-provided cell phones were often a perk to selected employees. Therefore, cell phones were classed as listed property. Now, of course, cell phones are priced for a mass market and may be a workplace necessity. The new law removes cell phones and similar devices from the category of listed property, effective in 2010. If an employer-provided cell phone is used primarily for business, employees won't have to report any taxable income for personal use.

Fed funding

Under the new law, the Small Business Administration (SBA) will create an online lending platform that lists all lenders offering SBA-guaranteed loans. This platform will display the interest rates each lender charges for SBA loans so that small business borrowers can compare rates.

Among other features of the Small Business Jobs Act are increased funding and lower fees for some SBA loans. The SBA also will conduct a three-year pilot program that offers grants to states with plans to increase small business exports. Beyond the SBA, federal contracting requirements are being amended to encourage bids from small companies, and federal agencies have been told to solicit bids from small businesses. ■

Did You Know?

Health insurance premiums for federal employees and retirees will increase an average of 7.3% in 2011, according to the U.S. Office of Personnel Management. In the private sector, an 8.8% average increase is projected by a Hewitt Associates survey of 325 large employers. Of those increases, 1.7 percentage points results from mandates in the new health reform law.

Source: www.workforce.com

More Flexibility in Retirement Planning

Some provisions of the Small Business Jobs Act of 2010 are not restricted to small companies or to job creation. Instead, they provide more choices for retirees and preretirees.

An annuity alternative

The new law gives individuals the option of annuitizing a portion of an annuity, an endowment, or a life insurance policy. That is, you can partially convert one of these financial instruments to a stream of income while the remainder is left alone. The annuity period must last for 10 years or more, or for the lives of one or more individuals.

Example 1: Carol Thomas, age 70, has invested \$100,000 in a deferred annuity. This is a type of investment contract that permits investment income to grow tax free until money is withdrawn. Carol's deferred annuity is now worth \$200,000.

Starting in 2011, Carol can annuitize part of her deferred annuity. She decides to use \$100,000 for an annuity that will pay her a fixed amount as long as she lives. The other \$100,000 remains in her deferred annuity, where Carol hopes for more growth. At the time Carol makes this decision, her deferred

annuity contract consisted of one-half taxable earnings (\$100,000) and one-half aftertax dollars she invested. Therefore, half of her cash flow would be tax free until Carol receives a full return of half of her investment: \$50,000.

Roth rollovers

The Small Business Jobs Act also allows rollovers from elective deferral plans to Roth-designated accounts.

- Elective deferral plans are employer sponsored retirement plans that allow employees to defer some compensation and the tax on that compensation. They

continued on page 4

include 401(k), 403(b), and 457(b) plans.

- Designated Roth accounts (DRACs) are employer sponsored plans with many of the same features as Roth IRAs. They are funded with aftertax contributions. After age 59½, and after five years, all DRAC withdrawals are tax free.

To execute a rollover, your company plan must offer DRACs to employees who participate in the retirement plan. Also, you must be entitled to take distributions from your employer's plan, which typically means that you are at least age 59½ or



have left the company, although some plans permit younger employees to take "in service" distributions.

If you qualify, you can execute a rollover immediately. Of course, you'll

owe income tax when you convert pretax money to an aftertax DRAC.

Example 2: Lynn Parker, age 60, works for ABC Corp., where she has \$80,000 in her 401(k), all from pretax contributions. Her plan permits Lynn to take distributions from her 401(k). In 2011, Lynn rolls over \$80,000 to a DRAC offered by ABC Corp. She will have to report \$80,000 of taxable income from the rollover.

Beginning January 1, 2016, Lynn can take as little or as much from her DRAC, tax free. ■

TAX CALENDAR

JANUARY 2011

January 18

Individuals. Make a payment of your estimated tax for 2010 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2010 estimated tax. However, you don't have to make this payment if you file your 2010 return and pay any tax due by January 31, 2011.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December if the monthly rule applies.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2010. Payments that are covered include (1) compensation for workers who are not considered employees, (2) dividends and other corporate distributions, (3) interest, (4) rent, (5) royalties, (6) profit-sharing distributions, (7) retirement plan distributions, (8) original issue discount, (9) prizes and awards, (10) medical and health care payments, (11) debt cancellations [treated as payment to debtor], (12) payments of Indian gaming profits to tribal members, and (13) cash payments over \$10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2010.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2010 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2010.

For all taxes, deposit any undeposited tax. If the total is less than \$2,500 and not a shortfall, you can pay it with the return. If you deposited the tax for the year in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2010. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

FEBRUARY 2011

February 15

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2010, but did not give you a new Form W-4 to continue the exemption for 2011.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2010. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2010. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is March 31.