

THE GUARDIAN

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With the midterm elections changing the Congressional landscape, it's still too early to know exactly how this will affect open tax issues for 2010 and 2011.

Specifically, when the "lame-duck" Congress returns this month, it must decide whether to "patch" the alternative minimum tax (AMT) for 2010 (increase exemption amounts, and allow personal credits to offset the AMT), as it has done in past years. It also must decide whether to retroactively extend a number of tax provisions that expired at the end of 2009. These include, for example, the research credit for businesses, the election to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes, and the additional standard deduction for State and local real property taxes.

In addition, Congress must decide whether to extend the Bush tax cuts for some or all taxpayers. These and other Bush-era tax rules expire at the end of this year. Without Congressional action, individuals will face higher tax rates on their income, including capital gains. Also, unless Congress changes the rules, the estate tax, which isn't in effect this year, will return next year with a 55% top rate.

In short, year-end planning which always involves some educated guesswork is a bigger challenge this year than in past years.

Year-End Tax Planning Checklist

I have compiled a checklist of actions that can help you save tax dollars if you act before year-end. These moves may benefit you regardless of what the lame-duck Congress does on the major tax questions of the day.

Year-End Moves for Individuals

Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Don't forget that you cannot set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids (2010 is the last year that FSAs can be used for nonprescription drugs).

Realize losses on stock while substantially preserving your investment position. For example, you can sell the original holding, then buy back the same securities at least 31 days later.

Increase your withholding if you are facing a penalty for underpayment of federal estimated tax. Doing so may reduce or eliminate the penalty.

Make energy saving improvements to your main home, such as putting in extra insulation or installing energy saving windows or buying and installing an energy efficient furnace, and qualify for a 30% tax credit. The total (aggregate) credit for energy efficient improvements to the home in 2009 and 2010 is \$1,500. Unless Congress acts, this tax break won't be around after this year. Additionally, substantial tax credits are available for installing energy generating equipment (such as solar electric panels or solar hot water heaters) to your home. This break stays on the books through 2016.

If you become eligible to make health savings account (HSA) contributions in December of this year, you can make a full year's worth of deductible HSA contributions for 2010.

Convert your traditional IRA into a Roth IRA if doing so is expected to produce better long-term tax results for you and your beneficiaries. Distributions from a Roth IRA can be tax-free, but the conversion will increase your adjusted gross income for 2010.

However, you will have the choice of when to pay the tax on the conversion. You can either (1) pay the tax on the conversion when you file your 2010 return in 2011, or (2) pay half the tax on the conversion when you file your 2011 return in 2012, and the other half when you file your 2012 return in 2013.

Purchase qualified small business stock (QSBS) before the end of this year. There is no tax on gain from the sale of such stock if it is (1) purchased after September 27, 2010 and before January 1, 2011, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of \$50 million or less, and a number of other technical requirements must be met.

Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70 1/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. A temporary tax law change waived the RMD requirement for 2009 only, but the usual withdrawal rules apply in full force for 2010. So, individuals age 70 1/2 or older generally must take the required distribution amount out of their retirement account before the end of 2010 to avoid the penalty. If you turned age 70 1/2 in 2010, you can delay the required distribution to 2011, but if you do, you will have to take a double distribution in 2011—the amount required for 2010 plus the amount required for 2011.

Make annual exclusion gifts before year-end to save gift tax (and estate tax if it is reinstated). You can give \$13,000 in 2010 or 2011 to an unlimited number of individuals free of gift tax. However, you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

Year-End Moves for Business Owners

Hire a worker who has been unemployed for at least 60 days before year-end if you are thinking of adding to payroll soon. Your business will be exempt from paying the employer's 6.2% share of the Social Security payroll tax on the formerly unemployed new-hire for the remainder of 2010. Plus, if you keep that formerly unemployed new-hire on the payroll for a continuous 52 weeks, your business will be eligible for a nonrefundable tax credit of up-to-\$1,000

after the 52-week threshold is reached. This credit will be taken on the business's 2011 tax return. In order to be eligible, the formerly unemployed new-hire's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period.

Put new business equipment and machinery in service before year-end to qualify for the 50% bonus first-year depreciation allowance. Unless Congress acts, this bonus depreciation allowance generally won't be available for property placed in service after 2010. (Certain specialized assets may, however, be placed in service in 2011.)

Make expenses qualifying for the \$500,000 business property expensing option. The maximum amount you can expense for a tax year beginning in 2010 is \$500,000 of the cost of qualifying property placed in service for that tax year. The \$500,000 amount is reduced by the amount by which the cost of qualifying property placed in service during 2010 exceeds \$2 million. Also, within the overall \$500,000 expensing limit, you can expense up to \$250,000 of qualified real property (certain qualifying leasehold improvements, restaurant property, and retail improvements). Note that at tax return time, you can choose not to use expensing (or bonus depreciation) for 2010 assets. This is something to consider if tax rates go up for 2011 and future years, and you'd rather have more deductions after 2010 than for 2010.

Set up a self-employed retirement plan if you are self-employed and haven't done so yet.

Consider using a credit card to prepay expenses that can generate deductions for this year.

Increase your basis in a partnership or S corporation if doing so will enable you to deduct a loss from it for this year. A partner's share of partnership losses is deductible only to the extent of his partnership basis as of the end of the partnership year in which the loss occurs. An S corporation shareholder can deduct his pro-rata share of an S corporation's losses only to the extent of the total of his basis in (a) his S corporation stock, and (b) debt owed to him by the S corporation.

Consider whether to defer cancellation of debt (COD) income from the reacquisition of an applicable debt instrument in 2010. The business can elect to have the COD income included in gross income ratably over five tax years beginning with the fourth tax year following the tax year in which the repurchase occurs (i.e., beginning with 2014).

Small Business Jobs Act of 2010

The recently enacted 2010 Small Business Jobs Act includes a wide-ranging assortment of tax breaks and incentives for small business, paid for with various revenue raisers. Here's a brief overview of the tax changes in the new law.

Tax breaks and incentives

Enhanced small business expensing

In order to help small businesses quickly recover the cost of certain capital expenses, small business taxpayers can elect to write off the cost of these expenses in the year of acquisition in lieu of recovering these costs over time through depreciation. Under pre-2010 Small Business Jobs Act law, taxpayers could expense up to \$250,000 of qualifying property—generally, machinery, equipment and certain software—placed in service in tax years beginning in 2010. This annual expensing limit was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service in tax years beginning in 2010 exceeded \$800,000 (the investment ceiling). Under the new law, for tax years beginning in 2010 and 2011, the \$250,000 limit is increased to \$500,000 and the investment ceiling to \$2,000,000. The new law also makes certain nonresidential real property eligible for expensing. For property placed in service in any tax year beginning in 2010 or 2011, the up-to-\$500,000 of property expensed can include up to \$250,000 of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

100% exclusion of gain from the sale of small business stock for qualifying stock

Before the 2009 Recovery Act, individuals could exclude 50% of their gain on the sale of qualified small business stock (QSBS) held for at least five years (60% for certain empowerment zone businesses). To qualify, QSBS must meet a number of conditions (e.g., it must be stock of a corporation that has gross assets that don't exceed \$50 million, and the corporation must meet active business requirements). Under the 2009 Recovery Act, the percentage exclusion for gain on QSBS sold by an individual was increased to 75% for stock acquired after Feb. 17, 2009 and before Jan. 1, 2011. Under the new law, the amount of the exclusion is temporarily increased yet again, to 100% of the gain from the sale of qualifying small business stock that is acquired in 2010 after Sept. 27, 2010 and held for more than five years. In addition, the new law eliminates the alternative minimum tax (AMT) preference item attributable for that sale.

General business credits of eligible small businesses for 2010 allowed to be carried back five years.

Generally, a business's unused general business credits can be carried back to offset taxes paid in the previous year, and the remaining amount can be carried forward for 20 years to offset future tax liabilities. Under the new law, for the first tax year of the taxpayer beginning in 2010, eligible small businesses can carry back unused general business credits for five years. Eligible small businesses consist of sole proprietorships, partnerships and non-publicly traded corporations with \$50 million or less in average annual gross receipts for the prior three years.

General business credits of eligible small businesses in 2010 aren't subject to AMT.

Under the AMT, taxpayers can generally only claim allowable general business credits against their regular tax liability, and only to the extent that their regular tax liability exceeds their AMT liability. A few credits, such as the credit for small business employee health insurance expenses, can be used to offset AMT liability. The new law allows eligible small businesses, as defined above, to use all types of general business credits to offset their AMT in tax years beginning in 2010.

S corporation holding period.

Generally, a C corporation converting to an S corporation must hold onto any appreciated assets for 10 years following its conversion or face a business-level tax imposed on the built-in gain at the highest corporate rate of 35%. This holding period is reduced where the 7th tax year in the holding period preceded the tax year beginning in 2009 or 2010. The 2010 Small Business Jobs Act temporarily shortens the holding period of assets subject to the built-in gains tax to 5 years if the 5th tax year in the holding period precedes the tax year beginning in 2011.

Extension of 50% bonus first-year depreciation.

Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008 or 2009 (2010 for certain property), by permitting the first-year write-off of 50% of the cost. The new law extends the

first-year 50% write-off to apply to qualifying property placed in service in 2010 (2011 for certain property).

Special rule for long-term contract accounting.

The new law provides that in determining the percentage of completion under the percentage of completion method of accounting, bonus depreciation is not taken into account as a cost. This prevents the bonus depreciation from having the effect of accelerating income.

Boosted deduction for start-up expenditures.

The new law allows taxpayers to deduct up to \$10,000 in trade or business start-up expenditures for 2010. The amount that a business can deduct is reduced by the amount by which startup expenditures exceed \$60,000. Previously, the limit of these deductions was capped at \$5,000, subject to a \$50,000 phase-out threshold.

Deductibility of health insurance for the purpose of calculating self-employment tax.

The new law allows business owners to deduct the cost of health insurance incurred in 2010 for themselves and their family members in calculating their 2010 self-employment tax.

Cell phones removed from listed property category.

This means that cell phones can be deducted or depreciated like other business property, without onerous recordkeeping requirements.

Offsets (revenue raisers)

Information reporting required for rental property expense payments.

For payments made after Dec. 31, 2010, the new law requires persons receiving rental income from real property to file information returns with IRS and service providers reporting payments of \$600 or more during the tax year for rental property expenses. Exceptions are provided for individuals renting their principal residences on a temporary basis (including active members of the military), taxpayers whose rental income doesn't exceed an IRS-determined minimal amount, and those for whom the reporting requirement would create a hardship (under IRS regs).

H.I.R.E. Act of 2010

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.

A qualified employee is an individual who does not own over 50% of the employer and is not a family member of any 50% owner but the spouse is not considered a family member.

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.

Health Reform for Small Businesses

For owners of small businesses and their workers, the recently enacted health reform legislation has some key provisions to pay attention to. The new law provides small employers with a tax credit 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 not more 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.

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, two percent shareholders of an S corporation, and five percent owners of the employer are not treated as employees for purposes of this credit. 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.

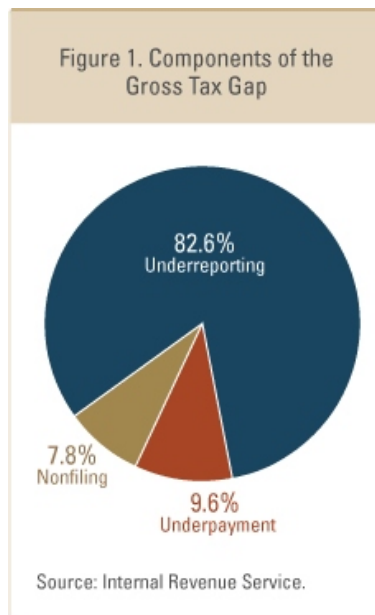
Although the new law imposes penalties on certain businesses for not providing coverage to their employees (so-called "pay or play"), most businesses won't have to worry about this provision because employers with fewer than 50 employees aren't subject to the "pay or play" penalty. For businesses with 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 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.

Tax Increase to Pay for it. To help offset the cost of providing health insurance to millions of Americans, the new law imposes an additional 0.9% Medicare tax on wages above \$200,000 for individuals and \$250,000 for married couples filing jointly. In addition, for these higher-income households, the new law adds a 3.8% tax on unearned income, including interest, dividends, capital gains and other investment income. 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 the deductions that are allocable to that income.

IRS TIDBITS

The Growing Tax Gap

The tax gap is the difference between taxes owed and taxes paid. The Internal Revenue Service estimates that over the past thirty years the tax gap has ranged from 16 to 20 percent of total tax liability. For 2001 the IRS estimates the gross tax gap at \$345 billion, or slightly over 16 percent of tax liability, of which \$55 billion will eventually be recovered through voluntary late payments and enforcement activities, leaving a net tax gap of about \$290 billion. Some view the tax gap as a major revenue source that can be used to close the federal budget deficit or to pay for reform of the alternative minimum tax, without raising taxes. In fact, the potential revenue gains from proposals to improve enforcement are quite limited.



IRS goes too far

The Service is starting to request and accept electronic tax records on audit. Those who use QuickBooks or Peachtree software can give agents a DVD, CD-ROM or flash drive. Taxpayers needn't print or sort documents stored electronically saving time and effort in preparing for audits. However, be careful what you hand over. Turning in all your records makes it easier for IRS to expand the scope of the exam.

Be Afraid

IRS is planning another round of compliance checks focusing on preparer outreach and education. The visits in 2011 will focus on compliance and will be targeted primarily at preparers who IRS suspects have made mistakes. Agents won't hesitate to assess penalties against preparers who have bent the rules.

Important Foreign Bank Reporting

Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts must be filed by June 30 each year to report any direct or indirect financial interest in, or signature authority of financial accounts with a financial institution in a foreign country with an aggregate value of all accounts exceeding \$10,000 at any time during the year. Willful failure to file may result in a penalty of the greater of \$100,000 or 50% of the highest annual amount of foreign account balance. Non-willful violations result in a penalty of \$10,000 per account.

Also, IRS is eyeing more foreign banks to sniff out offshore tax evasion like HSBC Bank. Of course, the IRS won't be able to uncover every tax cheat but the Service will clearly keep the heat on folks who don't report foreign accounts.

No More Coupons

Proposed regulations issued on August 19, 2010 would eliminate using paper coupons to make federal tax deposits. Do you drop off your federal tax payments at your bank? If so, you should know that the Internal Revenue Service (IRS) recently announced a new rule that calls for most businesses that now pay their federal taxes with a paper Federal Tax Deposit coupon (IRS Form 8109) to pay electronically as of January 1, 2011. Additionally, banks will no longer be able to accept tax payments. You will need to arrange for an alternative payment method for your federal taxes as of January 1, 2011. One option is for the IRS to pull the funds directly from your account using the Electronic Federal Tax Payment Service (EFTPS).

Mandatory E-file

The preparer e-filing mandate was part of the Worker, Homeownership, and Business Assistance Act of 2009 (PL 111-92). Effective for returns filed after Dec. 31, 2010, any return preparer who files or expects to file more than 100 individual income tax returns in a calendar year must e-file those returns. The IRS should also allow taxpayers to opt out of having their Form 1040 returns e-filed.

If you found this newsletter useful, share it with a friend. I am accepting new clients. Your referrals are greatly appreciated.