

TAX RELIEF IN 2011

On December 17, 2010, the President signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act), which has several provisions that are important to you in 2010, 2011, and 2012. This newsletter will cover the more important parts of this Act. In addition, it will cover multiple provisions from the Small Business Jobs Act, which was signed into law on September 27, 2010. We have also included other information that you may find useful.

One of the biggest short-term effects of the new Act is that most individual taxpayers will likely have to wait to file their income tax returns until mid- to late February due to changes in IRS forms and processing.

INCOME TAX RATES

The individual income tax rates which were expected to change at the end of 2010 have been extended through 2012.

The Act also extends the current capital gains rates at 0% for taxpayers in the 10% and 15% brackets and 15% for taxpayers in the 25% bracket and above, through 2012. Without the legislation, the capital gains rates were scheduled to expire at the end of 2010, and revert to 10% and 20%, respectively.

The provision for dividends taxed at capital gains rates has been extended through 2012 as well. Without the legislation, the provision would have expired, and dividends would be taxable as ordinary income.

The expanded 15% tax bracket for married couples put into place by EGTRRA in 2001 has been extended through 2012.

PAYROLL TAXES

For 2011 only, the Act reduces the Social Security (OASDI) tax rate on employees to 4.2% (from 6.2%)

and reduces the self-employment tax (SECA) rate to 10.4% (from 12.4%). However, the Act does not reduce the OASDI contribution base, which is \$106,800 for 2011. Thus, the maximum OASDI tax in 2011 for employees is \$4,485.60. In addition, the rate reduction is not taken into account in determining the SECA tax deduction allowed for determining net earnings from self-employment. As a result, the deduction for 2011 remains 7.65% of self-employment income (determined without regard to the deduction).

AMT PROVISIONS

For married individuals filing a joint return, the AMT exemption has been increased to \$72,450 for tax years beginning in 2010, and \$74,450 for tax years beginning in 2011. For an unmarried individual who is not a surviving spouse, the exemption amount is \$47,450 for tax years beginning in 2010, and \$48,450 for tax years beginning in 2011. For married taxpayers filing separate returns, the exemption amount is equal to one half of the married filing joint amount. The Act also allows personal credits and nonrefundable credits to offset AMT through 2011.

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DEDUCTIONS AND CREDITS

Standard Deduction.

In 2001, EGTRRA raised the standard deduction amount for married couples filing a joint return. The Act extends this provision through 2012; otherwise, the provision would have expired at the end of 2010.

Personal Exemption & Itemized Deduction Phaseouts.

The Act extends the repeal of the phaseouts on personal exemptions and itemized deductions through 2012.

The following deductions and credits will be allowed through 2011 (partial list):

- **Deduction for certain expenses of elementary and secondary school teachers;**
- **Deduction for state and local taxes;**
- **Deduction for mortgage insurance premiums;**
- **Deduction for qualified tuition and related expenses;**
- **Deduction for contributions of capital gain real property for conservation purposes;**
- **Deduction for student loan interest; (through 2012)**
- **Alternative fuel vehicle refueling property credit.**

Credit for non-business energy property. The credit for non-business energy property has been extended to include property placed in service on or before December 31, 2011, but with the credit structure and rates that existed before the 2009 American Recovery and Reinvestment Act. Thus, for property installed after December 31, 2010, the credit is 10%, with a maximum of \$500, with \$200 of that for windows. The new Act prohibits taxpayers from taking the credit for expenditures for qualified energy efficiency improvements made from subsidized energy financing.

The following credits have been extended through 2012 (partial list):

- **Child Tax Credit.**
- **Adoption Credit** (will be a lower, nonrefundable amount in 2012).
- **Dependent Care Credit.**
- **Earned Income Credit.**
- **American Opportunity Tax Credit.**

QUALIFIED SMALL BUSINESS STOCK

The law allows a 100% exclusion of the gain on the sale of small business stock purchased between September 27, 2010 and December 31, 2011 and held for more than five years. Under current provisions, it is not an alternative minimum tax item. This provision contains many conditions that must be met to qualify for exclusion.

The 2009 Recovery Act allows a 75% exclusion from 2-17-2009 to 9-27-2010.

An earlier bill allows a 50% exclusion from 8-10-1993 to 2-17-09.

Prior to 8-10-1993, there was a similar bill, but an earlier Congress repealed it, leaving those who purchased stock or started businesses prior to 8-10-1993 with a broken promise.

OTHER INDIVIDUAL PROVISIONS OF THE NEW ACT

Through 2011, the Act allows taxpayers age 70 ½ or older to make tax-free distributions to charities from their traditional IRAs and Roth IRAs up to \$100,000 per taxpayer per taxable year. The Act also permits individuals to make charitable transfers during January 2011 as if they were made during 2010.

The current provisions for Coverdell Education Savings Accounts have been extended through 2012.



life insurance proceeds are tax-exempt. Unfortunately, it is not that simple. If your business owns EOLI policies issued or changed *after* August 17, 2006, you are required to follow specific Notification and Consent requirements as well as file IRS Form 8925 with your tax return in order for the life insurance proceeds to be non-taxable.

In order to comply with the Notification and Consent requirements, *before* an employer owned life insurance contract is issued, the employee must:

- **Be notified in writing that the employer intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued.**
- **Provide written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and be informed in writing that the employer (or related party) will be a beneficiary of any proceeds payable upon the death of the employee.**

In addition, the employer must file Form 8925 with his or her tax return which includes the following information:

- **The total number of employees employed at the end of the tax year.**
- **The total number of employees insured under the employer's EOLI contracts issued after 8-17-06.**
- **The total amount of employer owned life insurance at the end of the year under the contracts.**
- **Whether the employer has valid consents for each employee covered by the insurance policies.**
- **The number of employees who has not given valid consent for the insurance policies.**

We recognize that these requirements may come as a surprise. Be sure to notify us about any life insurance contracts that require disclosure. Please contact us with any questions.

EXPIRING PROVISIONS

- **Standard deduction for real property taxes for non-itemizing taxpayers.**
- **Deduction for personal casualty losses in federally declared disasters.**
- **Carryback of net operating losses attributable to federally declared disasters.**
- **Making Work Pay tax credit.**

FUTURE PLANS

During the depths of the markets, our advice was to stay invested and stay diversified. To businesses, we advised to buy equipment that was needed, and not to cut where you brought on a self-inflicted recession on your business.

The markets have recovered some of their losses. The S & P was nearly 1600 at its high, retreated to 667 and today stands around 1260. We too are hopeful that we can look forward to better business conditions.

We believe the improvement will come slowly. Lenders now have less tolerance for risk. Consumers are more conservative. Governments at all levels can be expected to spend less due to fiscal constraints. If all this is true, business will receive new orders, but at levels less than in March 2007. With this, employment will remain stressed for some period.

So, *for individual investors*—set a percent of your assets into categories—stocks, bonds, CDs, money market instruments, real estate, natural resources, and gold. Rebalance periodically. If you need help, schedule an appointment.

For businesses—keep your costs at a level where you can be profitable at today's volumes. Buy new plants and equipment cautiously. Don't bid break-even jobs to maintain volume. Continue to follow good business practices for your core business. Continue to experiment, but with small amounts of capital. Make certain to protect what got you here—highest quality, best service, etc.





of any foreign financial accounts, and in addition to TD F 90-22.1 required by Treasury to disclose foreign accounts over \$10,000. The Sec 6038D requirements are broader. They require disclosure of investments in foreign securities, foreign hedge funds and private equity firms. It would also require the reporting of any foreign real estate owned. Nonresidents and bona fide residents are exempt from these disclosures. At this point, we believe that holding ADRs of a foreign stock or a traditional international mutual fund is exempt from reporting. Section 6038D is effective for tax years beginning *after* March 18, 2010. Most individual taxpayers will be subject to these requirements beginning in tax year 2011.

Penalties for non-compliance are severe. If you have assets which may be subject to reporting, make certain to bring it to our attention.

INDEPENDENT CONTRACTORS

We expect this area to get even more scrutiny. The Government Accountability Office estimated that 10 million workers are classified as independent and that as many as 20% are mis-classified. Other studies show that the government(s) get much more revenue from W-2 reporting than from 1099 reporting. With governments at all levels scrambling for money, we expect this issue to gain importance.

We encourage you to look at your practices from a risk standpoint. If you have one person at risk, that may be a small concern. If you have 20 persons at risk of being re-classified, that is a much bigger concern. Losing a case going back 2-3 years could cause a financial hardship to many businesses. The facts are so important to winning these cases. If you use 1099 type labor, review your practices at least once a year. We stand ready to help.

STANDARD MILEAGE RATES

The 2011 standard mileage rate is 51 cents per mile for business use of an automobile. The depreciation component of the business use rate is 22 cents. The rate is 14 cents per mile for use of an automobile to serve a charitable organization and 19 cents per mile for medical reasons and moving.

IRS AUDITS

Kiplinger reported in their August 6, 2010 issue that IRS no-change audits decreased from 13% to 10%. This means that 90% of those who were audited had changes made.

We find this to be a sobering development. For all of our history, we have taken pride in taking our clients through audit fighting hard for a no-change result. This starts with responsible preparation of tax returns, and then putting forth a professional defense for positions taken.

IRS auditors may be responding to pressure to adjust returns. A complex, ever-changing law makes it easy for any two persons to disagree.

Auditors conduct their audits according to a plan that is aimed at looking for income not reported or erroneous deductions claimed. As a result, most changes found by auditors result in increased tax owed by the taxpayer.

LOAN COVENANTS

Please read the fine print. Too often, clients sign new or renewal loan agreements routinely, just happy to have the loan. The agreements should be carefully read because lenders sometimes put in provisions that tie you to that bank, that allow them to offset other accounts at that bank, and that allow them to call the loan if certain capital ratios are not met. Each of these needs to be understood and considered.

Generally, when you are granted a loan, you could have received the loan anywhere. And generally, if you have a loan called, you can't borrow anywhere.

Accordingly, it makes sense to negotiate favorable terms when you are borrowing or renewing. This is the only time you are in a favorable negotiating position, and the only time you have choices.

EMPLOYER OWNED LIFE INSURANCE (EOLI) CONTRACTS

In the business world, it is common knowledge that



The current provisions for employer-provided educational assistance have been extended through 2012.

CODE SEC 179 EXPENSING

For assets purchased in 2010 and 2011, the expensing limit is raised to \$500,000 as long as the taxpayer does not purchase more than \$2,000,000 in qualifying assets in any one of these years.

Under the new law, for 2012, such amount is lowered to \$125,000, with a phase out threshold of \$500,000 (both figures to be adjusted for inflation). A \$25,000 maximum and \$200,000 phase out threshold will apply for tax years beginning after 2012 and will not be adjusted for inflation.

BONUS DEPRECIATION

For assets purchased in 2010 - 2012, the law will allow 50% of the cost of a qualifying asset to be deducted as bonus depreciation. The new tax bill signed by the President allows 100% of the cost of qualifying assets to be deducted as bonus depreciation for assets acquired and placed in service after September 8, 2010 and before January 1, 2012 (and during 2012 for some property).

The new Act also extends the provision allowing corporate taxpayers to elect to accelerate the AMT and research credits in lieu of bonus depreciation to the 2011 and 2012 taxable years.

This provision, along with Code Sec 179 expensing gives great flexibility to businesses in the reporting of taxable income. However, the acceleration on an expense means there is less to deduct in future years. At some point, we will be experiencing higher tax rates.

15-YEAR STRAIGHT-LINE DEPRECIATION FOR CERTAIN QUALIFIED IMPROVEMENTS

The new Act extends, from December 31, 2009, the special 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements to qualified property placed in service before 2012.

BUSINESS TAX CREDITS AND DEDUCTIONS

The following business tax credits have been extended through 2011 (partial list):

- **Credit for biodiesel and renewable diesel fuel** (for producers).
- **New energy-efficient home credit** (claimed by builder).
- **Excise tax credits for alternative fuels.**
- **Energy efficient appliance credit** (with some modifications) (for manufacturers).
- **Research credit.**
- **Railroad track maintenance credit.**
- **Employer wage credit for employees who are active duty members of the uniformed services.**
- **Work opportunity credit** (with some modifications).

The following business deductions have been extended through 2011 (partial list):

- **Charitable deduction for contributions of food inventory.**
- **Charitable deduction for contributions of book inventories to public schools.**

SMALL BUSINESS HEALTH CARE TAX CREDIT

Beginning in 2010, certain small business employers may be allowed a tax credit if they provide health insurance for their employees. The following requirements must be met to be eligible:

- **Employ less than 25 full-time equivalent (FTE) employees.**
- **The average annual earnings of those employees is less than \$50,000.**
- **The insurance is provided under a "qualifying arrangement"--- usually one in which the employer pays a minimum of half the premiums.**

The number of FTEs can be calculated by dividing the





total hours of service (including vacation, holiday, sick pay, etc.) for all qualifying employees by 2,080. If there is a difference, round down. Do not include seasonal employees in this total. The credit is decreased for employers with more than 10 FTEs or average annual wages over \$25,000. The credit is equal to 35% of an employer's premium expenses (25% for tax-exempt employers). Call us for an input form if you think you may qualify.

OTHER BUSINESS PROVISIONS OF THE NEW ACT

Section 1367(a)(2) provides that an S-corporation shareholder's 1367(a)(2)(B) basis reduction resulting from the corporation's charitable contribution of property equaled the shareholder's pro rata share of the adjusted basis of the contributed property. The Act extends this special rule from December 31, 2009, to contributions made on or before December 31, 2011.

The Act extends the temporary suspension of the taxable income limit on percentage depletion for oil and gas from marginal wells to depletion determined for taxable years beginning before January 1, 2012.

ESTATE TAX

When Congress passed EGTRRA in 2001, the original bill allowed for a repeal of the estate tax in 2010. In addition, it required inherited assets to take a modified carryover basis in 2010. Under EGTRRA, estate tax rates were scheduled to return to the pre-EGTRRA rates with a maximum 55% rate and an estate tax exemption of \$1 million in 2011.

The Act brings back the estate tax at a maximum rate of 35% for 2011 and 2012 with an estate tax exemption of \$5 million. The Act also brings back stepped-up basis for inherited assets from decedents dying after December 31, 2010.

The new law allows the estates of decedents dying in 2010 to elect one of the following options:

- **Be subject to the estate tax with maximum rate of 35% and use a stepped-up basis for inherited assets *or***

- **Not be subject to the estate tax and use a modified carryover basis* for inherited assets.**

This election can only be made by the decedent's estate, not the beneficiaries. It appears that no income limits exist for this election; however, more clarification is needed from the IRS. Due to this election, the IRS has extended the deadline for filing estate returns of decedents dying in 2010 to nine months following the date the law was enacted.

*Section 1022 allows an increase in basis for eligible property up to \$1.3 million. In addition, the property's basis may be increased by the decedent's unused capital loss carryovers, net operating loss carryovers, and some unrealized losses on the property. No piece of property may be increased above its FMV at the date of death. Sec. 1022 also allows for an extra increase of up to \$3 million to the basis of eligible property transferred to a surviving spouse. For other inherited property (not receiving an increase in basis), the recipient must use the lesser of the decedent's adjusted basis on the date of death or the fair market value of the property on the date of death.

The Act also allows for "portability" in the estate tax exclusion. For decedents who die *after* December 31, 2010, any unused estate tax exemption passes to the surviving spouse provided that an election is made on the decedent's estate tax return that the unused amount may be passed on to the surviving spouse. This election is irrevocable.

GIFT TAX AND GENERATION-SKIPPING TRANSFER TAX

Gift tax returns are required when gifts from one person to another person (other than spouse) exceeds \$13,000. EGTRRA set the gift tax at 35% with a maximum exclusion of \$1 million for gifts in 2010.

The new Act made the gift tax the same as the estate tax for 2011 and 2012, with a maximum 35% rate and a maximum exclusion of \$5 million.



The unified credit against gift tax was also reinstated by the Act for gifts made after 2010.

The generation-skipping transfer tax was set at 35% with a maximum exclusion of \$5 million for 2011 and 2012. Any unused portion of the GST is not transferrable to a surviving spouse. There is no generation-skipping transfer tax for 2010.

START-UP EXPENSES

Those who incur start-up expenses in 2010 of less than \$60,000 will be able to deduct up to \$10,000 of those expenses. In general, start-up expenses are those incurred to create a business, to investigate the creation of a business, or to acquire a business.

SELF-EMPLOYMENT INCOME

The costs of health insurance are now an allowable deduction in computing the self-employment tax. This provision applies to the 2010 tax year only.

For some years, self-employed individuals have been able to deduct health insurance as an "above the line" deduction, for income tax purposes, but no deduction was allowed for the self-employment tax.

CONVERSIONS TO A ROTH IRA

Starting in 2010, individuals with any amount of modified Adjusted Gross Income are free to convert a traditional IRA to a Roth IRA. Conversions are fully taxable at your regular tax rate. For conversions in 2010, taxpayers can spread the tax due over two years. Half the tax will be due in 2011, and the remaining half will be payable in 2012. Removing the limit on conversions effectively eliminates the income limit on contributions to Roth IRAs. A taxpayer with income too high to use a Roth will be able to contribute to a traditional IRA (which does not have income limits for contributions) and immediately convert to a Roth.

ROLLOVERS TO A ROTH IRA ACCOUNT

Beginning in 2011, state and local governments will be allowed to offer a Roth plan to their employees.

Such employees will also be allowed to rollover 401(k), 403(b) and 457(b) plans to a designated Roth account within their plans. For 401(k) and 403(b) plans, this is effective for distributions after 9-27-2010. This may be effective for 457(b) plans in 2011. A rollover in 2010 is to be 50% taxable in 2011 and 50% taxable in 2012.

We continue to be wary of Roth IRAs because their advantage presumes that tax laws will remain constant. Past practice shows us that the tax laws are less and less constant. Some are so disenchanted that they would propose a fair tax or other substitution for the income tax. All these are important considerations in making your decisions regarding Roth IRAs.

FORMS 1099

In general, individuals receiving rental income are now required to issue 1099s to service providers when amounts aggregate to more than \$600 in a year.

- **This provision applies to payments made starting January 1, 2011.**

We believe that service providers include carpenters, plumbers, electricians, accountants, lawyers, lawn services, painters, roofers, rental management companies, carpet layers, carpet cleaners, and appliance repairmen. This definition also appears to include payments for salaries and wages.

- **The exclusion of payments to Corporations appears to not apply.**

Penalties for failure to file 1099s will increase from \$50 to \$100 per each failure starting on January 1, 2011. If the failure to file is intentional, the penalty is \$250 per information return.

FOREIGN ACCOUNT DISCLOSURES

U.S. Taxpayers with foreign accounts have two different laws to comply with.

Sec 6038D of the Internal Revenue Code requires disclosure in the income tax return if the sum of foreign accounts and assets exceeds \$50,000. This is in addition to the box on Schedule B which asks if you had control

