TAX NEWS

Fall 2010

TAX CLIENT NEWSLETTER

With the end of the year approaching, it is time for you to begin thinking about the next tax filing season. A small business bill passed by Congress just a few weeks ago presents several opportunities for reducing your 2010 tax liability. The Act creates a $30 billion small business lending fund and provides $12 billion in tax breaks to help small businesses. The tax benefits are for investing in depreciable business property, but you must act fast. Most of these tax breaks only apply to purchases made this year. The Small Business Jobs Act is described below along with tips to help you take advantage of its provisions.

Also included in this letter on page 4 is a table showing key before-and-after figures for the expiring Bush tax cuts. As I am sure you have seen in the news, President George W. Bush's 10-year tax cut plan expires at the end of 2010. If Congress does not extend the lower tax rates, we all will be facing an automatic tax increase. We in the tax preparation business expect that Congress will convene for a lame-duck session after the November elections to address the expiring tax rates. If Congress fails to act before the end of the year, you can expect your withholding taxes to go up come January.

Finally, on page 4 I recommend some ways you can implement a tax recordkeeping system. Maintaining good records now can make the filing process a lot easier and less expensive.

SMALL BUSINESS TAX RELIEF BILL BECOMES LAW

In late September, President Obama signed into law Public Law 111-240, the "Small Business Lending Funding Act" (H.R. 5297). The Act contains a tax title, the "Small Business Jobs Act of 2010" which makes significant changes targeted at boosting the economic position of small businesses across the U.S. Many provisions are simply an extension of tax breaks already in place, such as generous depreciation deductions for investment in business property. A new provision dramatically increases the depreciation deduction for business vehicles. The bill also reduces the paperwork burden for business use of cell phones and makes changes to rules for Roth IRAs.

To raise revenue to pay for the tax breaks, the Act imposes a new reporting requirement on landlords who are not primarily in the rental business. They now must report expense payments they make in connection with renting property if the payments exceed $600 per year to any one person. A summary of the tax bill, along with planning ideas, appear below.

Summary of Tax Provisions

Here is a summary of the major tax provisions included in the new Act. Many of the changes can reduce your tax burden for 2010, especially if you invest in business property before the end of the year. If you have not purchased business property this year, you should consider buying that new computer or truck before January 1st.

Expensing Deductions

Under the expensing rules, a taxpayer can take an up-front deduction for the cost of property placed in service during the year. Under normal depreciation rules, business property deductions must be taken over a set number of years, which represent the useful life of an asset. The new law increases the immediate expensing deduction from $250,000 to $500,000 per year for property placed in service in 2010 and 2011. The deduction applies to new property as well as used property.

Because this bill is targeted to help small businesses, it imposes a limit on how much you can spend on business property before you begin to lose the benefit of the expensing deduction. The Act also increases this limit, allowing you to spend more each year and still get the generous deduction. Under the new law, businesses may purchase $2,000,000 in the aggregate of all business property each year before the $500,000 deduction begins to phase out, dollar-for-dollar, for purchases exceeding $2,000,000.

Example: If you buy depreciable business property totaling $1,000,000 in 2010, you will get to write off $500,000 of it. If you spend $2,200,000 on all qualified business property in 2010, you only will get a $300,000 expensing deduction. When you reach $2,000,000, your $500,000 deduction is reduced dollar-for-dollar by the amount your purchases exceed $2,000,000.

Real Property and Software. The Act also allows expensing of up to $250,000 of the cost of improvements to leased, nonresidential property, to restaurant property and to retail property. Finally, the bill extends the expensing option for investments in off-the-shelf computer software. Off-the-shelf software is any software product that is developed for the general market and is delivered in an identical format, such as Microsoft Windows. (Other intangible property, such as custom software developed for one business, does not qualify for an immediate expensing deduction and must instead be deducted over a longer period of time.)

Income Limitations: The expensing deduction is not refundable. That means that if you do not have enough yearly income to offset the deduction, you cannot use the full deduction in that year. In other words, the expensing deduction cannot exceed the total taxable income from all of your businesses. Even if you cannot use the full deduction this year, you will be able to carry it forward and use it to offset your future business income.

Note: These changes are in effect through 2011, when the higher expensing limits and phase-out threshold revert to significantly lower amounts. After 2011, the expensing deduction drops to

$25,000 and the purchase limits drops to $250,000. If you buy equipment or machinery this year and place it in service before January 1, 2011, you will get the entire expensing deduction on your 2010 tax return. If you wait until after the beginning of the year, you will get the higher expensing deduction, but not until you file your 2011 tax return.

Bonus Depreciation

The bonus depreciation rules allow you to immediately write off 50 percent of the cost of new equipment instead of taking the depreciation deductions over time. This write-off is in addition to the expensing deductions described above. The bonus depreciation rules were first allowed for property placed in service in 2008 and have been extended each year. The new Small Business Act extends the 50% bonus depreciation deduction through 2010 for most business property and through 2011 for long-production-period property and long-lived property, such as aircraft. (Long production period property is business property that takes over a year to manufacture.)

Increased Depreciation Deduction for Cars and Trucks

Under current law, automobiles and trucks under certain weight limits are subject to a cap on first-year depreciation of $3,060 for passenger automobiles and $3,160 for light trucks or vans. The Act increases those limits by $8,000 for each vehicle placed in service before 2011. This is a **significant** increase, but it is only available for cars and trucks purchased this year. So, act fast if you need to increase your fleet of business vehicles to take advantage of this generous write-off.

Five-Year Carryback of Small Business Credits

The new legislation allows small businesses to carry back general business tax credits for 2010 to offset their tax burdens from the previous five years. This means that if you had income in the previous five years and you cannot use a business tax credit this year because you have no profit, you can apply this year's tax credit to reduce income you earned in the previous five years. You do this by filing an amended return for the earlier years and getting a refund. Small businesses also will be able to count the general business credits against the Alternative Minimum Tax (AMT). Under previous law, your ability to use business credits was restricted if you were subject to the AMT.

The provision is targeted to small businesses that are: (1) sole proprietorships, partnerships or private corporations, and (2) have average annual gross receipts for the preceding three years of no more than $50 million. **Observation:** It is interesting that Congress considers small businesses to be companies that average less than $50 million per year.

Cell Phone Recordkeeping Rules Eased

This change is possibly the most significant relief provision for small businesses because it ends the burdensome record keeping previously required for business use of a cell phone. Retroactive to the beginning of 2010, the new Act relaxes the requirement that businesses account separately for every use of a cell phone that is used by employees for both business and personal purposes. The new law allows businesses to exclude the value of employer-provided cell phones from employee wages without the employee having to maintain logs of their business and personal use of cell phones. Before this provision became law, cell phones were considered "listed property," which meant that the employer had to document with detailed records whether each use of a cell phone was for business purposes or personal purposes. The new law does away with this type of detailed record keeping. As with other business property, taxpayers must still be able to substantiate their cost.

The rules apply to personal digital assistants (PDAs) with mobile communication features and smart phones as well. The Act also makes it easier for an employee's personal cell phone use to qualify as a nontaxable fringe benefit. Congress gave the IRS authority to determine how much personal cell phone use by an employee may be excluded, so I will be watching as this issue develops to see what the IRS decides.

Deductible Health Insurance for the Self-Employed

Under current law, business owners are not permitted to deduct the cost of health insurance for themselves and their family members for purposes of calculating self-employment tax. The new Act allows business owners to deduct the cost of health insurance paid in 2010 for themselves and their family members in the calculation of their 2010 self-employment tax. Note that this provision is strictly time-limited and only will help with your 2010 tax liability. **Important:** If you are in business for yourself and you have paid health insurance premiums this year for yourself and your family, please let me know so you can offset your self-employment taxes with the cost of your health insurance premiums.

Increased Deduction for Business Start-up Costs

Under current law, taxpayers may deduct up to $5,000 in trade or business start-up expenditures. The deduction is reduced if the amount of start-up expenditures exceeds $50,000. Start-up expenditures are defined as expenses paid to investigate or create a trade or business. Under the new Act, for 2010 only, the amount of deductible start-up expenses increases to $10,000. The Act also raises to $60,000 the amount a taxpayer may spend before the deduction starts phasing out. For example, if a taxpayer spends $65,000 for starting a business, the $10,000 deduction would be reduced by $5,000—the amount of start-up expenses that exceed $60,000.

Note: This is a time-limited provision. If you are interested in starting a business, act quickly to spend any investigation or start-up fees this year to get the maximum benefit from this deduction.

Gain Exclusion for Sale of Small Business Stock

The Act permits investors to exclude 100% of the gain from the sale of small business stock from their income if the stock is held for more than five years. A qualified small business is an active, domestic C Corporation with aggregate gross assets which do not exceed $50,000,000. Prior law limited the exclusion to 75% of gain. The new Act also excludes small business stock gain from the Alternative Minimum Tax (AMT). The effective date applies in this way: no regular tax or AMT is imposed on the sale of small business stock which is acquired after September 27, 2010 and before January 1, 2011 and is held for more than five years. This provision is designed to encourage investors to purchase small business stock right now—by the end of this year. Since the exclusion is tied to the acquisition date, if you have funds to invest, you should consider investing in

a business that qualifies for this generous capital gains exclusion.

S Corporation Built-in Gains

S Corporations generally are not subject to a corporate-level tax. Instead, income is passed through to the shareholders and reported on the shareholders' individual tax returns. However, when a C Corporation elects S Corporation status, "built-in gains" are subject to a 35% tax. Built-in gains are gains from the sale of appreciated assets that were originally held by a C Corporation before it became an S Corporation. A corporate-level tax is imposed on appreciated assets which are sold within a certain time after the conversion to S Corporation status. The 2010 Small Business Act limits this time period for taxing appreciated assets, so that if the S Corporation holds onto the assets for the required amount of time, it may not be subject to a corporate tax on the gain when the assets are sold.

Tax Shelter Penalties for Small Business

Congress enacted stiff tax shelter penalties in 2004 in an attempt to curb these perceived tax abuses. However, the penalties have had the unintended effect of catching small businesses that unwittingly invest in so-called "reportable transactions"—those transactions considered suspect by the IRS. In Summer 2009, members of the Congressional tax committees asked the IRS to suspend efforts to collect these penalties in cases where the annual tax benefits resulting from the transactions are less than $100,000 for individuals and $200,000 for business entities.

Congress now has voted to change the penalty structure to lower the maximum penalties, impose a minimum penalty and tie the penalty amount to the amount of tax benefits received from the transaction. Thus, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction, with maximum penalties ranging from $10,000 to $200,000 depending on the type of transaction and the type of taxpayer. The minimum penalties for failure to disclose a reportable transaction on the tax return are $10,000 for business entities and $5,000 for individuals.

Note: These changes are retroactive and apply to penalties assessed after 2006. If you have already paid a tax shelter penalty, you may file a claim for a refund. As your tax professional, I will be glad to evaluate whether or not you are entitled to a refund of any tax shelter penalties you may have paid in the last few years.

Revenue Raisers

Rental Expense Reporting

One provision in the new law that has been roundly criticized is the requirement that persons who are not in the rental business but who rent a limited amount of property must now report payments made to maintain the rental property. Beginning in 2011, any person receiving rental income must file information returns with the IRS identifying any expenses paid on the rental property to any one person in excess of $600 per year. For example, if a property owner hires a plumber or electrician to work on a rental property, payments made to the worker must be reported if they are in excess of $600 per year. If $300 were paid to a plumber and $300 to an electrician, the payments would not be reportable. Previously, rental expenses did not have to be reported if a taxpayer was not considered to be in the rental business.

The new law provides an exception for persons who rent their principal residence on a temporary basis, including active members of the military. The Act also directs the IRS to exempt from the reporting requirement individuals who receive a minimal amount of income in a year. Congress did not define what is a "minimal amount." Instead, Congress directs the IRS to determine by regulation exactly what constitutes a minimal amount of rental income exempt from the reporting requirements.

Increased Penalties for Failure to File Information Returns

Another revenue raiser in the Act increases penalties for failure to file information returns, such as any type of Form 1099, on time. The penalties are imposed per return, with maximum amounts per calendar year. The penalties may be reduced if you file the returns soon after the due date. These penalties are adjusted for inflation

The new law also increases the penalties for failure to furnish information returns to payees, such as those receiving dividends, royalties or interest. The penalties are imposed per return, with maximum amounts per calendar year. The penalties may be reduced if you file the returns soon after the due date.

Finally, the Act increases penalties for intentional disregard of the information return rules and provides that penalties will be indexed for inflation every five years, with the first adjustment to take place after 2012.

Small Business Exception: The Act provides a notable exception from increased penalties for small businesses that have annual gross receipts of $5 million or less for the preceding three tax years. The maximum penalty for failures corrected within 30 days is $75,000 rather than $250,000. For failures corrected after 30 days but before August 1st, the maximum penalty is $200,000 rather than $500,000. For information returns filed after August 1st, the maximum penalty is $500,000, rather than $1,500,000.

Retirement Plan Changes

Roth Contributions Allowed for Governmental Plans

Beginning in 2011, the Act allows retirement savings plans sponsored by state and local governments (457 Plans) to include Roth accounts, which are currently available only in 401(k) and 403(b) plans. Contributions to Roth accounts are made on an after-tax basis, and distributions of both principal and earnings are generally tax-free.

Allow Direct Rollovers into Roth Accounts

The Act allows 401(k), 403(b), and governmental 457(b) plans to permit participants to roll their pre-tax account balances directly into a Roth account. The amount of the rollover is includible in taxable income unless the plan account was funded with after-tax dollars. If the rollover is made in 2010, the participant can elect to pay the tax in 2011 and 2012.

CONGRESS, FACES TOUGH LAMEDUCK AGENDA IN DECEMBER, FATE OF BUSH TAX CUTS UNCLEAR

Congress recessed in October with Senators and Representatives going home to do some early campaigning for this year's elections. After the elections, the legislators face a tough agenda which includes

fashioning a workable compromise on the Bush tax cuts, including the estate tax repeal. With all of the political posturing in Washington on the extension of the Bush tax cuts, a consensus seems to be forming to temporarily extend the lower tax rates for all taxpayers, including upper-income taxpayers. House Minority Leader John A. Boehner, R-Ohio, has charged that the Democrats will hurt small businesses and further stymie economic recovery unless the Bush tax cuts are extended for all taxpayers. Most Democrats and the Obama Administration instead have advocated extending the cuts only for single taxpayers making less than $200,000 in income or married taxpayers with incomes under $250,000. Similarly, the Republicans have advocated repeal of the estate tax while the Obama Administration wants to leave it at the 2009 level, which had a 45% rate with a $3.5 million exemption per person.

Although this stalemate has been in place almost since President Obama was elected, there now are signs that Congress may agree to a temporary fix by the end of the year. A growing number of moderate Democrats and Republicans are backing a temporary extension of the lower tax rates for one to two years. At this point, it looks like Congress will pass a temporary extension of all of the Bush tax cuts, following its established pattern of failing to implement reliable, long-term tax policies.

The chart below shows the income tax rates and other tax provisions that will change automatically as of January 1, 2011 if Congress does not act to extend the Bush tax plan.

Note: As your tax advisor, I will be watching developments on the Bush tax cuts closely and will keep you updated on Congressional action on this important legislation.

Bush Tax Cuts, Current and Expiration Levels

TAX RATES	2010 LEVEL	2011 REVERSION
Individual Income Tax Rates	10%, 15%, 25%, 28% , 33%, 35%	15%, 28%, 31% 36%, 39.6%
Capital Gains Tax Rate	0% and 15%	10% and 20%
Dividend Tax Rate	5% and 15%	Ordinary income rates
Marriage Penalty Deduction	15% tax bracket for married couples is 200% of the 15% bracket for single taxpayers	15% tax bracket for married couples will be less than 200% of that for singles, resulting in higher taxes
Child Tax Credit	$1,000	$500
Itemized Deduction and Personal Exemption Limits	No Phaseout - full deductions and exemptions available	Deductions and exemptions phased out for upper-income taxpayers
Estate Tax	Repealed for 2010	Reinstated at a 55% rate and a $1,000,000 per taxpayer exemption.

KEEPING GOOD RECORDS REDUCES STRESS AT TAX TIME

Recently, the IRS released guidance on what it regards are important recordkeeping practices by taxpayers. The IRS's recommendations are worth noting. Maintaining good records now can make the filing process a lot easier, and it will help you remember transactions made during the year. If you keep good records, you are much more likely to prevail in an IRS audit. You do not have to keep your records in any special manner, but you should retain and safely store any documents that may have an impact on your tax returns.

Here are some suggestions for your tax recordkeeping:

Keep the following records supporting items on your tax returns for at least three years:

- Bills
- Credit card and other receipts
- Invoices
- Mileage logs
- Canceled, imaged or substitute checks or any other proof of payment
- Any other records to support deductions or credits you claim on your return

Retain records relating to property until at least three years after you sell or otherwise dispose of the property. Examples include:

- A home purchase or improvement
- Stocks and other investments
- Individual Retirement Arrangement transactions
- Rental property records

Small business owners must keep all employment tax records for at least four years after the tax becomes due or is paid, whichever is later. Examples of important documents business owners should keep include:

- **Gross receipts:** Cash register tapes, bank deposit slips, receipt books, invoices, credit card charge slips and Forms 1099-MISC
- **Proof of purchases:** Canceled checks, cash register tape receipts, credit card sales slips and invoices
- **Expense documents:** Canceled checks, cash register tapes, account statements, credit card sales slips, invoices and petty cash slips for small cash payments
- **Documents to verify your assets:** Purchase and sales invoices, real estate closing statements and canceled checks

Thank You for Your Business

As your tax professional, I assure you that I will be keeping a watchful eye on Congress and on IRS actions which may affect your business and your tax filings as the year comes to a close. I will be happy to address any concerns and answer questions you have about any of the issues covered in this newsletter. Thank you for the opportunity and privilege of allowing me to serve as your tax professional.

Best regards,

Service to the Tax Profession

"Today is the first day of the rest of your taxable year."

—Jeffery L. Yablon, partner at Pillsbury Winthrop Shaw Pittman and noted compiler of tax quotes in his book "As Certain as Death - Quotations About Taxes."