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Your business may qualify for a health care tax credit

The Patient Protection and Affordable Care Act (PPACA), signed into law earlier this year, has changed the landscape of the country's health care financing system for individuals and businesses alike. If you're an employer, you likely know that many of these changes don't take effect for several years.

But one significant tax break is available now: a tax credit designed to encourage small businesses to offer or maintain affordable health insurance for their employees.

How does it work?

Beginning with the 2010 tax year, the small business tax credit is available to employers with fewer than 25 full-time-equivalent employees (FTEs) and average annual wages under \$50,000. The credit is for up to 35% of the cost of group health coverage, including premiums paid before the act's effective date.

The credit is nonrefundable — that is, it can be used only to offset a business's actual income tax liability — but unused credits can be carried forward to future years.



Starting in 2014, an enhanced credit of up to 50% will be available for two years to small businesses that purchase coverage through one of the state insurance exchanges the act establishes.

The maximum credit is available to employers with 10 or fewer FTEs and average annual wages less than \$25,000. Organizations that exceed either threshold are entitled to partial credits on a sliding scale, and the credit is phased out altogether when an organization reaches 25 FTEs or average annual wages of \$50,000.

To qualify for the credit, an employer must provide health coverage under a “qualifying arrangement.” That means the employer pays an amount for each enrolled employee equal to a uniform percentage (not less than 50%) of the premium cost.

IRS guidance on the credit clarifies that it's available for premiums paid for comprehensive coverage as well as for limited scope coverage, such as dental or vision. But if an employer offers more than one type of coverage, it must satisfy the qualifying arrangement requirements separately with respect to each type.

Also, for 2010 only, a business is deemed to have a qualifying arrangement if it pays at least 50% of the single-coverage premium for each employee, even if the percentage is not uniform and even if the business pays less than 50% for family coverage.

Only the employer's portion of health insurance premiums counts in calculating the credit. And that amount is further limited to the amount the employer would have paid based on the average premium for the small group market in

the employer's state or area, if it's less than the actual premium. (See "Small business credit example" at right.)

The IRS guidance also clarifies that an employer's receipt of state subsidies or tax credits for health insurance doesn't affect its *eligibility* for the federal credit. But the amount of the federal credit cannot exceed the employer's *net* premium payments (after subtracting any state subsidies or credits).

Does your business qualify?

Don't assume that your business is ineligible just because you pay high salaries to management or have 25 or more employees. IRS guidance provides that, when determining the number of FTEs or average annual wages, you need not include the following employees:

- ⊙ Owners who work in the business, including sole proprietors, partners, more-than-2% S corporation shareholders and more-than-5% owners of other businesses,
- ⊙ Employees who are family members of the owners described above, and
- ⊙ Seasonal workers, unless they work more than 120 days during the tax year.

(But you can't take credits for premiums paid for these employees' health care coverage, either.)

Also, even if you have 25 or more employees, you may still qualify for the credit if some of them work part time. According to the IRS, to determine the number of FTEs, you should calculate the total hours of service for which your business pays wages to employees during the year (but not more than 2,080 for any one employee), and then divide that figure by 2,080.

Suppose, for example, that you have 28 employees, 20 of whom work 2,080 hours per year and eight of whom work 1,040 hours per year. Total hours

Small business credit example

For the 2010 tax year, Acme offers its employees a group health plan with single and family coverage, and pays 50% of the premiums. Acme has 10 FTEs with average annual wages of \$23,000. Six employees are enrolled in single coverage and four are enrolled in family coverage. Total premiums are \$4,000 a year for single coverage and \$10,000 a year for family coverage.

Average premiums for the small group market in Acme's state are \$5,000 and \$12,000, respectively. Acme's premium payments (\$2,000 for single coverage and \$5,000 for family coverage) don't exceed 50% of these averages, so it computes the credit based on its actual premium payments of \$32,000 ($6 \times \$2,000 + 4 \times \$5,000$). Acme's tax credit is \$11,200 ($\$32,000 \times 35\%$).

are $(20 \times 2,080) + (8 \times 1,040) = 49,920$. The number of FTEs is $49,920 \div 2,080 = 24$.

Service hours include paid leave, but no more than 160 hours for any single continuous period of paid leave taken by one employee. An employee's service hours for the year may be determined based on actual hours, a days-worked equivalency of eight hours for each day the employee works at least one hour, or a weeks-worked equivalency of 40 hours for each week the employee works at least one hour.

To determine average annual wages, divide total wages for the year (excluding wages paid to owners, owners' family members or seasonal employees) by the number of FTEs for the year.

Get a checkup

The health care tax credit can be good for your business's financial health. If you provide health insurance coverage to employees, get a checkup to see whether you qualify for 2010. If you don't, it might be worth exploring changes that will allow you to qualify for the credit in future years. If you're planning to offer a health plan in the future, your advisor can help you structure it to maximize the benefits of the credit. ⊙

Is your 529 plan underwater?

A 529 plan continues to be one of the most powerful tools available for financing higher education costs. In addition to being available to taxpayers at all income levels, 529 plans offer generous contribution limits, creditor protection, minimal impact on financial aid eligibility and various gift and estate tax advantages. Contributions aren't deductible, but earnings accumulate tax-deferred and may be withdrawn tax free if used to pay for a beneficiary's college tuition or other qualified higher education expenses.

Like most investment vehicles, however, these plans aren't immune to market risk, and many have experienced significant losses over the last couple of years. Here's an often-overlooked strategy to consider if your 529 plan is "underwater" — that is, its current value is less than the amount you've contributed to it.

Cutting your losses

If it will be several years before you'll need the 529 plan funds to pay college expenses, it may make sense to sit tight on your plan and wait for it to recover. But if you'll need the funds soon — or if you could use a large tax deduction this year — there may be a better option: Withdraw all of the funds, close the account and claim the loss as a miscellaneous itemized deduction.

Because you aren't withdrawing any earnings, there are no taxes or penalties (regardless of how you use the money). And the deduction can significantly reduce your tax bill.



Suppose, for example, that you and your spouse invested \$150,000 in a 529 plan for your daughter and its value has dropped to \$110,000. You close the account and claim the \$40,000 loss on your 2010 income tax return.

Miscellaneous itemized deductions are deductible only to the extent they exceed 2% of adjusted gross income (AGI). Assuming that your 2010 AGI is \$200,000 and that you don't have other miscellaneous itemized deductions, you can deduct a \$36,000 loss. That translates into a federal tax savings of more than \$10,000 (at a 28% marginal tax rate). For higher tax brackets, the potential savings is even greater.

But the alternative minimum tax (AMT) also must be considered. The AMT could limit or even negate the tax savings from this strategy.

More to consider

In addition to potentially cutting your tax bill, this strategy gives you access to the money with no strings attached. You can continue saving the money for college expenses or you can use it for more immediate needs.

If you do reinvest the funds in another 529 plan, it's a good idea to wait at least 61 days so the IRS doesn't treat the transfer as a nontaxable rollover and deny the deduction. And keep in mind that investing in a new 529 plan likely will constitute a new taxable gift to your beneficiary, so check to see whether your \$13,000 annual exclusion and \$1 million lifetime gift tax exemption will cover it.

Don't try this at home

A losing investment is never a good thing. But smart tax planning can help soften the blow. Whether this strategy is right for you depends on several factors, including the amount of time you have to save for college, the availability of other

resources to pay education expenses, and your overall income, gift and estate tax situation.

If it will be several years before you'll need the 529 plan funds to pay college expenses, it may make sense to sit tight on your plan and wait for it to recover. But if you'll need the funds soon — or if you could use a large tax deduction this year — there may be a better option.

Before you close your 529 plan account, consult with your tax advisor to evaluate the relative benefits and risks of withdrawing the funds vs. keeping them invested. ©

A defective (but strong) trust

Transfer wealth with the power of an IDGT

When Dan created his estate plan, he and his tax advisor discussed several strategies to transfer wealth to his loved ones. One particular strategy caught his eye because of its odd name: the intentionally defective grantor trust (IDGT). Dan's advisor explained that, despite its name, this trust could be a highly effective way of removing assets from his estate while minimizing estate taxes.

A one-two punch

What gives the IDGT its one-two punch is the fact that the IDGT terms include a “defect” that allows you, the grantor, to remove the trust assets from your estate while still continuing to be liable for income tax on the trust's earnings. In fact, you're responsible for paying income tax on income you never receive. But that isn't a bad thing in this scenario — assuming you're trying to reduce your estate.

According to the IRS, as long as the IDGT is properly structured, it won't be considered a taxable gift when you pay income tax on trust earnings. So you are, in essence, making an additional tax-free gift to the trust each time you pay tax that would otherwise be paid by the trust itself.

This allows you to accomplish two important objectives: 1) The trust assets can grow without being reduced by income taxes, and 2) you can further deplete your estate — and reduce the associated estate tax — each time you pay the income tax on the trust earnings. (Note that even though, as of this writing, an estate tax repeal is in effect for 2010, the estate tax is scheduled to return in 2011. Check with your tax advisor for the latest information.)



Keep in mind, however, that other transfers you make to the trust will be considered taxable gifts. You can avoid the income tax by selling assets, such as real estate, securities, and stock in a closely held business, to the trust in exchange for an installment note with interest.

So long as an IDGT is properly structured, it won't be considered a taxable gift when you pay income tax on trust earnings.

Before you sell assets to the trust, you should initially fund it with additional assets (equal to at least 10% of the assets you're transferring). The goal is to give the trust a sufficient degree of economic substance independent of the business or asset. This avoids having the assets you're

selling constitute the sole source of payment for the note and, ideally, helps you avoid IRS questions about the transaction. If the assets you're selling are the sole source of payment, the IRS might argue that the transaction is a transfer with a retained interest, causing the property to be included in your estate.

If you're concerned that the income tax burden might become overwhelming if the assets grow significantly more than expected, the trust documents can provide the right to distribute trust assets to you to pay the associated income taxes. When properly drafted, such a power won't create a problem. But beware — an improperly drafted document could cause the trust assets to be included in your estate, undermining the IDGT strategy.

A powerful trust

For those with large estates, an IDGT offers the power few other asset transfer strategies can match. But make no mistake — an IDGT is complicated and requires the knowledge of an experienced tax advisor to ensure it passes muster with the IRS. ©

tax TIPS

Failure to maintain W-9s can cost your business

If your business issues Forms 1099 to service providers (generally required for providers you pay more than \$600 per year), be sure that you have a signed Form W-9 on file for each recipient. W-9s are used to request a Social Security number or other taxpayer identification number (TIN) from a service provider. The form certifies 1) the provider is a U.S. citizen or a company organized in the United States, 2) the TIN listed on the form is correct, and 3) the provider isn't subject to backup withholding.

If you don't obtain completed, signed W-9s from providers for whom a Form 1099 is required, you must withhold tax at a 28% rate from payments you make to them. Failure to do so can leave your business on the hook for the amount that should have been withheld. ☉

Deduct estate tax on inherited IRA

You may not realize that, if you inherit an IRA, you're entitled to an income tax deduction for any estate taxes attributable to the IRA assets. Say, for example, that you inherit a \$200,000 IRA from your father, who died in 2009 with an estate well over the estate tax exemption amount. Assuming a marginal estate tax rate of 45%, inclusion of that \$200,000 in your father's estate generated \$90,000 in estate taxes.

When you withdraw funds from the IRA, you're entitled to an itemized deduction equal to the amount of estate tax allocable to the withdrawal. So, for example, if you withdraw half of the account (\$100,000) in 2010, you'll have \$100,000 in taxable income (assuming the IRA has maintained the same



value as the estate tax return value and doesn't include any nondeductible contributions).

This will cost you \$35,000 in income taxes if you're in the 35% bracket. But you can also claim an itemized deduction on your 2010 return for half of the estate taxes (\$45,000), saving you \$15,750. ☉

Don't overlook reinvested dividends

Most investors instruct their mutual funds to automatically reinvest dividends, but they often overlook this fact at tax time, which can result in unnecessary taxes. When you use dividends to purchase additional mutual fund shares, you increase your tax basis in the fund, which, in turn, reduces your gain or increases your loss when you redeem shares.

If you don't track reinvested dividends and include them in your basis, you'll end up paying tax on them twice: once when they're paid and again when you sell your shares and they're included in the proceeds. ☉

ABC Test: Employee vs. Independent Contractor

By Glenn Schwier JD

In the modern business world there are many variations of workers such as employees, independent contractors, consultants, etc. The distinction between employee and independent contractor has become increasingly complex. Why is the label so important?

An employee may collect unemployment benefits. An independent contractor is disqualified. An employee is eligible for pension benefits, whereas an independent contractor is not. An employee qualifies for worker's compensation, but not an independent contractor. An employer pays unemployment taxes for a worker classified as an employee but not an independent contractor. Therefore, misclassifying an employee can have a significant impact on both the employer and the employee.

New Jersey applies the ABC Test to determine if a worker is truly an independent contractor. As determined in the court case; *Carpet Remnant v. NJ DOL*, 125 NJ 567 (1991), if New Jersey determines a worker's classification, the employer has the burden to prove otherwise.

The three part ABC Test used by New Jersey is incorporated into N.J.S.A. 43:21-19(i)(6):

(a) Such individual has been and will continue to be free from control or direction over the performance of such service, both under his contract of service and in fact.

Under Part A an independent contractor is one who renders services but retains control over manner in which services are performed. Independent contractor agrees only to the result to be accomplished. The employer must establish not only that the business has not exercised control in fact, but also that employer has not reserved right to control individual's performance. New Jersey looks beyond labels but peers into facts and circumstances.

(b) Such service is either outside the usual course of the business for which such service is performed, or that such service is performed outside of all the places of business of the enterprises for which such service is performed.

(c) Such individual is customarily engaged in an independently established trade, occupation, profession or business.

A worker's business activity must be able to survive independently of their relationship with one employer. If the individual's business cannot survive the loss of the service relationship with the employer than part C is not satisfied. Factors that Department of Labor and Courts consider are 1) business office versus home office, 2) businesses licenses, 3) business telephone, cards/stationary, 4) equipment owned by worker and 5) filing of Schedule C for the business on federal tax return.

Example:

A good example is when you need to call a plumber. The plumber will tell you when he is available and whether he will be coming or sending one of his assistance. He will bring his own tools and will not rely on you to tell him how to handler the repair work. He is an independent contractor.

DOL Audit

NJ DOL conducts periodic audits of company's classification of workers. If an employer fails the ABC test requirements, then the business is liable for the unpaid unemployment and temporary-disability contributions corresponding to the misclassified employees. Including the "employees" share. Before your business dismisses the unemployment and disability tax liability for workers classified as independent contractors, remember your ABCs.