

The

"CHREST

LETTERS"

A Small Business Guide to Tax Planning

Brian F. Chrest, CPA

MISSION STATEMENT

The purpose of "The Chrest Letters" is to enlighten business owners to show the variety of ideas that are available. Whether the business owner prepares his own taxes or hires a professional, the information provided is to be a source to generate new ideas. Tax planning and business planning are dynamic areas. It is always changing. It is often too easy to become complacent. The old adage is, if it isn't broken don't fix it. Sometimes if it isn't broken it can still be improved upon. These ideas included in "The Chrest Letters" are to be taken to your advisor or the tax-knowledgeable business owner. Then with proper advice from the advisor or the tax-savvy business owner, these ideas can be placed into action to start saving tax dollars year in and year out.

DEDICATION

I dedicate this book to several individuals. First, I dedicate this book to my wife, Andrea De Labio Chrest. I thank her for her indulgence and forgiveness of all the time this book stole from my personal time with my family. All my desires and inspirations start and end with Andrea, the love of my life. Secondly, I dedicate this book to my eight-month-old daughter, Olivia Lily. I look into Olivia's eyes everyday and see the innocence and purity of a new life. I tried to translate that into words of wisdom to hopefully introduce the reader to new ideas he/she may not otherwise have known about. I hope I am successful. Thirdly, I dedicate this book to my Dad, Charles L. Chrest, Jr. CPA. My dad taught me how to conduct myself as a businessman in a moral and ethical manner. I owe my business success to my Dad's ongoing example. Fourthly, I dedicate this book to my father-in-law Richard A. De Labio. He inspired me to stay dynamic and always improve on that which is already perfect.

The Chrest Letters

Table of Contents

Letter one: Business Startup

Letter two: Payroll

Letter three: Retirement Plans

Letter four: Children

Letter five: Tax Credits

Letter six: Tax Deductions

Letter seven: Trusts

Letter eight: Tax Shelters

Letter nine: Tax Free

Business Start-Up

BANKING: Some of the best sources of borrowing may be a home equity loan. The tax laws allow you to borrow up to \$100,000 on a home equity loan. Proceeds of the home equity loan can be used to fund a start-up business. The interest is 100% deductible. Usually the interest rate is lower than a traditional business bank loan. A pitfall is that interest on a home mortgage loan used for any other purpose other than to build, buy, improve or for an unincorporated business is not deductible for the alternative minimum tax. Other sources of borrowing include your retirement plan, family and friends, or your brokerage account. The benefits when borrowing from your retirement account include simplicity to arrange and usually a modest interest rate.

If you are a key employee, a highly paid executive or greater than five percent owner, you can't deduct your interest payments even if the funds are used for a deductible purpose. If you leave the company the loan must be repaid at that time. Any unpaid portion will be counted towards taxable distributions. Borrowing between family and friends can be tricky, to say the least. Keep these rules in mind. If the loan is for \$10,000 or less, no interest has to be charged. If you choose to calculate interest, you should use the federal applicable rates. See the applicable tables in the appendix. You can arrange a margin loan against your investment portfolio generally up to 50% of value. Interest is usually tied to the prime rate and can vary from month to month. A downside to a margin loan is if the value of your investments drop, you still have to stay within the limits. You may be forced to sell a security or infuse cash to satisfy the loan. Another source of

money could be an insurance policy. If you have a life insurance policy other than term, you may be able to borrow from your built-up cash value. Any outstanding loan amount at death is subtracted from the death benefit. This type of borrowing is easy to arrange and interest rates are usually lower. There may be gift tax issues involved with intra-family loans. If the interest rate is set too low or at zero, the IRS may consider the loans to be gifts. You may be required to pay gift taxes or it may erode your estate unified credit. With today's low federal applicable rates it is possible to create very low interest loans between family members with no gift tax consequences. The Applicable federal rates, otherwise known as the AFRs are at a very low point.

A caution to be aware of is that getting out of debt can be a tax trap. A discharge of a debt will create a phantom income to be reported on your tax return. If the amount is more than \$600, it will be reported on a form 1099 to the IRS. One exception to this rule is insolvency. If you are insolvent, that is your debts exceed your assets, then you do not have to report the discharge of debt income on your tax return. Another exception to the rule is **bankruptcy**. If your creditors settle for pennies on the dollar and the debt is discharged in a bankruptcy proceeding, you are not required to report the discharged debt as income. A banking technique approved by the IRS is borrowing from your company's profit sharing or pension fund. This extraordinary technique allows you to borrow money, pay yourself interest, deduct the interest paid and receive interest tax-free. To qualify the following must be met. The loan provisions must be available to all participants on an equal basis. The loan provisions are not made available to the highly compensated employees in a percentage greater than that available to other employees. The loan is made in accordance with specific provisions regarding such loans set in

the plan. The loan must bear a reasonable rate of interest and be adequately secured. The vested portion of your account can be used as collateral.

CHOICE OF ENTITY: The choices you have for types of business entities are as follows: Corporation, S Corporation, Sole-Proprietorship, Partnership, Limited Liability Partnership, Limited Liability Company, and Family Limited Partnership. As a side-note, the appendix at the back of this booklet includes a very exhaustive chart comparing all of these forms of businesses. This chapter will address certain complex issues that the chart does not. Let's address certain issues relating to S corporations first. The #1 issue is double taxation. An S Corporation avoids the double taxation that is present under a regular Corporation. This holds true as long as your business entity has been an S Corporation its entire life. Income under a regular corporation is taxed at the corporate level first and then at the individual level. In an S Corporation, income is generally not taxed at the corporate level and any income or loss flows down to the individual level allocated by ownership percentage. Since the income is passed down to the individual, it allows opportunity to reduce taxes by having your children as non-controlling owners. This will be covered in much more detail in the chapter titled "Children."

Tax-favored capital gains rates apply to capital gains earned through an S Corporation, where as regular rates would apply under a regular corporation. Another advantage of an S Corporation is the avoidance of the possible accumulated earnings penalty tax. A disadvantage of the S Corporation is that health

insurance for more than 2% owners and their families is not deductible as a business expense. What occurs in this case is that the premiums are added back on the shareholder's W-2 form and then are subtracted back out as an adjustment to income on the individual 1040 tax form. When the premiums are added back to the W-2 form they are subject to the social security and medical employee withholding taxes as well as the employer-matching amount. This will be covered in more details in the chapter titled "Payroll". If you started as a regular corporation and wish to convert to an S Corporation, there are some issues of which to be aware. These issues are the unused loss carryovers will be lost; tax may be due at the time of conversion and if any business assets are sold within ten years of the conversion the business could be liable for a built-in gains tax for additional appreciation. Some reasons why a regular corporation would hold an advantage are as follows. Health insurance premiums would be a fully deductible business expense as long as some discrimination testing rules are followed. If you have losses carried forward, it would reduce future taxable income of the regular corporation.

Let's look at the Limited Liability Company. The LLC (Limited Liability Company) at times offers the best of both worlds. They give you the limited liability protection as a regular or S Corporation would give. Their income is taxed as a partnership, at the individual level. The LLC pays no income tax - it is taxed on the member level. Owners of an LLC are called members. If there are two or more members, the LLC files its own informational tax return. For a one member LLC, the activity is reported on the schedule "C" of the owner's individual 1040 tax return. Another advantage of the LLC is that the allocation of income or loss can easily be changed year by year; this offers some excellent planning opportunities to shift income or losses. Also an advantage of the LLC is in cases of multi-state activities.

You can set up an LLC for each state you transact business, that is as long as that state has an LLC statute.

Most states by now offer the LLC as an entity choice. The advantage to this is simplicity when it comes to state-to-state activity and adjustments to tax returns. Each state could have different rules, so consult legal counsel. Consider having combined entities. As long as each entity has a distinct function and purpose, you may be able to employ the benefits of each entity without being hurt by the downside of each various entity. Using a family partnerships may offer some income tax planning as well as some estate tax planning opportunities. By giving or selling an interest in your business to a family member, you can possibly shift income to lower tax brackets. For this to work under IRS rule the partnership must be genuine. A family partnership can be created with capital being contributed, gifting, selling a partial interest, or accepting into the partnership a family member that can perform services.

Some other advantages of a regular corporation are as follows. The corporation can purchase up to \$50,000 of term life insurance for its employees, including the officers of the corporation. It is a deduction for the corporation and tax-free for the employees. The corporation can pay for the health insurance for its employees, including the officers. It is deducted by the corporation and tax-free for the employees. Disability insurance premiums are also deductible by the corporation and tax-free to the employees. The corporation can receive dividend income and exclude up to 80% from tax. The corporation can accumulate dividend income up to \$50,000 at the low rate of only 15% federal tax. Also the regular corporation provided limited liability to the shareholders. Owning business assets under separate entities may be advantageous. Assets such

as real estate can be separated from personal property such as vehicles or equipment. This may result in tax advantages as well as legal advantages. S corporations give the following advantages: no double tax, loss shifting, and income shifting. To reduce potential future estate taxes a discount valuation gift of business interest to family members can be considered. The annual gift exclusion will allow a gift of up to \$13,000 per person per year. For married couples the exclusion is double to \$26,000. When a gift is made of a minority interest in a private business, a valuation discount is permitted to reduce the worth of the gift. These discounts could be as much as 40% for lack of marketability or lack of control conveyed.

BUYING/SELLING A BUSINESS: Here are some items of interest to look for when buying a business. Consider buying a company's assets versus buying that company's stock. Buying the assets will allow you to allocate the purchase price among those assets. Most commonly, these assets are inventory, equipment and goodwill. Goodwill is written off over 15 years. Equipment can be elected to be written off in one year and/or depreciated over five or seven years. Inventory is written off when sold. On the other side of the fence, purchase of stock cannot be written off at all. It is only used to offset the selling price in the future when or if you ever sell the business. Sellers of a business would prefer a stock sale because the gain is taxed as a capital gain. If the holding period is one year or more, the gain would qualify for preferential tax rates. A sale of assets would generate a combination of ordinary income and capital gain. For a regular corporation, the asset sale is taxed at the corporate level and then again when the sale proceeds are distributed to the shareholders. A typical clause in most sales contracts is

allowances for continuing assistance and advice. Former business owners who will be paid for their advice or continuation of work for the company should have those payments labeled as "covenants not to compete." When such payments are characterized as such, they avoid being taxed for social security taxes and medicare taxes and unemployment taxes. Structure the sale as an installment sale. This will require less payment up front for the buyer. The benefit to seller is that taxes are generally not due until the payments are received. An installment sale could defer taxes to future years.

ACCOUNTING: Cash or accrual, that is the question. This is the first accounting issue that every business must tackle. This choice is formally made on the first tax filing of the business. For the sake of setting-up the books this decision must be made early on. Under section 448 of the IRS code, the following entities are generally prohibited from using the cash method:

1. regular corporations with an average gross receipts of five million dollars
2. partnerships with a regular corporation partner having gross receipts over five million
3. tax shelters including limited liability partnerships where more than 35% of the losses are allocated to limited partners

The cash method is reporting income when the cash is constructively received and reporting expenses when the cash is actually expended. Constructive receipt occurs when property is available for use. The accrual method is reporting income when earned, regardless of when the payment is received. Expenses are reported when the taxpayer becomes liable for them and economic performance occurs. Income is considered earned when

all events have occurred that fix the right to receive the income and the amount can reasonably be determined. Hybrid methods are allowed in certain circumstances. Hybrid methods contain features of both the cash and accrual methods. The most common example is a business with inventories. This company could account for its sales and purchases using the accrual method and account for its service income and other administrative expenses using the cash method.

What is inventory? The following factors are used in determining this question:

1. are the materials significant to producing income?
2. are the materials indispensable and inseparable from the provision of service?

Under the cash method you cannot postpone booking the income by waiting to deposit the item. Under the accrual method the application of the all-events test can be a vague area. Some guidelines for handling certain situations:

1. right order but wrong invoice: you send the right order, but place the wrong amount on the invoice. According to the IRS, you must accrue the correct amount of the income when the goods are shipped and not when the dispute is settled.
2. right invoice but wrong order: you send the wrong order attaching an invoice reflecting what should have been sent. In this situation you don't have to accrue the income upon shipping. The wrong items were shipped so the all events test have not occurred yet.

Cash basis taxpayers must book advanced payments for services as income when constructively received. For accrual basis taxpayers, this can become a little blurry. Generally the accrual basis taxpayer must accrue the income even if the transaction is

not consummated until next year - just as the cash basis taxpayer. There is an exception to this rule. If the work is completed by the end of the next year, you can accrue the advance next year. You can't delay accruing beyond next year.

For goods held on consignment, you do not report any income until your goods are actually sold. Year-end planning becomes very important based on your accounting basis. New rules make it easier for a business currently under the accrual method to switch to the cash method of accounting. This is accomplished by completing and filing IRS form 3115. Cash basis taxpayers can control to a certain extent when to report income, such as delaying sending invoices until later in the year so payment is actually received next year. As a result of tax rates and levels of income, you may actually want to accelerate income. This is accomplished by either completing your work sooner and mailing invoices more quickly or by sending progress billings for work partially completed. Financed equipment purchases placed in service before the year ends can be fully deducted in the current year whether you are on the accrual or cash methods. Regardless of when the financing is paid off, your deduction occurs in this year. A large part can be written-off completely while the remainder is depreciated using the IRS tables. This can produce a positive cash flow in the first year of an equipment purchase. An accrual basis taxpayer can claim a charitable deduction if the board adopts before the end of the year and it is actually paid within 2 $\frac{1}{2}$ months after the close of the year.

Salaries and other payments to an S corporation owner are only deductible when paid, even if the business is on the accrual basis. In a regular corporation on the accrual basis an owner can accrue and deduct a bonus before the year ends as long as it is paid within 2 $\frac{1}{2}$ after the year ends. For retirement plans, a cash basis

or accrual basis taxpayer can deduct the current years contribution from its taxes. The contribution doesn't have to be paid until the filing deadline date, with extensions, of the tax return. Examine inventories on-hand for damaged goods. Offer them for sale to take the write-off or donate them to charity before the year ends. Before the year ends, make sure the owners or board of directors hold a meeting so any actions can be formally stated in the minutes of the corporation.

PAYROLL

TAX DEPOSITS: An employer is required to deposit federal payroll taxes either electronically or with form # 8109. This chapter will narrow its focus to just federal taxes. Each state will have its own set of rules. The best place to start for information on various states is on the internet. By now I am sure each state has its own web page. Depository taxes include federal income tax withheld, social security taxes and medicare taxes. Social security taxes are withheld at the rate of 6.2% with the employer matching dollar for dollar. Medicare taxes are withheld at the rate of 1.45% of all wages with no ceiling and the employer matches this dollar for dollar as well.

As a separate tax, federal unemployment taxes are paid by the employer at 6.2% on the first \$7000 of wages per employee. The 6.2% will be reduced to .8% if the employer pays into a certified state unemployment fund and thus receives a total credit of 5.4%. Your state unemployment tax must be paid and filed timely to receive the credit. **The federal payroll tax is one tax not to pay late.** The penalties imposed are as follows: 2% if up to five days late, 5% if six to 15 days late and 10% if more than 15 days late. Penalties may be waived only in the case of reasonable cause, which usually relates to health reasons or death in the family. A safe harbor for an under payment would be less than \$100 or 2% of the amount to be deposited. Form 8109 must be mailed or hand delivered to an authorized financial institution, such as a bank. Depositors are broken down into two categories; monthly or semi-weekly. If your total federal payroll tax liability is less than \$50,000 for the look-back period, then you are a monthly depositor. If over \$50,000, then you are a semi-weekly depositor. The look-back period is defined as the one year period

ending the previous June 30th. A monthly depositor's liability would be due the 15th day of the following month. A new employer would be classified as a monthly depositor for the first year. A semi-weekly depositor's liability due date would depend on which day of the week is payday. If payday is on Wednesday, Thursday or Friday then the due date would be the following Wednesday. If payday is on a Saturday, Sunday, Monday or Tuesday then the due date would be the following Friday. The wage base does not follow an employee from one employer to another. An employee can recoup excess social security taxes withheld beyond the annual limitation by claiming the excess as a credit on line 65 of the form 1040 for the year. An exception to the employer-to-employer rule is if the new employer is a successor organization of a merger or a reorganization.

PAYROLL FORMS: All new employees must complete a W-4 form. This form informs his employer how much to withhold in federal income taxes. If a new employee has not submitted a W-4 for to the employer, the employer must use the single tax tables with zero exemptions. An employee can claim exempt from federal withholding taxes if he/she owed no taxes in the prior year or he/she reasonably expects to owe zero federal tax in the current year. This form is kept in the employer's files unless one of the following apply:

1. an employee claims more than 10 exemptions
2. an employee claims exempt from tax but that employee's normal wage would be more than \$200 per week
3. the IRS notifies the employer in writing requesting a copy of a W-4 form

Whenever there is a change in marital status, exempt status, or number of exemptions a new W-4 must be completed and signed

by the employee. Every state has a new hire registry where the employer notifies the state of any new employees. Again, check your state's website for more information. The federal forms you will be required to file are: form 941, form 940, form W-2, and form W-3. The form 941 is due for each quarterly calendar period and is due the last day of the following month. This form recaps your total payroll liability for the quarter and the deposits made for that quarter. If your total quarterly liability is under \$2,500 you may pay with the 941 form and forego making deposits. The form 940 is an annual recap of your federal unemployment taxes for the calendar year and is due on the last day of January every year. The tax however must be paid with form 8109 at anytime during the year it exceeds \$500. Form W-2 must be given to the employees no later than January 31st. The federal copies of the W-2 form along with the W-3 form are due by February 28th.

CUTTING PAYROLL TAXES: In tough economic times every employer should try to find ways to save money. One area of possible savings is payroll taxes. Here are some possible ideas. Consider offering non-taxable fringe benefits instead of raises to your employees. This will reduce your payroll tax base and it will also reduce the taxable income of the employees, which could include the business owner as well. Some possible benefits are employee discounts, group term life insurance up to \$50,000, dependant care assistance up to \$5,000, educational assistance up to \$5,250, on-site meals and lodging if they are for the employer's convenience, no-additional cost services such as telephone service for workers, working condition benefits, or any other de minimis fringe benefit. Timing of bonuses at year end could result in payroll tax savings by watching the social security limits and plan accordingly. By moving up or pushing back the bonus could keep

the bonus in a year where you have already exceeded the social security limits.

Companies can offer flexible spending accounts to cover employers unreimbursed medical expenses. Employees can agree to contribute a portion of the pay to the FSA plan. Amounts contributed by employees are not subject to federal income taxes, social security taxes, medicare taxes, unemployment taxes, and matching employer taxes. **The employee saves and the employer saves.** And again the employer many times will be the employee at the same time. The cost of administrating such a plan is usually modest. Currently, unused committed amounts by employees are lost to that employee forever. It is, a use it or lose it proposition, so err on the side of conservatism.

Discrimination rules may also apply, so be aware. If an accountable plan is in place, you may reimburse your employees for out of pocket business expenses. These amounts are not payroll, thus you save federal taxes, social security taxes, medicare taxes, and unemployment taxes. To qualify as an accountable plan, the company must adopt a written policy that requires employees to substantiate their expense account record with receipts timely and refund the company any excess advances. You can employ your kids. If you are a sole-proprietorship any wages you pay your kids who are under the age of 18 will not be subject to social security taxes or medicare taxes. If the child makes a small amount, that child will owe zero income taxes. Here you have saved federal income tax and employment taxes. The wages need to be reasonable for the tasks being accomplished. Keep a good record with time cards just as you would with any other employee. Helping your employees save for retirement may help your bottom line. In lieu of raises institute a plan where your employees and put money into a retirement account and thus defer income taxes. The

bottom line is that it reduces taxes and keeps more money in the employee's pockets.

Various plans are available: SEP IRA, Simple, 401(k), profit sharing, money purchase, and more. All of which will be addressed in a future chapter. From the company's perspective it will pay to set up a plan, which in most cases is modest. It may however qualify for a credit of \$500 per year for the first three years. The company may also make a matching contribution to ensure that the plan doesn't discriminate the highly compensated. **Premium only cafeteria plans** may also reduce the employer's burden. The employees share of the premium may come out pre-tax which will save the employee federal income tax, social security taxes and medicare taxes. The employer saves social security taxes, medicare taxes, and unemployment taxes. Commuting expenses are generally non-deductible but may become a tax free fringe benefit. Expenses that would qualify are monthly pass for bus, subway or rail traveling. Also qualifying would be monthly parking pass. This could be on-site or the location to which the employee commutes by bus or train. Under the proper structured plan, these pre-tax costs would save federal income and employment tax for employee and employee.

INDEPENDENT CONTRACTORS: Non-employee compensation paid to an independent contractor is reported on a 1099-MISC form. If anyone is paid \$600 or more he/she must be issued this form. Payments to a corporate entity are exempt from this filing. Payments made to an independent contractor are not subject to employment taxes such as social security, medicare and unemployment taxes. Therefore, the temptation exists to classify a worker as independent rather than an employee. An independent contractor is also exempt from workers compensation. If the IRS reclasses a worker from independent

to an employee, the employer faces huge liabilities for the federal, state, employment taxes as well as penalties and interest. As you can see, it is a very important distinction. Some criteria that the IRS would use in making this determination are:

1. who controls when, where and how the work is performed
2. who sets the work schedule
3. who states if the work must be performed by a particular individual
4. the method of payment
5. are the worker's services available to the public
6. who provides the worker's tools

The key element is the right to control the worker. Certain employees are defined as independent by law. These include real estate agents and direct sellers. The following are strategies to consider when employing independent contractors:

1. Have the contractor sign a written statement attesting that he is independent.
2. Have the worker provide his/her own tools.
3. The worker should bill the company for the services performed.

If the independent contractor hires his/her own helpers, it proves flexibility. The company should require proof of insurance from the independent worker. Give the worker the discretion on how he/she is to perform certain tasks. It is much easier to prove a worker as an independent if that worker has other sources of income other than your company. A taxpayer who doesn't know how to classify a worker can file form SS-8 with the IRS. On this form you set forth the facts and circumstances and from this data the IRS makes the determination. The IRS wants to classify the worker as an employee, but if the facts are there

to prove the point it will rule in your favor. To make the wrong determination as to his/her being an independent, the IRS has weapons to fight you on the issue. The IRS can issue a compliance check to see if the company is treating employees as independent contractors. There is no such term as a "compliance check" in the IRS code, it is just an excuse to peruse your books. A compliance check is not an audit. The difference is once you have passed an audit on this topic, you have a prior audit defense. Once you have a no change letter from an audit, the IRS cannot come back and back again on the same issue. The IRS can come back again and again for a compliance check. How can you avoid difficulties yet reap the benefits of hiring independent contractors? Under federal law, if you make prima facie case that an individual is independent rather than an employee the burden of proof shifts from you to the IRS. Now the government must prove the worker is an employee versus your proving that the worker is an independent contractor.

FRINGE BENEFITS: There are a number of benefits that can be offered to your employees. A section 125 plan offers many ways for an employee and employer to save income taxes and employment taxes. Nontaxable benefits include group term life insurance, disability benefits, dependent care, accident and health premiums, and out-of-pocket medical expenses. Contributions may be excluded from gross income, which includes federal and state income tax and employment taxes. **The following conditions must be met.**

1. the participant must choose nontaxable benefits
2. the same service requirements must apply to all participants
3. participation is limited to employees only
4. the plan's requirements must not discriminate in favor of the highly compensated

5. the contributions and benefits must not favor the highly compensated participants

Two or more benefits consisting of cash and qualified benefits must be offered for the participating employees to select. Reimbursing an employee for business expense may be an allowable benefit. Normally, when reimbursements are available to an employee for a business expense incurred it is allowed as a business deduction. The following benefits can generate a direct savings to the company.

Accountable plans - the employee submits travel and expense receipts for reimbursement.

No-additional-cost-service - It's a benefit that carries no extra cost to the employer. The value is excluded from the employee's gross income if the service is offered to the public and the employer incurs no additional cost.

Accident and health plans - This plan pays for the premiums of qualified employees. This is tax-free for the employee but subject to non-discrimination testing.

Monthly transit pass: Employees who pay for their public transit cost or monthly parking cost can have pre-tax deductions from their pay. This will save the employee income and employment taxes. This will also save the employer the employment taxes. The employee can exclude an amount per month for transit passes and for parking costs.

Flexible spending arrangements - This is for medical expenses and dependant care expenses and is deducted pre-tax. Some of these arrangements can cut insurance costs as well because some insurance policies are tied to the taxable gross compensation.

Archer medical savings account - For high deductible health plans, company or employee contributions are fully deductible but are limited to 65% of the policy deductible. (75% for family

policies.) Contributions to an Archer plan are limited to employers with less than 50 employees in either of the previous two years. **Company funded health reimbursements** - This is an employer funded plan in which the company contributes a fixed amount on behalf of its employees. The employees can use the money for out of pocket medical costs. These amounts can be carried forward into other years.

Adoption assistance - Expenses associated with the legal adoption of an eligible person. This is tax-free for the employee with dollar limitations and AGI phase-outs. **Deferred compensation:** The employee agrees to defer receipt of salary work already performed. May be taxable or tax deferred depending on the various conditions.

De Minimis Fringe - Minimal benefits, such as occasional use of equipment or supplies by the employee are tax-free for the employee.

Special work arrangements - Some examples are flex-time, telecommuting, and job sharing. These arrangements keep people on the job by satisfying special needs. Part time employees may not be entitled to certain benefits, thus saving the employer dollars.

Child-care assistance - Employers that provide on-site child-care services or help employees make arrangements may cut absenteeism. The employer can reimburse employees up to \$5,000 per year for child-care expenses, and all amounts are tax deductible. The employer can provide child-care facilities on the premises. The employer can claim a credit of 25% of the qualified costs. The employer can provide child-care referral services. The employer would qualify for a credit of 10% of the cost. The total dollar amount an employer spends on child-care facilities and referral services cannot exceed \$150,000.

Educational assistance - An employer can assist his employees by paying up to \$5,250 towards educational costs. Qualified

costs include tuition, fees, books and supplies. The education doesn't have to be related to the employees' work.

Meals and Lodging - Meals and lodging provided to employees on the employer's premises are tax free to the employees if furnished for the convenience of the employer and for lodging only, a condition of employment.

Some other fringe benefits include employee discounts, job placement assistance, on-premises athletic facilities, working condition fringes, retirement planning services, moving expenses, retirement plans and employer-provided vehicles.

For the owners: Have your company buy a large group term life insurance policy on your life. The premiums are fully deductible by the company as long as the group policy doesn't discriminate against lower-income employees. The taxable cost, that is the cost over \$50,000 of coverage, must be included in the owner's taxable income. The taxable cost could be much less than an individual policy purchased outside the company. The only cost to the owner/employee is the tax paid on the amount added to taxable income. Have the company pay for your health insurance and as long as the plan doesn't discriminate against all eligible employees it is fully deductible by the business and tax-free to the owner/employee. Set up an educational assistance program under section 127 of the IRS code. The company can pay up to \$5,250 a year of your college or graduate school costs, or even your child's education costs if your child is your employee. The education does not have to be job related. Such a plan cannot discriminate against the lower paid employees. An additional benefit is that if the education costs are job related there is no dollar limitation. Take out a disability insurance policy but don't have the company pay for it. At the end of the year, at a point when you know you will not collect against the policy have your

company reimburse you for the premiums that you paid. When the company pays the premium, it is a deductible expense. But if you subsequently collect on the policy, it would be taxable. This arrangement would also be subject to nondiscrimination rules.

For retirement plans, if you are more than twenty years older than other company employees, consider a **defined-benefit plan**. The amounts saved for retirement for the employee/owner will be much larger than the amounts saved for other employees. This is because you are funding a particular retirement amount and are closer to retirement than the other employees. Employers with retirement plans in place can provide tax-free retirement services. The tax-free services are not limited to information about the company's retirement plan, but also apply to advice about retirement income and how the company's plan fits the employees' needs.

RETIREMENT

TRADITIONAL IRA: The annual maximum to contribute to a traditional IRA account is \$5,000 per year or \$6,000 per year for those age 50 and older. These are the limitations for 2010. To contribute the maximum into the IRA, you must have at least that much of earned income for the year. If you do not have any earned income or just don't have enough earned income, you are allowed to work off of your spouses earned income to qualify for a spousal IRA. All of the above scenarios have adjusted gross income limitations where your IRA deduction will be phased out and then completely eliminated. These limitations are different based on your marital status, whether you or your spouse contributes to a retirement plan at your place of employment, and your total adjusted gross income. Refer to the charts in the back appendix for the exact threshold limitations. When changing jobs rolling over an existing employer's retirement account into a regular IRA may or may not make sense.

Rollovers will allow you to maintain the tax deferral aspect of the account while gaining control over your money. After the money has been transferred to the IRA account it may be advantageous to convert the account to a Roth IRA, depending on your level of income. When you convert, you pay the deferred tax in the year of conversion, and eventually receive tax-free money when you start withdrawing from the Roth IRA. The Roth IRA has its own set of rules as you will see in the next section. Rolling the money over when you need the cash is a mistake. You should take the money now in a lump sum. If you were born before 1936 a special ten-year averaging method is available which will reduce your tax.

After a rollover to an IRA, this special averaging method is lost. Also, rolling over when you have outstanding plan loans is a mistake because you must repay the loans before the rollover can be made. This will reduce the amount you have remaining in your IRA. Another reason not to rollover into an IRA is the possibility that your plan may permit loans; which leaves the door open in the future for possible loans. Once in your IRA account, you will not be permitted to take loans. Rolling over if you need creditor protection is a mistake. Money in your retirement plan at work is generally protected from creditors. Depending on your state of residence, your IRA may not be protected. Check your particular state before you make any type of rollover. You may not want to rollover money from your employer's plan into an IRA if you are between the ages of 55 and 59 $\frac{1}{2}$. Withdrawals from plans before the age of 59 $\frac{1}{2}$ are generally subject to an additional 10% penalty.

One exception to this is if you were at least 55 in the year you left your employment. It would be better taking a withdrawal out of the company plan than the IRA account. Rolling over appreciated company stock may be a big mistake. If you roll over company stock with a high appreciation, you may be forfeiting a huge tax break. The strategy that should be utilized is the withdrawal of the employer shares while rolling over the balance to the IRA. You will owe tax now, but only on the value of the company stock at the time it was contributed. The unrealized appreciation will be taxed when and if you sell the company stock at capital gain rates, which could be as low as a 5% federal rate. If company stock inside a plan is valued at below the contributed value, don't take an immediate distribution. You will pay ordinary tax rates today and have a capital loss when you sell. If your plan includes any after-tax dollars, do not roll these over. You can

usually withdraw the after-tax amounts without any tax or penalty to pay.

One mistake to avoid when rolling over into an IRA is taking the distribution directly from your old employer then turning around and rolling the money over. When you take the distribution directly, your employer will be required to withhold 20% of the total in federal tax withholdings. This means you only have 80% of the account to rollover. If you don't have access to other funds, you will end up paying taxes on that 20% of the total account. The best way is a trustee-to-trustee transfer. You never see the money and your employer doesn't withhold any taxes.

ROTH IRA: The maximum amounts you are allowed to contribute to the Roth IRA are the same as the traditional IRA amounts. The qualifications, however, are different. There is also a distinction between a Roth IRA and a Roth Conversion IRA. They both have slightly different rules. You are allowed the full contribution if your Adjusted Gross Income is equal to or below \$105,000 for single taxpayers and \$167,000 for joint taxpayers. If you converted a prior IRA to a Roth and then your account value decreased, your best action would be to reverse your conversion. Upon the conversion of the IRA to a Roth IRA, you pay tax based on that value. If that value goes down, in a sense you have paid taxes on something you no longer own. When you reverse your conversion you avoid the tax.

You can re-characterize a Roth conversion to treat it as though it never happened. This can be done as late as October 15th of the following year in which the conversion took place. The ability to revoke a conversion is a can't-lose proposition. If the value goes up you retain your conversion and have a tax-free build-up of gain.

If the value goes down, you revoke the conversion and you have not lost anything. If you have losses from investments inside a traditional IRA funded with non-deductible contributions or a Roth IRA, it might be possible to deduct them on your tax return. The potential deductible loss is the value of your IRA investment minus your basis in the plan. The basis is the amount of non-deductible contributions made to the IRA. Losses in a traditional IRA made with deductible contributions are never tax deductible. To deduct losses in the Roth IRA you must empty all of your Roth IRA accounts. Distributions are generally tax free, but a 10% early withdrawal penalty may apply if you are under the age of 59½. The difference between the value of all your Roth IRA accounts and your basis is your potential tax loss, but other obstacles must be overcome. The capital loss limitations of \$3,000 per year do not apply to Roth IRA losses. The loss is reported as an itemized deduction on schedule A, so you have to itemize versus taking the standard deduction to benefit from the loss. The category of itemized deductions thus falls in the miscellaneous itemized category which is first limited by 2% of your Adjusted Gross Income. As an itemized deduction, your loss is subject to the overall limit that reduces the total itemized deductions by 3% of the amount by which Adjusted Gross Income exceeds \$166,800 for single and married filing joint taxpayers, or \$83,400 for married filing separate taxpayers. These are 2009 limitations. Also, the IRA loss could trigger the Alternative Minimum Tax. It's likely to occur if the loss is relatively high compared to your other income.

SEP IRA: The SEP IRA is best suited for business owners who want simplicity, volatile profits and low employee turnover. The deadline for making contributions is the due date of the business tax return including extensions. The contribution is that of the employer. The deadline for establishing the plan is the due date

of the business tax return including extensions as well. All employees over the age of 21 who have worked for the employer any part of three of the past five years must be included. Any employee making less than \$450 per year does not have to be included. The employer is under no obligation to make a contribution, it is a year-by-year voluntary contribution. The annual maximum contribution is 25% of compensation, up to \$49,000 for each employee. The plan cannot discriminate toward the highly compensated.

SIMPLE IRA: The simple IRA has advantages that other retirement accounts don't offer. The key advantage is that there is no discrimination testing applicable. Business must have fewer than 100 employees to qualify for the SIMPLE IRA. It is best suited for the employer who wants to encourage employee savings but avoid costly administration. The employer-match obligation is very small compared to other plans, usually 3% of gross payroll, but only for those employees who choose to participate with at least a 3% deferral. **The good news** - even if no other employee participates the owners can still participate to the fullest extent. The plan must be in place by October 1st to qualify for the current year. The employer contribution match must be made by the due date of the owner's business tax return. Any employee who earned more than \$5,000 during any of the previous two years must be given the opportunity to participate. The annual maximum employee deferral for 2009 is \$11,500. Those over 49 can contribute another \$2,500. The accounts are immediately 100% vested. The only reporting required is that the employee must be given a summary plan and a contribution notice by November 2nd of each year. Each employee directs his/her own investment accounts. If you withdrawal money from a SIMPLE IRA before the age of 59½ in the first two years you participate

you will incur a 25% penalty along with the income tax liability. After two years the penalty goes to 10%. Rollovers from a SIMPLE IRA to a traditional IRA are not permitted in the first two years. Loans are not permitted from SIMPLE IRA accounts, as is the case with traditional IRA accounts. If you have family members on the payroll you can have your spouse and children participate in a SIMPLE IRA as well. If you have a modest income, the SIMPLE IRA will allow you to put away more because there is no percent-of-income limitation. **If you make \$9,000 you then can put that \$9,000 into the SIMPLE IRA account. That is 100% of your income.**

ONE PERSON 401(k): The one-person 401(k) plan is, naturally, perfect for a one-person/employee company. It is available to corporations, sole-proprietorships, and the self-employed whom have no employees other than themselves. To participate, the one owner/employee must be at least 21 years of age and have been established for one year with 1000 hours of service per year. Annual contribution from the employer is 25% of eligible payroll. Non-incorporated businesses have a maximum of 20% of compensation. Annual contribution by the employee is generally 100% Of compensation or \$16,500 whichever is less. For individuals 50 and older, the limit is \$22,000. Contributions are voluntary on a year-by-year basis. The plan must be in place by the end of the company's tax year, December 31st if a calendar year applies. The employer contribution must be made by the filing of the business tax return, including extensions. The employee's deferral from payroll must be accomplished by December 31st. The employer or the individual directs how the funds are invested. Loans are generally available through this type of plan. Employee amounts are vested immediately. Employer amounts can be vested immediately or vested over several years.

LIFE INSURANCE: After contributing the maximum amount to Roth IRAs, which is really a tax-free account, considering investing in a variable annuity life policy. There are no taxable income limitations to qualify and very few limits on the amount you can invest. To qualify for the tax benefits of a variable annuity life policy, a sufficient amount of insurance must be purchased. This is defined in the IRS code - your insurance agent will crunch all the numbers for you. With this account you direct your total investment among several sub-accounts, usually mutual funds. These policies usually offer a large variety of bonds and stock funds. You may also change your investment allocation during the year as well. No taxes will be due on this account as long as the money stays inside the policy. You can access the cash value of the policy without paying tax. When you want to withdraw money, you can first take out as much as your basis in the policy. Your basis is the amount you paid into the policy. Beyond that, you may withdraw tax-free loans against the cash value of the policy. Such a loan usually carries a very low interest rate but these loans reduce the cash value and the death benefit. At the end of the policy, your beneficiaries will benefit from a substantial death benefit. As you can see, a variable annuity life policy can provide tax-free retirement income with tax-free death benefits to your heirs.

Avoid letting your policy lapse - this could cause the account to become taxable. Once withdrawals begin, you may want to choose an automatic income option to have a check sent to you periodically without initiating new paperwork each time you want a withdrawal. Keep a close eye on your cash balance - you do not want to completely drain it. This type of policy offers flexibility during the years you are contributing money because the amounts can fluctuate year to year. This plan offers the valuable

protection to your family with the death benefit. Another possibility is to use your retirement plan to purchase life insurance with pre-tax dollars. A word of caution: usually self-dealing is prohibited by the IRS. As a plan sponsor you cannot enter into a transaction with the plan.

Some exemptions do apply which may allow you to accomplish this, but conditions must be met:

1. the plan must acquire the insurance policy for the lesser of the cash value or the participant's account balance
2. no lien or debt can be attached to the policy
3. the transfer must not conflict with the plan documents
4. the plan document must permit the purchasing of life insurance

Existing term policies can be transferred with no consideration since term insurance has no cash value. New policies can be simply purchased with plan dollars. If your qualified plan continues to pay the premiums of your policy, those payments will be taxable. The amount subject to tax is only the portion of the dollars used to buy the insurance. You'll pay a modest amount because the cost of term insurance is relatively inexpensive. Be sure to keep good records over the years. At some point in time, you may want to transfer the policy out of the plan back to yourself. The cash surrender value at that time will be the taxable amount. However, that taxable amount can be reduced by the amount you were taxed on over the years.

ANNUITY: Is your retirement going to last you during your golden years? According to the AARP, a fifty-year old person can expect to live for 30 more years. Consider an immediate annuity. This can pay you an income for life regardless of how long you live. For a joint married couple, an immediate annuity could last

as long as either spouse lives. A word of caution - decisions regarding immediate annuities are usually irrevocable, so great care should be taken when making such decisions. These are different than your usual annuity product. In a typical annuity you would pay premiums over several years. At a later point in time you would annuitize the policy for a set amount of money for the rest of your life. But an immediate annuity works a bit differently. There is no investment build-up in an immediate annuity. You give a lump sum upon buying the product and receive an income stream immediately. These can be a fixed amount or a variable amount which is tied to equity performance. When this is purchased outside of a tax-deferred account a portion of your income payment will be taxable. The portion above and beyond your initial contribution will constitute the tax-free portion.

Buying a single life annuity does come with risks. Upon death, payments cease. Upon immediate death, the estate would never receive a payment or any of the principal back. If this is a concern, consider a guaranteed annuity that will pay for a minimum number of years after your death. After your death a beneficiary will continue receiving the payments. An alternative is a joint-survivor annuity that would continue after death for the life of the spouse. The trade off for these two provisions above is that the monthly payment of income will be lower.

DISTRIBUTIONS: The distribution rules can become quite complex. Generally you can't withdraw money from a retirement account until you are the age of $59\frac{1}{2}$ or you face a statutory penalty assessed by the IRS of usually 10%. There are exceptions to this rule. At age $70\frac{1}{2}$ you are required to take out your minimum required distribution using the IRS table. Be sure that you consider the tax cost of your distribution when figuring how much you will need to live on. Look at your projected total income in

retirement, which will most likely include social security benefits - it could be anywhere from 50% to 85% taxable. If you are working part-time during your retirement and haven't reached the full retirement age for social security, which usually is at age 65, you will lose one dollar of benefit of every two dollars of wages you make over a prescribed limit. Distributions from retirement plans are taxable at ordinary income rates of which the highest is 35% in 2009. If you were born before 1936 and take a lump-sum out of your retirement account it will qualify for a special tax method called the ten-year-averaging method. **This method will lower your tax on the lump-sum distribution.**

Distributions from ROTH IRAs are tax-free as long as you are over 59½ years of age and the account has been in existence for at least five years. **The company retirement fund usually offers you choices upon retirement.**

1. A lump-sum could qualify you for the special ten-year-averaging method.
2. You could transfer the account into your IRA account. This enables you to manage your own funds and to keep the tax deferral running.
3. Or you could leave the funds in the employer plan.

Funds in a **qualified retirement plan** are protected from creditors. Money inside an IRA has only the creditor protection afforded by the state, which can vary greatly from state to state. Another decision when thinking about distributions is naming a beneficiary. Most people name individuals as beneficiary.

There are some instances that you may want to name a trust as the beneficiary. One such case would be leaving a large IRA account to a minor child or grandchild. In such a case you would name the trust as the beneficiary, then name the minor children as trust beneficiaries. The trustee of the trust will have the discretion to take money and distribute it to the beneficiaries. To name a trust as beneficiary you must have the following four elements present.

1. the trust must be valid under state law
2. the trust can be revocable during your lifetime but must be irrevocable after your death
3. the individual trust beneficiaries must be clearly defined
4. the trust documents must be provided to the IRA administrator

If these are in place, the balance of the IRA can be distributed over the life of the beneficiary. If there is more than one beneficiary, generally you use the age of the eldest. In the following circumstance, each beneficiary is allowed to draw over his/her life expectancy. Separate shares must be created in the beneficiary designation of your IRA. By September 30th of the year following your death each beneficiary must establish a separate account and use his individual life expectancy for a withdrawal rate. If those elements are in place then younger beneficiaries will enjoy decades of tax-deferred growth in their account.

Beginning in 2004, IRA custodians were required to report to the IRS which account owners are required to draw a minimum distribution. The custodian, before January 1st, must provide the IRA owners with either the required minimum amount or offer to calculate the amount upon request. The new regulations on

distributions may offer a tax shelter to those who inherited an IRA a few years ago. Under old rules, you had five years to distribute the entire IRA. The new rules would allow you to stretch out the IRA distributions if permitted by the IRA document. If you were, for example, age 65 you would have a 21-year life expectancy. So therefore you would have a 21-year period of withdrawals rather than five. The tax-deferral impact of 5 versus 21 years is huge. It is vital to name a beneficiary and also a contingent beneficiary. If you die without a named beneficiary the IRA will go to your estate and it will require a much shorter pay out period. Short falls in your required minimum distributions are taxed at a penalty rate of 50%, so **it is important** to calculate and draw out the correct amount. This 50% penalty also applies to inherited ROTH IRA accounts. During the account holder's life, there are never any required minimum distributions from a ROTH IRA account. After your death, the designated beneficiary will be required to withdraw minimum distributions based on his/her life expectancy.

CHILDREN

BABIES: There are numerous avenues to explore in this area. Put your **infant** to work as a model or actor in devising your company's advertising campaign. Infant children were allowed earned income up to \$5,700 before owing any tax for 2010. The next \$8,350 of income is only taxed at 10%. Above that level, to \$33,950 the income tax rate is 15%. Also, up to \$5,000 can be contributed to an IRA account. You can set up a trust for the baby. The trust instrument gives you more control than a custodial account. In a custodial account, the child becomes the legal owner at 21. The trust allows you to control the assets well beyond age 21 and to make distributions contingent upon events such as college. A custodial account may still make sense to some. Accounts covered by your state's uniform gift-to-minor's act will be owned by the child and in your control up to age 18 or 21 depending on the state. Any income generated by the account will be taxed on your child's tax return.

For kids under the age of 18, the first \$950 of investment income is tax-free. The next \$950 is taxed at 10%. Income above \$1,900 will be taxed at the parent's marginal tax rate. The above refers to 2010 parameters. The value of these accounts is considered owned by the custodians, therefore it is not a great idea for older grandparents to be custodians for the grandchildren. This is because there is a greater risk of being includable in an estate at an earlier time. For a better solution, the grandparent should gift the money to someone younger. For example, the parents who can in turn open a custodial account for their children.

When children own US savings bonds, consider reporting the interest income annually rather than at maturity. The chances are high that the baby will not owe any income tax year by year whereas he/she probably would owe tax if reported all at once at the end of maturity of the bond. File a return the first year a bond is purchased and every year thereafter to elect to report this income, even if the child is below the filing requirements. Do not forget to obtain a social security number for the baby at birth, which is usually accomplished at the hospital. Also, remember to update wills to name a guardian for your new baby. If a guardian is not named in your will, the courts will appoint one for you, usually a relative. If additional life insurance is purchased when you have a baby, consider having the policy issued into a trust for the benefit of the baby. This prevents the proceeds at your death from being included in your estate. You could set up this trust for the principal to go to the child, but have the interest going to your surviving spouse. This gives the survivor income for his/her lifetime without including the principal in the estate. You receive the full dependency exemption regardless of when the baby is born.

For 2010, this exemption amount is \$3650. When both parents work and hire a day care provider, they qualify for the child-care credit. Consider shifting S corporation stock into a child's name if it is producing little current income, but has a greater chance of future growth. This could also be placed into a trust for the benefit of the children. The appreciation will be taxed at the child's rate and the asset is no longer in the parent's estate.

SHIFTING: The easiest tax savings tactic is to shift income to lower tax brackets by hiring your children to perform tasks in your business. Wages of children under 18 are not subject to social security or medicare taxes if paid from an unincorporated

business. Earned income is not subject to the kiddie-tax rules. Each child can take the standard deduction of \$5,700 for the year 2010 completely tax-free. Each child can also contribute up to \$5,000 a year into an IRA account. **This total of \$10,700 of tax-free income is shifted to each child. The next \$8,350 and \$25,600 are taxed only at 10% and 15%, respectively.** These rates are far below the maximum individual rate of around 35%. These tax savings are even more when factoring in state tax savings. The IRA contribution is a great way to start your child at an early age with a retirement account. The tax courts have allowed children's wages for kids as young as seven years. It is important to pay a comparable wage as any other non-related party may receive. Keep detailed employment records for job descriptions and duties and time cards for hours worked. Such a deduction is not a priority issue for the IRS. Before hiring your child review your state or local labor laws and check with his/her school.

Another approach to shift income is to have children own assets that are used in the business. Real estate is a prime example. Rental payments made by the business are fully deductible. Payments received by the children may be taxed at a much lower tax rate. This can be efficiently accomplished through a pass-through entity such as a family limited partnership. This entity is created to own the assets. This entity leases the assets to your business. The entity's income and deductions are reported on the personal tax returns of the owners. Ownership shares can then be gifted to the children in certain increments to stay below the gifting thresholds. Discounting of gifts is often available in these situations to increase the value that can be gifted to your children. The 2009 annual exclusion for gifting is \$13,000. The discounting of value is usually because of the lack of marketability and the minor ownership shares, which have no

controlling interest. Joint gifts can be made to double the annual exclusion. Rental income is not subject to the kiddie-tax - major tax savings can result even for children under the age of 18. The asset also is removed from the business owner's estate, reducing possible estate taxes in the future.

Another approach to reduce taxes is by actually shifting the ownership of your business to children. The method here is to organize the business as a pass-through entity and to give the children a share of the ownership. Children over 17 can use their standard deduction and the lower 10% and 15% tax brackets to lower taxes. A series of annual gifts may accomplish the goal of not exceeding the \$13,000 exclusion. The original owner can gift the majority shares but still retain management control over the business. This is accomplished with an S corporation where the original owner owns voting stock while giving non-voting stock to the children. It is also accomplished if the entity is a limited liability company or a limited liability partnership. The original owner is the general/managing partner while the children are the limited partners. Make gifts of the business when the value of the business is low - typically during the first years after start-up. The value of the gift will be the fair market value; not the original start-up cost, otherwise known as the basis of the business. Gift before the value of your business escalates. Transfer stock to family members with a preferred stock re-capitalization. The owner transfers some common stock to the children and the remaining balance is exchanged for newly issued preferred stock with a face value equal to the fair market value of the balance of the common stock.

This creates no gifts or income tax if the following conditions are met.

1. The preferred stock is entitled to a cumulative market rate dividend. This is a dividend that if not paid when due will accumulate and is eventually paid.
2. The shares must be valued at the current market value.
3. The value assigned to the common stock must be at least 10% of the total value of the corporation. Refer to IRS code sections 2701 and 2702.

SELLING: Consider the following when selling a business to your children. If you want to keep your business in the family give it to your family members or hold onto it and let your family inherit the business. These may generate hefty gift or estate taxes. If you sell the business to your children, you can make preparations to provide retirement income and it may be taxed at only 15% if handled properly. The installment method of selling would make the payments manageable for your children and interest would have to be charged, but using the federal applicable rates would be rather low. Using the installment method would also help defer the capital gains over several years which could drive the capital gains rates even lower. The sale of your business would remove the value of your business from your estate as well as any future appreciation. As the seller, you must receive at least one payment after the year of the sale of your business. To receive capital gains treatment you may have to remove yourself from the business, otherwise the sale proceeds may be construed as dividends by the IRS and taxed as ordinary income.

This being the case, you may not be in a position of control after the sale of your business to your children. This restriction is generally found in a regular corporation. If your company is structured as an S corporation, you might avoid this problem. Another alternative is to sell to your children only non-voting shares in your S corporation and retain the voting common shares.

If you do this, part of the value of the business is out of the estate. In this situation you would be able to serve on the board of directors keeping control of the company. In a regular corporation or an S corporation if you die and part of the installment plan payments are unpaid, the value of the unpaid payments is still includable in your estate. To prevent this, you may want to sell your shares to your children on the installment method with a self-canceling installment note. If you die before all the installment payments are made, the remaining payments are cancelled and the remaining portion of the payments is not included in your estate. This will be challenged by the IRS if death occurs within a year of the sale. To obtain this estate tax break, your children should make concessions when negotiating the sale. Your children should be willing to pay a higher purchase price for the business or pay a higher rate of interest. The remaining payments would escape estate tax, but may be subject to capital gains tax. **Isn't it better to pay a 15% capital gains tax rather than almost a 50% estate tax?** The downside is if you survive beyond the term of payments, your children may have overpaid for the business.

A corporate redemption under code section 302 is also an available option. Under this section the corporation is permitted to buy your shares back, thus increasing the share of other stockholders. You must remove yourself from control, otherwise the redemption payments may be treated as dividends. No matter how you sell your business to your children, an independent appraisal should substantiate the selling price. If you sell below market value the IRS may construe the transaction as a partial gift. The terms must set each party's obligation and must be in writing. The bottom line is to have an arms-length transaction as though the two sides are unrelated and to be fair for both parties.

TAX CREDITS:

DEPENDANT CARE: The dependant child care credit is available for single-working families and married filing jointly working families. If you work and incur dependant care expenses, a credit is allowed for these expenses. To qualify you and your spouse must work and earn income during the year - a spouse is considered to have worked if he or she is physically or mentally unable to function without help. You must also maintain a home for the dependant and yourself. This means that you provide more than 50% of the costs to maintain the home. A qualified dependant is one who is under the age of 13. The dependant may not have more than \$3,650 of gross income for 2010. Your spouse would qualify as a dependant if mentally or physically unable to care for oneself.

The maximum expense allowed for the credit for 2010 is \$3,000 for one qualifying dependant and \$6,000 for two or more. The actual dollar amount of the credit depends on your adjusted gross income level. The credit percentage starts at 35% and goes down to 20% depending on the adjusted gross income. The definition of qualifying expenses is broad enough to include summer camp. The credit can apply if one spouse works and the other spouse is a full time student. A full time student is defined as one who is in school for at least 5 months during the year. Payments for dependant care services to family members may qualify, but be aware that it is taxable income to the recipient. Shifting tax dollars to lower tax brackets may be a beneficial tax strategy.

EXCESS SOCIAL SECURITY: If you worked two or more jobs in the same year and got paid by two or more employers you may be eligible for this credit. Each employer deducts up to limit for

social security taxes. If your cumulative earnings go beyond the total limit, you have overpaid your social security taxes. If so, claim the overpayment as a credit on form 1040. Even if you owe no other taxes, this amount will be refunded to you.

CREDIT FOR THE ELDERLY AND DISABLED: This credit targets those elderly over 65 and disabled whom do not receive a social security benefit. In this way the credit attempts to help place all elderly on the same level. The maximum base amount is \$7,500 for a married filing joint return, \$5,000 for a single return, and \$3,750 for a married filing separate tax return. The base amount is reduced by pensions and annuities received plus one-half of the adjusted gross income over \$10,000 for joint returns, \$5,000 for married separate returns and \$7,500 for single tax returns.

CHILD TAX CREDIT: For each dependant child under the age of 17, you may be eligible for a credit in the amount of \$1,000 for 2009. A child includes a son, daughter, grandchild, stepchild, or a foster child who qualifies as a dependant. Part of the credit is refundable, regardless of your tax liability. A return must be filed to claim the credit.

EDUCATION CREDITS: Education expenses for yourself, your spouse or your dependents qualify for the credits. There are two credits for which you have a choice - the Hope Credit and the Lifetime Learning Credit. The Hope Credit is applicable for the first two years of college education costs. The Lifetime Learning credit is applicable for any higher education. The amount of the Hope credit is \$1,800 maximum. The amount of the Lifetime Learning credit is 20% of the first \$10,000 of college costs. Certain limits do apply to qualifying for either credit. The adjusted gross income phase-out range for single taxpayers is

from \$50,000 to \$60,000. The adjusted gross income phase-out range for married taxpayers is from \$100,000 to \$120,000. Your child can claim the credit on his return even if you paid for the expenses, as long as you waive the dependency exemption for the child. You need to weigh the dependency exemption with the value of the credit. Your child would need taxable income for this strategy to work, because the credit is non-refundable. The Hope Credit amount is per child, whereas the Lifetime Learning Credit amount is the aggregate total for the tax return. To qualify for the Hope Credit you must be at least a half-time student. There is no such requirement for the Lifetime Learning Credit. Don't overlook taking the Hope credit for one dependant and the Lifetime Learning Credit for other dependants.

ADOPTION CREDIT: The tax law allows for a credit up to \$10,160 of eligible adoption expenses for the tax year. The full credit applies even if the full amount is not expended for special needs children. For expenses paid in any year before the adoption becomes final, take the credit in the year after the year of payments. If the expenses are paid in the year the adoption becomes final, take the credit the year the adoption became final. For expenses paid in any year after the adoption becomes final, take the credit in the year the payments are made. These rules are for adoption of U.S. Citizens. Foreign adoptions can be different - you may claim the credit even if the adoption falls through. You cannot claim the credit for adopting your spouse's child.

401(K)/IRA: This credit can be claimed in combination to the tax deduction of the IRA or 401(K). The credit is based on your adjusted gross income level. It ranges from 10% to 50% of contributions up to \$2,000 per person. The highest credit is \$1,000 per person. On a joint return, no credit applies if your

adjusted gross income is over \$50,000. On a head of household return, no credit applies if your adjusted gross income is over \$37,500. On a single return, no credit applies if your adjusted gross income is over \$25,000. The credit cannot be claimed by a full-time student - anyone under the age of 18 or anyone who can be claimed as a dependant on another tax return. The credit is reduced by any withdrawals during the current year, two prior years, and the following year.

EARNED INCOME CREDIT: Certain low-income taxpayers are entitled to this credit, which is refundable. The amount of the credit depends on whether the taxpayer has one, more than one, or no dependants. The program was designed for low-income taxpayers with children. A modest credit also applies for low-income taxpayers without children. Any dependant who lives with you for more than half the year allows you the higher credit. The dependant doesn't have to be your child. Failing to file a return to obtain the credit, even if you are not required to file a tax return is a common mistake. The credit is refundable, so file the tax return for no other reason than to claim your credit.

WORK OPPORTUNITY CREDIT: This credit is generally equal to 40% of the first \$6,000 of qualified wages paid to members of a targeted geographical group. Thus, the maximum credit is \$2,400. No credit is allowed unless the individual is employed for at least 120 hours in the first year.

WELFARE TO WORK CREDIT: This credit is 35% of the first \$10,000 of eligible wages paid to recipients of long-term family assistance in the first year of employment and 50% of the first \$10,000 of wages paid in the second year.

BUSINESS DEDUCTIONS

TRAVEL: Write-off the actual costs of business travel only if a record of all expenses is maintained. If you maintain less detailed records, write-off your business travel using the **IRS per-diem rates table**. Deductions are allowable for each day you spend out of town on travel - **receipts are not required**. If it's the case of an employee reporting expenses to an employer, the employee doesn't need to bother with receipts and the employer can deduct the costs based on the per diem rates. The employer needs an **accountable plan** in place where the employees submit for reimbursement based on the number of days away. These amounts are not subject to employment taxes. The basic rate is \$85 but changes based on locality. The highest per-diem rate is \$258 per day for Manhattan. For simplicity you can use the high-low substantiation rates as published by the IRS. This will avoid having to track several rates for different cities. This method would allow the use of only two rates - a high-cost-area rate of \$204 and an all other area rate of \$125 per day. These tables also give a rate for meals and incidental expenses, so again there is no need to save receipts for meals and entertainment. The table gives you a rate for lodging and for meals and incidentals.

Since 2003, the meals and incidental rates no longer include items such as laundry, dry cleaning, lodging taxes, telegrams, and telephones. So these expenses, with receipts as the proof, can be added to the per-diem rates. Remember you may still use your actual costs if they exceed the per-diem rates, but you must have the receipts to prove them. To deduct travel expenses the taxpayer must be away overnight from his tax home. The definition of overnight is literally to stay/sleep away from home for at least one night. This overnight rule requires more than

just a pause in your schedule or a meal break. In order to be away from your tax home, we must define tax home. It is the taxpayer's principal and regular place of business - in other words it is where the taxpayer works.

Under travel expenses, include costs incurred on the items listed below:

1. *air, train, bus, personal car, taxi, house trailer*
2. *telephone*
3. *gratutities*
4. *cleaning and laundry*
5. *transportation from eating to sleeping*
6. *meals*
7. *baggage handling*
8. *public stenographer*

The tax law does allow you to combine a business trip with a vacation. The IRS concedes that you are entitled to a deduction for a business trip if it enhances and benefits the business. There is no reason that while on a business trip you can't enjoy a vacation as well. Also, if the business purpose can be substantiated, the expenses of your spouse can be deducted, but it has to be in the course of your spouse's employment. Your spouse must be a bona fide employee of the company to qualify as a deductible business expense. The trip however has to be primarily for business versus pleasure. If the trip is primarily for pleasure, the transportation costs are not deductible. Therefore, the number of business days must exceed the pleasure days. If you spend 5 days, at least 3 of those days must be business to qualify as primary.

Special rules apply for travel outside the United States. You must allocate your expenses based on the amount of time spent on business versus pleasure. If you stay for a week and stay through the weekend to take advantage of the lower airfares, your lodging and meals for those extra days are considered business days and are deductible.

If the purpose of a trip has a charitable intent, you can deduct your costs as an un-reimbursed volunteer expense. This is claimed as a charitable contribution on form 1040 schedule A. When you take courses to maintain your job skills you can deduct any traveling costs involved as well as the cost of any courses or fees. If you suffer from obesity or any other medical condition that requires you to travel, the traveling expenses are allowed as a medical deduction on schedule A of itemized deductions. Remember - to claim a medical deduction you must exceed 7.5% of your adjusted gross income.

VACATION HOMES: By the renting out your vacation home you can cover some of the expenses. If rented for fewer than 15 days, the rent is not considered taxable income and can be rented to your own company for an executive meeting or an employee picnic. It is a deduction for the company and **tax-free to you**. Be sure you use a fair market rental rate. The only deductions allowed are mortgage interest and property taxes. If it is rented for 15 days or more the rules become quite complex. If the vacation home is used less than 14 personal days it is considered rental property. If the personal use is more than 14 days but less than 10% of the rental days it is considered a rental property. If your vacation home is classified as a rental property based on the above rule, it is possible to lose some of your mortgage interest deduction.

An example would be as follows: you use your vacation home for 30 personal days and rent it for 335 days you would have 92% rental activity and 8% personal usage. That means that 92% of your deductions are deductible against your rents, which includes your mortgage interest deductions. If rented for only 14 days - a full deduction for the mortgage interest on your schedule A would be granted. You are allowed to deduct interest and property taxes on your primary residence plus a second home. If you have two homes the decision would be how to classify the second home - a rental or a secondary residence. If you have more than two homes then the decision is really which one to rent out and which one to keep as a second residence. If your second home is classified as a residence then you will be able to deduct the mortgage interest and real estate taxes, but not any operating expenses such as repairs and insurance. As a rental you may deduct all your expenses including depreciation as long as you subtract any personal portion. You are allowed to deduct active rental losses up to the amount of \$25,000 as long as your adjusted gross income is below \$100,000. As your adjusted gross income exceeds \$100,000 your loss allowed would be phased out proportionately until you reach \$ 150,000 where it is phased out completely.

Losses not allowed are carried forward year by year to offset future rental income. If there are still losses when the property is sold, they may be utilized at that time. Even if the vacation home qualifies as a rental property, your rental losses may still not be deductible. If the average rental period is less than seven days, losses are not allowed. IRS regulations prohibit the deduction of the passive losses if you violate the seven-day rule. The best strategy is to limit your rental to full 7 day week periods without exception. This will assure that this technicality won't cost the tax breaks a rental affords you. To deduct the

losses from renting your vacation home, it has to be proved that you were attempting to make money. Activities not aimed at making money will be deemed a hobby by the IRS and will not be deductible. It may be beneficial if your vacation home can show a net profit from time to time because there is a presumption in the tax law that if a profit is shown in one year out of five your business is not operated as a hobby. If you just never show a profit you can still show your rental activity as a business, not a hobby, by keeping good accounting records of attempting to make a profit. After all, not all businesses make a profit, but all businesses try to make a profit. Instead of selling your vacation home consider a like-kind exchange when it is considered rental property. A like-kind exchange can defer taxes while your basis is carried forward.

Another strategy is to sell your personal residence and move into your vacation home making it your new personal residence. If you live there for 2 full years sell the home as your personal residence and **exclude up to \$250,000 if single or \$500,000 if married filing jointly**. The only amount you would have to include in income is some of the depreciation deductions you took over the years, which would probably be far less than your actual gain.

VEHICLE EXPENSES: Automobile expenses incurred in conducting your business are deductible whether they occur away from your business home or even when you are not away. To get the deduction here you must establish a connection between the auto use and your business or income producing activity. If the auto is used for business and personal use, allocate the expenses and deduct the part that is attributable to the business. In allocating your car expenses there are two main methods to which

to subscribe. The first simple method is known as **the mileage cost basis**. To use this method multiply your total business mileage by the standard mileage rate established by the IRS. The standard mileage rate for 2009 is 55.0 cents a mile. In addition to this total any parking and toll expenses, interest on a car loan and taxes can be deducted. Only the business percentage of these expenses is allowed.

The standard mileage rate is not available in the following circumstances:

1. use of a car for hire, such as a taxi
2. operating two or more cars at the same time, that is a fleet operation
3. if you have previously taken the section 179 one-time write-off on the vehicle previously
4. if you previously used an accelerated depreciation method on the vehicle

The second method is taking actual expenses on the vehicle which include repairs, maintenance, insurance, car washes, interest, taxes, tolls, parking, licenses, gas, oil and depreciation. Only deduct the business percentage of all your vehicle expenses based on the allocation of your business mileage to your total mileage for the entire year. If you have more than one car, proper tax planning is required to compute which car would net the greater tax benefit. There are also avenues to explore in making both cars partially deductible for business when attempting to maximize your tax benefit. **A taxpayer cannot usually deduct commuting mileage.** If you have a regular place of business deduct the mileage from that regular place of business to temporary places of business. A temporary place of business is any location at which the taxpayer performs services on an irregular or short-term basis. A regular place of business is

where business where the taxpayer works on a regular basis. If the taxpayer's regular place of business is at an **office in the home**, every mile from home to various clients until he/she returns home is deductible. The key is to qualify for the office in the home and having no other place to work.

Before buying a new car decide who will hold title to the vehicle. The vehicle can be titled in your name personally or can be titled in the business entity under which you operate. If you own the car personally you will report your outlays for the business use of your personal vehicle. You will be paying the expenses out of pocket and submitting receipts to the company/employer for reimbursement which is tax-free. The company then claims this as a deduction. Any un-reimbursed business expense can be claimed as a miscellaneous itemized deduction. It will be necessary for the company to have formal accountable plan in place. This will require an accounting to the company for the business expenses for reimbursement. Any excess reimbursements must be returned to the company. If an **accountable plan** is in place, the reimbursements will be tax-free. If your company owns the car, the company pays for the car and takes full deductions and pays for all expenses year by year. In turn you calculate your personal usage and pay tax on some imputed income. If the company owns more than one car it may be able to obtain a lower insurance rate. Also, the company may be able to negotiate better financing terms. Your company would show the asset on its financial statement.

Should you or the company lease or buy? If your company leases the car, it will deduct the lease payments when paid. Some taxable income must be imputed on the personal usage of the vehicle. Generally this imputed income, which is modest, would be based on the value of the car. If you lease the car personally,

deduct the business percentage of the lease payments as well as that percentage of your various expenses for gas, insurance, etc. If either you or your company own a vehicle, depreciation deductions would be allowed. Special depreciation rules would allow a big deduction in the first year, however there are limitations. The so-called luxury limitations could lessen your deductions. Depending on the price of the vehicle and the financing terms leasing may provide a greater tax benefit because of these limitations.

Some non-tax issues that come into play are that a lease might be the better choice if you plan to trade in the car every few years or buying might make sense if you tend to keep a car for several years.

Some facts and figures for mileage rates for 2010 are as follows:

1. business travel - 50 cents
2. charitable - 14 cents
3. medical and moving expense - 16.5 cents

The usual luxury vehicle rules vary. Any car with an original cost of more than \$15,300 is classified as a luxury vehicle. First year depreciation is limited to \$2,960, second year is limited to \$4,800, third year is limited to \$2,850. For each year thereafter until fully depreciated the annual depreciation is limited to \$1,675. Code Section 179 expense election is generally not available for luxury vehicles.

Exceptions to the luxury car rules:

1. ambulance
2. hearse
3. vehicles used by the taxpayer directly in a trade or business such as a taxi

limo, or delivery truck

4. vehicles over a gross weight of 6000 pounds

The general method for depreciating automobiles with a greater than 50% business use is the MACRS 200% declining-balance method over 5 years. You may elect the five-year straight-line method to avoid recapture of excess depreciation if the business use drops below 50%. You may elect the 150% MACRS declining method to eliminate any potential AMT adjustment. For non-luxury vehicles, you may elect the special section 179 expense election. **The total cost of business assets that may be deducted under Code Section 179 for 2010 is \$134,000.** For autos with less than 50% use, the alternate MACRS straight-line 5 year method must be used. The special section 179 election is not available. A taxpayer may claim a current deduction of up to \$2,000 for clean-fuel vehicles placed in service or up to \$10,000 for trucks or vans over 10,000 pounds. Three vehicles that qualify are the Toyota Prius (2001 - 2003), the Honda Civic Hybrid (2003), and the Honda Insight (2000-2003). Also, the luxury rules are lifted for electric clean-fuel automobiles.

In 2001 a special first year bonus depreciation provision was established in the amounts of 30%. In 2003 a special first year bonus depreciation provision was established in the amounts of 50%. This still applies for tax year 2004, but is set to expire as of 1/1/2005.

MEALS & ENTERTAINING: You can have the IRS pay for part of your business meals and entertaining. In order to deduct any expense for meals and entertainment you must have a receipt for or other documentary evidence for any expenditure over \$75. The deductible portion of your meal and entertainment expenditure is 50%. The custom of entertaining business clients

or potential clients will be deductible if they meet the requirements of an ordinary and necessary expense. No deduction is allowed unless the taxpayer can prove a direct business relationship and a clear business purpose. It is recommended that a journal be kept of your meals and entertaining that includes the cost, where you dined, who was entertained, and the business that was discussed.

The taxpayer can pass the directly related test if the taxpayer had more than a general expectation of deriving some business benefit, actively engaged in the business discussion or the principal aspect of the meal was the active conduct of the taxpayer. **Some meal and entertainment expenses are 100% deductible.** These includes:

1. expenses treated by the employer as compensation to the employee
2. expense reimbursements made under an accountable plan
3. recreational or social activities provided by the employer
4. expenses for goods and services made available to the general public such as promotional tickets
5. expenses related to the ticket package costs for sporting events arranged primarily for the purpose of a charity
6. overtime meals provided to employees

You can entertain guests at a social or athletic club, theatres, sporting events, fishing or hunting trips, or on a yacht. The IRS might consider some of these places to be too noisy to actually conduct business. Nevertheless, you can still take the deduction as long as you comply with the **associated test**. Under this rule a deduction is permitted for entertainment that occurs before or after a business meeting/discussion. The entertaining does not have to be on the same day as the business discussion as long as you can show why it wasn't on the same day. If your spouse or

that of your business associate joins in, 50% of the total bill will generally be deductible. **Again, keep a detailed log of your entertaining.** Keep this log current, because trying to recreate it later will draw skepticism from the IRS.

CHARITY: If the economy has hurt your pocketbook to the degree that you have scaled back your charitable giving, there are other ways to support important causes. Some credit card companies have charitable rebate programs. Merchants who participate return a percentage of what you charge to the credit card company and donate it to charity, which is usually limited to the choice of charities given by your credit card company. The rebate is not taxable to you and the portion donated can be claimed as a charitable contribution as an itemized deduction. You take the deduction in the year that your credit card company transfers it to the charity. Ask your credit card company for the necessary paperwork to elect this option. You can donate the market value of used cars, clothing, household furniture, appliances, and anything else that you would like to donate to charity. Prepare a list of every item that you donate, because the charity usually won't prepare one - retain this list with your estimated market value to support your deduction. Request a written receipt from the organization, it will always provide a statement that a donation was made on a certain day without itemizing it.

On your tax return complete form 8283 for non-cash contributions. When valuing your car donation go to www.kbb.com to determine the Kelly Blue Book value. You will have to consider your car's mileage and condition. If the value is beyond \$5,000 you must have an independent appraisal of the vehicle. The cost of the appraisal is also an itemized deduction reported as a miscellaneous deduction limited by the 2% threshold. If the

organization sells the vehicle without performing a significant intervening use, the deduction is limited to the gross proceeds of the sale.

With real estate values escalating, making a gift of real estate to a charity may benefit you as well as the charity while escaping the capital gains tax. The deduction for real estate owned for more than a year is based on the property's fair market value. Donations of real estate without a mortgage can be made through a **charitable remainder trust**. This is a trust in which the donor retains the income stream for life. Typically, the trust will sell the property and invest in income producing-property to create an income stream to you for life or for a set number of years. After which the remaining assets are turned over to the trust. In the year of the donation you receive a deduction, which is reported on the itemized schedule for the present value of the gift. This is determined by using IRS tables. In donating artwork, to maintain the deduction, the item of art must be used for the charity's tax-exempt purpose. A prime example would be a museum. Make certain that you hold the piece of art for more than one year before making the donation. If you do not, the deduction is limited to the cost of the piece, not the appreciated value. If valued over \$5,000 you must obtain a certified appraisal of the item.

Any out of pockets expenses for volunteer services is also allowed as a charitable contribution deduction. Traveling expenses are deductible when associated with a charitable event. You can establish a private foundation, which will cut your tax bill. Then use the tax savings to really help the cause to which you are close. As a side effect, you may unite family members and gain favorable publicity for your business. You may be able to leave

more to your heirs than they would have received by not making gifts at all.

A private foundation is a charitable organization that you fund and operate with a board of directors, which can be family members. The after-tax cost of funding this foundation can be much lower than you may realize and the tax savings can be used to fund wealth replacement life insurance that benefit your heirs. The proceeds of the life insurance will be equal to or greater than the assets your heirs did not receive because of the gift to the foundation. The best asset to use to fund such a foundation is a **tax-favored retirement plan** such as an IRA or a profit-sharing account. That is, because these assets are subject to income tax and estate tax upon the owner's death. **This double layer of tax can reach up to 80%.** A private foundation would avoid this. For example, you have an IRA account worth \$100,000. **Income and estate taxes at death could erode this down to \$30,000.** In high-income tax states, this number will be even lower. If you create a private foundation and make it the beneficiary of your IRA account, there will be no income or estate taxes upon your death. Upon death your foundation will have \$100,000 for its charities. For you heirs, when you establish the foundation it can also create a life insurance trust and fund it with a life insurance policy. In the above example you would want a death benefit of at least \$30,000. The trust could then receive the policy death benefit proceeds at your death with no tax liability. The beneficiary of this trust would be the family member who would have been the beneficiary of the IRA. This would make him/her whole, with a cost of much less. The cost can be even less if you buy a second-to-die policy with your spouse.

You can also make cash or property gifts to your private foundation and receive an immediate tax deduction. The deductions for appreciated property to a private foundation cannot exceed 20% of your adjusted gross income for that tax year. Excess amounts can be carried over to future years. Deduction of cash to a private foundation is limited to 30% of your adjusted gross income. Excess amounts can be carried to future years. A family foundation can help promote family cohesiveness by having members of the family working together. Family members may serve on the board, help manage investments, direct the foundation's purpose, or help select the beneficiaries. An annual meeting that brings the family together to elect the board of directors can involve the entire family. Family members who perform services for the foundation can be compensated a reasonable salary. A private foundation can provide favorable publicity and influence in the community, which may be beneficial for a family business. The **cost of establishing a private foundation is not great**. It can be as low as a \$150 filing fee plus a \$250 annual filing fee, but legal fees will also be involved. The law requires a foundation to distribute at least 5% of its proceeds to charity each year. With good investment returns, the foundation can grow in size indefinitely.

EDUCATION: There are various IRS code sections to provide benefits for education related expenses.

Section 117 - exclusion from tax for scholarships, grants, fellowships

Section 127 - employer provided education assistance

Section 132 - working related fringe benefits

Section 162 - ordinary and necessary business expenses

Section 222 - higher education expense deduction

Section 221 - student loan interest deductions

Section 135 - education savings bonds interest exclusion

Section 530 - education IRA accounts

Section 25A - Hope and Lifetime Learning credits

Section 529 - qualified state tuition programs

Section 62 - the educator expense deduction

Education expenses are deductible if incurred in maintaining or improving employment skills, or if required to maintain your employment status. Qualified expenses include cost of tuition, books, supplies, and transportation and fees. Student loan interest is allowed up to \$2,500 as a deduction from gross income. This deduction is proportionately reduced as your income goes from \$100,000 to \$130,000 for married filing joint taxpayers and \$50,000 to \$60,000 for single and head of household taxpayers. These phase-outs are adjusted annually for inflation. The higher-education deduction is an above-the-line deduction which means you that it does not have to be itemized. This deduction is based on your adjusted gross income.

The limits for 2010:

1. for married filing joint the deduction is \$4,000 if adjusted gross income is below \$160,000
2. for single, head of household, and married filing separate the deduction is \$4,000 if adjusted gross income below \$80,000

You cannot claim this deduction in the year you claim an education credit. Your dependant cannot claim this deduction. If your child pays some of his/her tuition, that child cannot claim the deduction if you claim him/her as a dependant. Only college level and above qualify for this deduction.

A taxpayer who redeems qualified US Savings bonds may exclude the interest from the redemption form income up to the amount of the qualified education expenses. These expenses include tuition and fees for college level and beyond for the taxpayer, spouse, or dependant. The bonds must have been issued after 12/31/89. The taxpayer must have been at least 24 years old before the purchase date of the bond. The bond must be in the name of the taxpayer or spouse, not in the name of the child. This exclusion is phased-out for married taxpayers with an adjusted gross income of between \$104,900 and \$134,900. This exclusion is phased out for single and head of household taxpayers with an adjusted gross income of between \$69,950 and \$84,950. **Qualified state tuition programs** are offered by each individual state, of which each can vary.

The key features to most of these plans are as follows:

1. there is no adjusted gross income limitations
2. distributions are excluded from income tax of the beneficiary and the contributor if used for qualified education at the college level and beyond
3. the contributor retains control over these assets until distributions are made
4. the contributor has control over when distribution are made
5. the contributor has control over the amount of the distributions

Maximum contributions vary greatly with many states allowing as much as \$250,000. Some states allow an additional state tax credit or deduction. Non-qualified distributions, those not used for qualified education costs, are taxable to the contributor. A penalty is assessed unless the withdrawals are made after death of the beneficiary or because of obtaining scholarships or other

educational assistance. Only the administrator is allowed to make the investment decisions, not the contributor. Any contribution is eligible for the \$13,000 gift tax exclusion. A special election may be made to take the contribution prorated over 5 years. Anyone can contribute on behalf of a beneficiary. The beneficiary can be changed to other family members if that particular beneficiary does not go to college or need the funds because of scholarships.

Education IRAs, also known now as a Coverdell Education Savings account, is limited to a contribution of \$2,000 per year per child. It may be used for tuition, fees, tutoring, special needs services, books, computers, room and board, uniforms and transportation for grade school and beyond for any beneficiary under the age of 18. It is phased-out for married taxpayers with adjusted gross income between \$190,000 and \$220,000. It is phased-out for single and head of household taxpayers with adjusted gross income between \$95,000 and \$110,000. Anyone may contribute if under income limitations. Therefore, if you don't qualify, a grandparent may contribute if below the limitations.

Employer provided assistance programs could provide employees with up to \$5,250 per year for qualified educational expenses. These expenses include tuition, fees, books, supplies, and equipment related to college level and graduate level. The courses do not have to be job-related. There would be no limit placed for courses that are job-related. The employer would be allowed to pay for this and deduct 100% of the costs. It is treated as a work related fringe benefit. Out-of-pocket expenses such as transportation would qualify as well.

Scholarships, fellowships, and grants are generally tax-free if used for tuition, books or fees by a degree candidate at an educational institution. The Hope Credit applies to tuition and

fees for the first two years of college. It is limited to \$1,800 per year. This is a per-person limit. The Lifetime Learning Credit is 20% of the first \$10,000 of tuition and fees for the tax year 2004. This credit is not limited to just the first two years. This is a per-return limit. The same income limitations apply to both of these credits. For a joint return the phase out is between \$100,000 and \$120,000 of adjusted gross income. For single or head of household the phase out is between \$50,000 and \$60,000 of adjusted gross income.

These credits can be claimed by either the parents or the child regardless of who actually pays the expense, but the parent must waive the dependency exemption for the child to enable the child to claim the credit. Payments made directly to educational institutions on behalf of someone else are treated as tax-free gifts and aren't limited to the usual gift exemption of \$12,000 per person per year. This applies to tuition at any level. A taxpayer may not take both credits for the same student in any one year. However, the taxpayer can still qualify for both credits if there is more than one child in college.

Eligible educators qualify to take an **above-the-line deduction of \$250**. An eligible educator is a teacher, instructor, counselor, principal, or aide who works at least 900 hours a year. Qualified expenses include un-reimbursed expenses paid on books, supplies, software, computer equipment, or other supplementary materials.

MEDICAL: There is an extensive list of expenses that qualify for an itemized medical deduction. Remember that to claim a medical deduction your total expenses must exceed 7.5% of your adjusted gross income. With a little planning you can bunch income and expenses in opposite years to claim a higher medical deduction. The following is a substantial listing of qualified

medical expenses: Acupuncture, ambulance service, apartment rent, artificial teeth, wheelchair cost, hospital care, elastic stockings, crutches, education aids, lip-reading costs, automobile expense, communication costs, birth control, Braille books, capital expenditures in excess of increase in market value of home, dental care, lab services, contact lenses, eyeglasses, prescriptions, central air conditioner, massages, meals and lodging if out of town for medical treatment, hearing aids, guide dogs, medical premiums, long term care insurance, guide for a blind person, medical transportation, medicare premiums, x-rays, remedial reading, paint removal, organic foods, elevator, nursing services, nursing home costs, oxygen equipment, doctors' fees, reclining chair, retirement homes, school for the handicapped, sex therapy, stop smoking programs, special diets, home for the mentally retarded, swimming pool costs, specially designed cars, telephone equipment, tutoring fees, prosthetic devices, prescribed vitamins, handrails, infertility services, physical therapy, chiropractic care, contact lens supplies, alcoholism treatment, wheelchair cost, Christian Science practitioner, drug addiction treatment, home care, legal fees, learning disabilities, medical conferences, operations, optometrist, psychiatric care, television for hearing impaired, sterilization, and weight loss programs.

MISCELLANEOUS ITEMIZED: Expenses that fall into this category of itemized deductions are limited to deducting only the amounts that exceed 2% of your adjusted gross income. The strategy here would be to bunch your deductions on an every other year basis in an attempt to surpass the 2% limitation.

An extensive list of expenses that fall into this category follow:
attorney fees that are used to produce income
attorney fees for estate tax planning services

accounting fees for estate and income tax planning services
tax preparation fees or software
bad debts
bar and cpa exam fees
gambling losses to the extent of gambling income
job hunting expenses
tax litigation costs
uncollectable loans
advertising and auditing expenses
bookkeeping services
collection of rent cost
custodian fees
damage paid on a breach of contract lease
depreciation on furniture and buildings
exchange of asset losses
interest
utilities
investment counseling
fire insurance
legal expenses
licenses, taxes and fees
management expenses
mortgage foreclosure losses
moving expenses of machinery and equipment
protection services
janitorial services
waste removal costs
salaries
safe deposit boxes
traveling expenses

Unreimbursed employee business expenses also fall into this category.

This would include the following:

automobile expenses and tolls
conventions
labor dues
business association dues
education
employment agency fees
entertainment and travel
insurance premiums
gifts to customers and contacts
job hunting
fidelity bond cost
union dues
initiation fees
laundry and cleaning
legal fees
lodging away from home
office furniture and supplies
computer supplies and equipment
outside sales expense
passport fees
safety equipment
reimbursed expenses if included in income
tips
tools
telephone
subscriptions
periodicals
transportation and baggage charges
taxis
tuition fees
uniforms and work clothes

OFFICE IN HOME: Specific tests must be met in order to qualify for the office-in-home deduction. The word home includes house, apartment, condominium, mobile home, or boat. It also includes structures on a property such as an unattached garage, studio, barn, or greenhouse. **The space must be used in a trade or business on a regular and continuing basis.** Some items which would secure the passing of this test are: storing inventory, having one location, providing daycare services, meeting clients and being the principal place of business. Management of your individual investment portfolio is never considered a trade or business. The taxpayer must present sufficient evidence to convince the IRS that the business was conducted on a regular basis.

The second test is the exclusive test. The work area must be used **100%** exclusively for the business activity with no personal use no matter how little it may seem. The use of a partial room is acceptable as long as the taxpayer can prove a particular portion was used exclusively for business.

Exceptions to the exclusive test include the following:

storing of inventory

the residence is the only fixed location of the taxpayer's trade or business

the space is used for product samples or the space is separately identifiable

If the business area is a separate structure, the structure does not have to be the taxpayer's principal place of business or where place the taxpayer meets clients. The taxpayer can still deduct expenses for a detached structure, such as a garage if the taxpayer uses the structure exclusively and regularly in the

business. Determining your principal place of business is a subjective process in which all the facts and circumstances should be considered, including factors as time spent in that area, identification of most important activities and the relative importance to the business. Utilizing the same space for more than one business could be quite difficult. The deduction would only be allowed if each business could prove the exclusive-use rules.

A better approach would be to define separate business areas so both could qualify without any cross over complications. The office-in-home deduction, which is limited to the net income of the business activity, cannot create or add to a net loss. Unused losses can be carried forward until future years until the business has a net profit. To determine your deduction, you first need to measure the business use area versus the total useable area of the home. This will provide a ratio, which will be applied to prorate various office expenses from personal to business.

Included in home office expenses are the following:

1. interest
2. property taxes
3. ground rents
4. common area maintainance and repairs
5. insurance
6. utilities
7. separate phone lines for phone or fax or modem
8. computer equipment and supplies
9. internet access
10. mobile phones
11. household improvements
12. extra insurance coverage

Remember any expenses directly related to the business area are 100% deductible and do not have to be proportioned.

OTHER BUSINESS DEDUCTIONS: A good rule of thumb when determining if a business expense is ordinary and necessary is to ask yourself the following question. **If I were not engaged in this business, would I be spending money on this item?** If the answer is no, then the expense is most probably an ordinary and necessary business deduction and allowed by the IRS. Health insurance can be a huge deduction especially in today's world of high premium health insurance costs. To cover a family today could set you back \$1,000 monthly. If you operate your business with family members without much outside help, it is very likely you would be set-up to deduct 100% of your premiums.

The question is whether your plan discriminates. Under the law, you are not allowed to discriminate - all full time employees must be treated equally. If you use a regular corporation as your entity, all of the group's premiums that the corporation pays are deductible. If you operate as an S corporation, premiums for more than 2% shareholders and their spouses must be added back to the owner's W-2 form and is subject to federal, state and employment taxes. Beginning 2003, 100% of that add-back is then deducted as an adjustment to income on the front of your form 1040 tax form - the only costs to the company and the owner are the employment taxes.

If you operate as a sole-proprietor or a **single member LLC** you are entitled to deduct 100% of the premiums - although, the premiums for the owner do not reduce the basis for the employment taxes.

The IRS Code sections 105 and 106 will convert health care costs into a 100% deductible business expense, which will work for a sole-proprietorship or a single member LLC. Keep in mind the following: As the owner of the business you employ your spouse. It is recommended that an employment agreement is written to establish that the employee (spouse) is rendering services, the type of services rendered, compensation rates and benefits and to determine the length of employment. This agreement should be signed by both parties. Medical insurance fringe benefits will allow the owner to provide benefits to the employee/spouse. It can be structured to include the spouse, but exclude some other employees without actually discriminating. It can cover the spouse of the employer and the family. A formal plan must be adopted. The business reimburses the employee/spouse for all out-of-pocket medical expenses. The plan will define the eligibility requirements and set yearly maximums. The business must communicate the plan to eligible employees. Even if the spouse is the only employee, the reimbursements are a business deduction for the employer and not taxable to the employee/spouse.

Some often overlooked deductions are:

1. a restorative contribution made to a retirement plan
2. a deduction for laundry, cleaning, lodging taxes, and telephone calls while away on business
3. net operating losses can be carried back five years to offset past taxable income to receive a tax refund today
4. starting a retirement plan in the current year can create a tax credit of \$500 if the plan covers at least one employee that is not considered highly compensated
5. if you have an outstanding debt that may never be collected a bad debt deduction is available if using the accrual basis of accounting

6. a deduction is allowed for loss in value of inventory if it has declined or has been reduced to the point that it can't be sold
7. the company can deduct interest on below market loans from officers/shareholders even if it is not actually paid - this phantom interest can be deducted by the corporation, but must be reported as income by the officer/shareholder
8. a taxpayer can claim a 30% bonus depreciation deduction for certain assets purchased after 9/11/2001 - if you bought assets during this period but didn't claim this bonus deduction you can file an amended tax return to claim a refund
9. a taxpayer can claim a deduction when an asset is abandoned - any undepreciated cost basis may be taken as a deduction in the year of abandonment
10. a missed deduction often is in a real estate purchase for personal property contained in the house you are buying - If so, and the property is income-producing, an amount of the gross sale price can be allocated toward personal property - this amount is either written off over seven years or immediately in the year of purchase.
11. maintain a family side business in the name of a spouse that has already exceeded the social security maximum limitation - a taxpayer would save 12.4% on the entire net profit of the business
12. a taxpayer can claim a deduction for donating excess inventory or unused depreciable assets when it is donated to a charitable organization

TRUSTS

PURPOSES: Some of the general purposes of trusts are as follows:

1. reduce estate taxes
2. enhance lifetime gifting opportunities
3. provide professional asset management
4. provide special needs trust designed to help a disabled person's basic support
5. minimize probate exposure
6. provide charitable giving opportunities that provide current tax deductions while receiving a stream of future income and spendthrift provisions

Depending upon the family, a taxpayer may feel that a trust will enhance family harmony rather than inviting objections to the will. If a beneficiary is incapable of exercising control over money, the trust can provide that a beneficiary cannot transfer interest in the trust until certain points on time. This insulates the trust itself for claims of the beneficiary's creditors.

A taxpayer may wish to take advantage of the **\$13,000 annual gift exclusion**, but could be uncomfortable with putting large amounts of money in the control of certain others. An appropriate trust can receive annual gift exclusion amounts and exercise a certain amount of control. By using a combination of trusts, a decedent may leave the applicable exclusion amount of estate property and thus make use of the exclusion amount.

CHARITABLE REMAINDER TRUST: This trust allows a taxpayer to create a current income tax deduction for a charitable gift while maintaining a future income stream. To accomplish this, an asset

of the taxpayer is placed into this trust which is then sold to enable the purchase of an asset that will provide an income stream. At the termination of the trust - the death of the taxpayer, the asset goes to the charity. The income stream can be a fixed amount per year or a fixed percentage of the asset base. The deduction for the charitable gift is determined by the projected value that will go to the charity at your death. This value is determined by your age, life expectancy based on **IRS tables**, the income stream received and the assumed interest rate that the trust is expected to obtain. The property placed into the trust is generally a highly appreciated asset. Neither the taxpayer nor the trust will have to pay any capital gains tax on the appreciation under such an arrangement. A common strategy is to use the tax savings generated from the charitable deduction to purchase life insurance. This will accomplish replacing the asset you gifted to the trust, thus making your heirs whole again. Structured correctly, this life insurance will not be included in your estate with the use of a life insurance trust.

LIFE INSURANCE TRUST: Using an **irrevocable life insurance trust** will avoid the estate tax on the insurance proceeds to your beneficiaries. The trust must be in place before the trustee could apply for a life insurance policy on the death of the taxpayer, with the trust being the owner. The proceeds will be payable to the trust at the death of the taxpayer. Your intended heirs will be the beneficiaries of the trust. The taxpayer will need to name a trustee of the trust and that person will have the job of making certain the intended terms of the trust are followed. The proceeds payable to the trust are free from estate taxes as long as you have no control over the policy. The taxpayer gifts the trust enough money to pay for the annual life insurance premium. These gifts qualify for the annual exclusion

of \$13,000 or \$26,000 with a consenting spouse, but the trustee must notify the trust beneficiaries of their right to withdraw the amounts given. A taxpayer can also gift an existing policy to a trust. The policy proceeds will be taxable in the taxpayer's estate if death occurs within three years of the trust transfer.

BYPASS TRUST: Under current law unlimited amounts of money can be left to your spouse free of estate tax. The problem is that at the first death, the taxpayer does not take advantage of the one million dollar estate tax exemption. At the second death, the surviving spouse pays estate tax on the lost exemption. You can reduce your estate by taking advantage of the bypass trust. **Everyone, because of the 2009 tax law, can leave up to 3.5 million dollars of assets without paying estate taxes.** When a will is drafted it creates a bypass trust that will be funded with up to one million dollars. Usually, the surviving spouse receives the income from the trust with the trust assets passing to the couple's children when the surviving spouse dies. There are no estate taxes paid on the first death as well as the death of the surviving spouse. Your beneficiaries receive 100% of the asset with zero estate taxes and the appreciation of the trust assets from the first death to the death of the surviving spouse also pass free of estate taxes. The surviving spouse has rights to the income for life as he/she has to the principal for purposes of health, education and welfare. **This trust is also called the "B" trust or the Credit Shelter Trust.** The surviving spouse can be named the trustee of this bypass trust. This may help where almost all the assets are in such a trust. If the surviving spouse feels a loss of control because of having to ask the trustee every time money is needed, making the spouse a trustee will give more control.

A cap can be placed in the will to limit the amount that goes into the trust. You can fund a bypass trust to the amount of the estate tax exclusion and name your spouse as sole beneficiary. This would help provide for your spouse. Assets in a well-drafted bypass trust will escape the surviving spouses estate. The children would be named remainder trust beneficiaries to inherit the assets after the surviving spouse's death. The estate tax deduction could be split into two **bypass trusts**. One trust could be solely for the benefit of the spouse, the other could have multiple beneficiaries, including the spouse. A disclaimer can be used in conjunction with a bypass trust. After your death, your spouse can evaluate his/her financial situation and the current estate tax law, then can disclaim, that is to give up, an appropriate amount to the bypass trust. The assets now will not be taxed by the estate. An heir cannot disclaim assets after having the enjoyment of any benefit of the assets.

QTIP TRUST: A taxpayer may defer taxes and retain control over property with the use of a qualified terminable interest property trust (QTIP). Assets left to a QTIP qualify as a marital bequest, therefore no estate taxes will be owed until the death of the surviving spouse. As the originator of the trust, you decide where the assets go upon the death of the surviving spouse. QTIPs are useful if you had divorced, remarried and had children from the previous marriage. For a QTIP to work properly all the income must be paid to the surviving spouse and he/she must have the right to a reasonable return on the assets. If he/she does not, at the death of the first spouse estate taxes must be paid.

QPRT: A primary personal residence or a vacation home can be transferred to a trust. When the term of the trust is complete, the property passes to the trust beneficiary and escapes estate taxes in the estate. You retain the right to use the property for

the term of the trust and can rent after the term of the trust as long as you pay a fair rental value to the beneficiaries. This is another way to remove money from the estate if you are in a taxable estate situation. The transfer of the asset into a trust with a set term represents a deferred gift - the longer the term, the smaller the taxable gift. Ten to fifteen years is typical. The property will be included in the estate if death occurs before the term of the trust.

GRATS: You can receive income along with tax advantages with the use of a grantor retained annuity trust, also known as a GRAT. You can donate assets such as stocks, bonds, real estate, or shares of family owned businesses to this trust and retain the right to receive an income stream every year. The trust is set with a terminable life. After the term, the assets in the trust go to the beneficiaries. The higher the income stream and the longer the trust term, the smaller the taxable gift. The key for this arrange to benefit is for the assets to appreciate at a greater rate than the income you receive. This trust may allow more wealth to transfer to younger family members estate tax free. You need to outlive the trust term or the assets are included in your estate.

Instead of just on GRAT with a single terminable life, consider separating the assets into three different trusts with each having a different term. This may ensure that your family will receive some tax benefit. Even if you don't survive all three trusts, it is likely you will survive one or two of the trusts.

QUALIFIED SUBCHAPTER S TRUSTS: You can use a qualified subchapter S trust (QSST) to shift income to a low-bracket family member. These trusts are eligible S corporation shareholders. They permit the grantor of the trust, the

corporation's owner, to attach strings to the assets placed into the trust. Income taxes are saved by shifting shares to a family member who is in a lower tax bracket, such as a young child. You can retain control over the corporation by transferring non-voting shares of the S corporation into the trust. The cash flow from the corporation to the trust must be distributed from the trust to the income beneficiaries. All income is taxed at the beneficiary's tax rate. For greater control over cash flow you can use an electing small business trust (ESBT) instead. This trust is allowed to accumulate income rather than distributing it annually. **An ESBT is the better choice** if your S corporation pays out a great deal of income each year and you would rather not distribute to the beneficiaries. The trustee would still have the discretion to sprinkle income and principal to various beneficiaries if needed. Trust administration may be easier with an ESBT because you can have multiple beneficiaries.

With a QSST you are only allowed a single beneficiary. So if you have more than one beneficiary you will need more than one trust. All ESBT income will be taxed at the highest individual rate. So therefore you may be actually shifting income to higher bracket. Careful planning is necessary in determining which trust is best for you.

DEFECTIVE GRANTOR TRUST: You can gift shares of a limited liability company, partnership, or S corporation to a defective grantor trust. This trust is established under IRS code sections 671-679. For income tax purposes this trust doesn't affect anything. The grantor is considered the owner of the assets, not the trust. So therefore the grantor is taxed as though no transfer has been made. For estate tax purposes, this trust takes the asset placed into it out of the grantor's taxable estate. It also provides current income to the beneficiaries of the trust.

OTHER TRUSTS: Special needs trusts will provide for children with a physical handicap or illness during and after your lifetime. Any payments on behalf of the handicapped child should go directly to the third party and not directly to the child. A living trust has no tax savings benefit for income or estate taxes. A living trust will help avoid probate which may be time consuming and costly. They are revocable during the grantor's lifetime. After the grantor's death, it becomes irrevocable and the control of the assets revert to the alternate trustee. The spendthrift trust will protect the trust assets from creditors. They are commonly used in wills, trusts, and parents transferring assets to a trust for a minor. The spendthrift trust offers no protection when the beneficiary has the power to direct trust property for his own benefit.

TAX SHELTERS

OIL & GAS DRILLING: Certain types of investments in oil gas are deductible. The tax advantage with oil and gas drilling is the ability to deduct currently capital investments known as intangible drilling costs. Intangibles are defined as any cost incurred in the project that has no salvage value and is incident to and necessary for the drilling and preparation of wells for the production of oil and gas. Essentially, nearly all costs of drilling and completing the well are deductible in the year incurred. There is a catch, though. You will not be allowed to deduct more than the amount of money that you actually invested in the project. Tax shelters, whether on the cash or accrual basis, will not be able to deduct prepaid expenses until both economic performance occurs and the expense is actually incurred.

A deduction will be allowed for prepaid expenses where economic performance occurs after the end of the year if all three of the following conditions are met.

1. economic performance occurs within 90 days of the year-end
2. the requirements of present law are met
3. the deduction is limited to the amount of the cash investment

Additional benefits are the use of the 200 percent declining-balance depreciation and a statutory depletion deduction which is 15% of the gross income from the wells before expenses. The usual method to invest in such a project is through limited partnerships with one or more oil or gas prospects. The IRS's position is that a working interest in a **oil or gas well constitutes a trade or business for purposes of the self-employment tax.**

It is irrelevant whether the operations are conducted by the working interest owner or through a third party. These deductions are determined without consideration to the passive loss rules. Losses can be fully used to offset your other income. An investment in an oil and gas limited partnership can yield a deduction of as much as 70% of the investment amount. Even if you borrowed the money to make the investment, it is still deductible. Of course you're debt will have to be repaid whether the project is successful or not. If successful and generating income, the depletion deduction kicks in and lowers your taxable income, leaving more cash flow to lower any debt.

LOW INCOME HOUSING: This is a long-term investment program producing tax credits, which will lower your tax dollar for dollar. The tax credits of ten years result from the construction or rehabilitation of housing primarily for low-income tenants. These programs also aim for a cash flow at the end of the project term when the units are sold at the end of the ten-year credit period. Public limited partnerships are structured to give out about \$14,000 for every \$10,000 invested. Your risk is reduced when investing through public limited partnerships because they typically invest in more than one property at a time. Private partnerships usually generate greater tax benefits, but come along with greater risks because the investment is generally limited to just one property. Annual credits are limited by the passive loss rules. You can't take more than the equivalent of a \$25,000 deduction. That would be \$9,650 for a taxpayer in the 38.6% tax bracket. You can't use low-income housing credits to offset the alternative minimum tax.

REHABILITATION CREDITS: The tax law allows a credit for expenditures put into preserving historical structures. Investors can claim a 20% tax credit for the cost of rehabilitating

certified historical structures, which include buildings listed on the National Register of Historic Homes and buildings located in registered historical districts that contribute to the significance of that area. Investors can claim a 10% tax credit for expenses of rehabilitating non-historic non-residential buildings built before 1936. The rehabilitation must be a substantial percentage of the structure. It must also be used in a trade or business and be depreciable. The owner must hold the property for a full five years or risk paying back some of the credit received. These two credits of 20% and 10% are mutually exclusive you apply for one or the other, not both. Which credit applies depends on the building, not the owner's preference.

INVESTMENT SWAPS: An investment swap is an intriguing idea that will allow you cash out a bad investment and take the tax loss. If you are contemplating such a swap, be aware of the wash rules. The wash rules would prevent you from taking the tax loss if you bought back the substantially identical investment with a 30-day period after the sale. Substantially different has never really been defined. But if you buy a different investment with similar features, such as selling one utility stock and buying another utility stock, you should be okay. The other alternative is to wait for the 31st day and buy it back then.

Another alternative is to sell the particular investment to take your loss, but buy it back in a different name, such as one of your children. Of course, the advise of your investment adviser will certainly play into your strategy. You can deduct the realized loss on your investment as long as the sale takes place before the year ends. **The capital loss is allowed up to the point of any capital gains for the tax year plus an additional \$3,000.** Any unused losses can be carried forward into future tax years.

GIFT LEASEBACK: This technique is a way to shift income to lower tax brackets. The taxpayer gifts assets used in his trade or business, such as real estate or equipment or furniture, to a trust. The taxpayer's children are the beneficiaries of this trust. Then the business property, now inside the trust, is leased back to the taxpayer's business. The lease payments by the business are deductible by the higher tax bracket taxpayer and the lease payments going into the trust are taxable to the lower income beneficiaries. The taxpayer has relinquished title to the assets placed into the trust, but has achieved tax savings by shifting income. There is no depreciation recapture or investment tax credit recapture on such a transaction.

For this to work and be legitimate there are some guidelines to follow.

1. The lease must be in writing and must be fair market value rents. The trustee of the trust should have the property appraised to help determine a fair rental value. The trustee should also compare rents of similar property in the open market place. The bottom line is that the transaction be treated as an arms-length transaction.
2. The grantor, the business owner who gifts the property to trust, must not retain any control over the property. This requirement is satisfied by the fact that an independent trustee is named in the trust document.
3. The lease back to the business owner must be a bona fide business expense of that business. It may be a requirement in some jurisdictions to have a bona fide purpose for the gift as well as the gift back. The gift back is generally not an issue as long as it is a necessary and ordinary business expense in your line of work. The gift on the other hand can be more difficult to prove. To place the assets away from the arms of creditors,

which a trust can afford you, is usually not enough of a business purpose. A suggested business purpose may be to get managerial expertise in the control and operation of the property. This would provide a legitimate business reason for having the assets in trust.

4. The taxpayer must not possess a disqualifying equity in the property gifted. The taxpayer may not even have a reversionary interest in the property, according to IRS revenue rulings. One way to avoid problems is to create a remainder interest that passes to the taxpayer's spouse or children, or to a corporation (set up for this reason) at the termination of the trust.

TAX FREE INCOME

LIST OF TAX FREE INCOME SOURCES:

1. Gifts of all kinds
2. Roth IRA distributions after the age of 59 $\frac{1}{2}$
3. Flexible spending accounts for medical and dependant care expenses subtract from your salary
4. Children's salary paid from a family business up to \$5,700 for 2009
5. Expense reimbursement from an employer
6. Home rentals of up to 14 days
7. Life insurance proceeds
8. Gain on the sale of your personal residence of \$250,000 or \$500,000 if married filing joint
9. Borrowed funds from a life insurance policy
10. Parking paid for by an employer
11. Like kind exchanges allow you to exchange an appreciated property for a similar property while deferring taxing until the new property is sold
12. Frequent flying miles
13. A reverse mortgage on you house which allows a home owner an income stream which will ultimately be repaid by the estate
14. Capital gains property held until death will go to your heirs income tax free
15. Tuition reimbursement of up to \$5,250 per year provided by your employer
16. Interest free loans can be a source of cash with no income tax to be paid
17. Long term health care insurance proceeds
18. Long term health care premiums paid by your employer

19. State municipal bonds are free from federal income tax and sometimes state tax-free too
20. Scholarships and fellowships used to pay tuition and books and supplies
21. Adoption expenses paid by your employer up to \$10,000
22. Employer provided life insurance up to \$50,000 of death benefit
23. Section 529 account distributions if used for college tuition and expenses
24. Coverdell Education Savings account distributions used for school tuition and supplies
25. Employer provided health insurance premiums
26. Group legal plans provided by employer
27. Merchandise distributed to employees on Holidays if not a substantial value
28. Employee death benefit in the amount of \$ 5,000
29. Meals and lodging provided by your employer at your place of business and for your employer's convenience
30. Employee discounts
31. Workers' compensation benefits
32. Benefits provided under a section 125 cafeteria plan
33. Out of pocket medical expenses provided under a section 105 plan
34. Employee awards
35. Social Security benefits if under the income thresholds (To help stay under the threshold consider moving certain investments to series E Bonds or annuities where the income won't affect the income threshold.)
36. The exclusion ratio part of your retirement annuity
37. Inheritances
38. Damages for physical personal injury or sickness
39. Child support payments
40. Disability payments other than for loss of wages

41. Employer provided dependant care services
42. Health insurance proceeds not attributable to medical expense taken in prior years, and Welfare payments.

APPENDIX #4 - SALES SHEET

Receipts for the Month of _____

1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
18								
19								
20								
21								
22								
23								
24								
25								
26								
27								
28								
29								
30								
31								

APPENDIX #5 -FAMILY EMPLOYEE

CHECKLIST FOR HIRING FAMILY EMPLOYEES

<u>QUESTION</u>	<u>YES</u>	<u>NO</u>
IS THERE A WRITTEN CONTRACT		
ARE TIME RECORDS KEPT		
IS THERE A WRITTEN JOB DESCRIPTION		
IS THE PAY PERIODICAL		
IS THERE A I-9 ON FILE		
IS THERE A W-4 ON FILE		
ARE PAYROLL TAX RETURNS FILED		
ARE W-2'S ISSUED		
DOES THE EMPLOYEE DEPOSIT IN OWN ACCOUNT		
IS WAGE COMPARABLE TO FAIR MARKET		

APPENDIX #6 -TRADE OR BUSINESS CHECKLIST

TRADE /BUSINESS CHECKLIST

<u>QUESTION</u>	<u>YES</u>	<u>NO</u>
DOES TAXPAYER CARRY ON IN BUSINESS LIKE MANNER		
DOES TAXPAYER HAVE EXPERTIZE IN AREA		
DOES TAXPAYER DEVOTE SUFFICIENT TIME & EFFORT		
ARE ASSET VALUES APPRECIATING		
HAS THE TAXPAYER BEEN SUCCESSFUL IN OTHER VENTURES		
ARE THERE SUFFICIENT AMOUNTS OF PROFITS IN RELATION TO LOSSES		
DOES TAXPAYER RELY ON ACTIVITY FOR SURVIVAL		
DOES ACTIVITY HAVE A HISTORY OF INCOME MORE THAN LOSSES		
ARE THERE ANY OTHER FACTORS INDICATIVE OF A BUSINESS AS OPPOSED TO A HOBBY		

APPENDIX #7 - PER DIEM TABLES

PLEASE VISIT THE FOLLOWING WEBSITE:

WWW.POLICYWORKS.GOV/PERDIEM

APPENDIX #8 - EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

Employees vs. Independent Contractors

The tax law covering independent contractors is very complicated. Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing services may be -

- An independent contractor
- A common-law employee (Employee)
- A statutory employee
- A statutory nonemployee

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

It is critical that you, the employer, correctly determine whether the individuals providing services are employees or independent contractors. Generally, you must withhold taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment wages paid to an employee. You do not generally have to withhold or pay any tax payments to independent contractors.

Caution: If you incorrectly classify an employee as an independent contractor, you are held liable for employment taxes for that worker, plus a penalty.

Who is an Independent Contractor?

A general rule is that you, the payer, have the **right to control or direct only the work** done by an independent contractor, and **not the means and methods of accomplishing the result**.

Example: Steve Smith, a computer programmer, is laid off when Megabyte Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specification for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay Federal and state taxes, and receives no benefits from Megabyte. Megabyte will file a [Form 1099-MISC](#) (PDF). Steve does the work on a new high-end computer which cost him \$7000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

Refer to the page on [Paying Independent Contractor](#) if you need information on

responsibilities are when paying contractors.

Who is a Common-Law Employees (Employee)?

Under common-law rules, anyone who performs services for you is your employee if you control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the way the services are performed.

To determine whether an individual is an employee or independent contractor under common law, the relationship of the worker and the business must be examined. The degree of control and independence must be considered. In an employee-independent contractor determination, all information that provides evidence of the degree of control and independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the worker. Refer to Publication 15-A, [Employer's Supplemental Tax Guide](#) for additional information.

Who is an Employee?

A general rule is that anyone who performs services for you is your employee *if you control what will be done and how it will be done.*

Example: Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week, and is on duty in Bob's showroom on certain assigned days and times. She appraises transactions, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Statutory Employees

If workers are independent contractors under the common law rules, such workers nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories: the three conditions described under **Social security and Medicare taxes** , below.

- A driver who distributes beverages (other than milk) or meat, vegetable, bakery products; or who picks up and delivers laundry or dry cleaning, if you are your agent or is paid on commission.
- A full-time life insurance sales agent whose principal business activity is selling insurance or annuity contracts, or both, primarily for one life insurance company.
- An individual who works at home on materials or goods that you supply ; the materials must be returned to you or to a person you name, if you also furnish supplies for the work to be done.
- A full-time traveling or city salesperson who works on your behalf and takes orders from you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work for you must be the salesperson's principal business activity. Refer to the **Salesperson** section located in **Publication 15-A, Employer's Supplemental Tax Guide** for additional information.

Statutory Nonemployees

There are two categories of statutory nonemployees: *direct sellers* and *licensees* and *agents*. They are treated as self-employed for all Federal tax purposes, including

employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked and
2. Their services are performed under a written contract providing that they are to be treated as employees for Federal tax purposes.

Refer to information on **Direct Sellers** located in **Publication 15-A, Employer's Supplemental Tax Guide** for additional information.

Resources

- [**Tax Topic 762 Basic Information**](#)
To determine whether a worker is an independent contractor or an employee, you must examine the relationship between the worker and the business. All facts and circumstances that provide this evidence fall into three categories: Behavioral Control, Financial Control, and the Type of Relationship itself.
- [**Publication 1976, Section 530 Employment Tax Relief Requirements**](#)
Section 530 provides businesses with relief from Federal employment tax obligations if certain requirements are met.
- [**IRS Internal Training: Employee/Independent Contractor**](#) (PDF)
This manual provides you with the tools to make correct determinations regarding worker classifications. It discusses facts that may indicate the existence of an independent contractor or an employer-employee relationship. This training manual is not legally binding. If you would like the IRS to make the determination of worker status, please file IRS Form SS-8.
- [**Form SS-8**](#) (PDF)
Determination of Worker Status for Purposes of Federal Employment Tax and Income Tax Withholding
- [**Publication 15-A**](#) (PDF)
The Employer's Supplemental Tax Guide has detailed guidance including information for specific industries.

APPENDIX # 9 - RECORD KEEPING

How long should I keep records?

The length of time you should keep a document depends on the action, expense, the document records. You must keep your records as long as they may be needed to verify the income or deductions on a tax return. For more information on the responsibilities for entries, deductions, and statements made on your tax returns, refer to [What is the proof?](#)

The time you are required to keep records includes the period of time during which you amend your tax return to claim a credit or refund, or that the IRS can assess more than 25 percent of the tax shown on the return, and can be longer. You also keep copies of your filed tax returns in the following situations:

1. You owe additional tax and situations (2), (3), and (4), below, do not apply; keep records for *3 years*.
2. You do not report income that you should report, and it is more than 25 percent of the gross income shown on your return; keep records for *6 years*.
3. You file a fraudulent income tax return; keep records *indefinitely*.
4. You do not file a return; keep records *indefinitely*.
5. You file a claim for credit or refund* after you file your return; keep records for *3 years or 2 years after tax was paid*.
6. Your claim is due to a bad debt deduction; keep records for *7 years*.
7. Your claim is due to a loss from worthless securities; keep records for *7 years*.
8. Keep information on an asset for the life of the asset, even when you dispose of the asset; keep records *indefinitely*.

The following questions should be applied to each record as you decide whether to keep the document or throw it away.

Do the records support an entry on my tax return?

Records you could use to verify the information you report on your tax return should be kept as long as an audit is possible. The IRS normally has 3 years to audit a return. This period, called a statute of limitations, begins the day the return is filed, or the due date if filed earlier, and can be extended for a number of reasons. Examples include 2 years for a following additional claims filed later by you, or a total of 6 years for understating tax by more than 25 percent. For records that would help you through an audit, a conservative approach is to keep them for 7 years.

Are the records connected to business property?

Some records establish the basis (or value) of property for depreciation deduction or calculating the gain or loss at sale. These records should be held for as long as you own the property plus the same 7 years as above.

Do the records support deductions that will be applied to other tax years?

Sometimes deductions, such as limited charitable contributions, casualty losses, operating losses, are carried forward or backward and applied to other tax years. Records that substantiate the original loss or expense should be retained for as many years as you are carrying forward the deduction plus the same 7 years as above.

APPENDIX # 10 - APPLICABLE FEDERAL RATES

GO TO THE FOLLOWING WEBSITE:

<http://www.irs.gov/taxpros/lists/0,,id=98042,00.html>

APPENDIX #11 - HOUSEHOLD EMPLOYEES

Topic 756 - Employment Taxes for Household Employees

Household employees include housekeepers, maids, baby-sitters, gardeners, and others who work in or around your private residence as your employees. Repairmen, plumbers, contractors, and other business people who work for you as independent contractors, are not your employees. Household workers are your employees if you control not only the work they do but how they do it.

If you pay a household employee cash wages of \$1,400 or more in the year 2003, you generally must withhold social security and Medicare taxes from all cash wages you pay to that employee. Unless you prefer to pay your employee's share of social security and Medicare taxes from your own funds, you should withhold 7.65% (6.2% for social security tax and 1.45% for Medicare tax) from each payment of cash wages. Instead of paying this amount to your employee, pay it to the IRS with a matching amount for your share of the taxes. However, do not withhold or pay these taxes from wages you pay to:

- your spouse,
- your child who is under age 21,
- your parent, unless an exception is met; or
- an employee who is under age 18 at any time during the year unless performing household work is the employee's principal occupation. If the employee is a student, providing household work is not considered to be his or her principal occupation.

You are not required to withhold Federal income tax from wages you pay to a household employee. However, if your employee asks you to withhold Federal income tax and you agree, you will need [Form W-4](#) (PDF), *Employee's Withholding Allowance Certificate*, and [Publication 15](#), (Circular E), *Employer's Tax Guide*, which has tax withholding tables.

If you withhold or pay social security and Medicare taxes, or withhold Federal income tax, you will need to file [Form W-2](#) (PDF), *Wage and Tax Statement* after the end of the year. You will also need a [Form W-3](#) (PDF), *Transmittal of Wage and Tax Statement*. To complete Form W-2 you will need both an employer identification number and your employee's social security number. If you do not already have an employer identification number (EIN), one can be requested by submitting [Form SS-4](#) (PDF), *Application for Employer Identification Number*, or electronically, by accessing the "Business's link on the IRS website at www.irs.gov. IRS assistants will provide you with an EIN via the phone if you cannot use the Internet application. Call 1-800-829-4933 from 7:30 a.m. to 5:30 p.m.. Refer to [Topic 752](#) and [Topic 755](#) for further information.

If you paid cash wages to household employees totaling \$1,000 or more in any calendar quarter of 2002 or 2003, you generally must pay Federal unemployment tax on the first \$7,000 of cash wages you pay to each of your household employees in 2003 and 2004.

If you must file Form W-2 or pay Federal unemployment tax, you will also need to file a [Form 1040, Schedule H](#) (PDF), *Household Employment Taxes*, after the end of the year with your individual income tax return, [Form 1040](#) (PDF), U.S. Individual Income Tax Return. However, a sole proprietor who must file [Form 940](#) (PDF), *Employer's Annual Federal Unemployment (FUTA) Tax Return*, and [Form 941](#) (PDF), *Employer's Quarterly Federal Tax Return*, for business employees, or [Form 943](#) (PDF), *Employer's Annual Tax Return for Agricultural Employees*, for farm employees, may include household employee tax information on these

forms.

You can avoid owing tax with your return if you pay enough Federal income tax before you file, to cover both the employment taxes for your household employee and your income tax. If you are employed, you can ask your employer to withhold more Federal income tax from your wages during the year. You can also make estimated tax payments to the IRS during the year or increase the payments you already make. Use [Form 1040ES](#) (PDF) to make estimated tax payments.

You may have to pay an estimated tax penalty if you do not prepay your household employment taxes during the year. Refer to [Topic 355](#) [Topic 306](#) .

APPENDIX #12 - Health coverage credit

HCTC: Individuals - Overview



The Health Coverage Tax Credit (HCTC) is a program that can help pay for nearly two-thirds of eligible individuals' health plan premiums. This website can help you figure out whether you are eligible for the HCTC and help you through the registration process. Please follow all instructions carefully so you and your family can receive the full benefit of this program.

Check the topic page titled [Eligibility](#) for more information on eligibility requirements.

To claim the credit, you must be enrolled in a qualified health plan. Go to the topic page titled [Qualified Health Plan](#) for more information.

If you are eligible for the HCTC and enrolled in a qualified health plan, there are two ways to receive the credit:

1. You can register for the [advance credit](#) to help pay for monthly health plan premiums as they become due, or...
2. You can choose to receive the credit when you file your 2003 federal tax return.

Go to [Claim Your Credit](#) for more information.

It is important to note that the credit does not cover 100 percent of your health plan premium. Even if you receive the advance credit, you will still have to pay a portion of your premium on a monthly basis. See the section titled [Your Payment Responsibility](#) for more details.

See a list of [Frequently Asked Questions](#) by Individuals.

Basic Information

The [HCTC Program Kit \(PDF\)](#) is mailed to candidates that are potentially eligible for the Health Coverage Tax Credit. This online version of the document contains eligibility and registration information, but does not include the HCTC Registration Form.

If you received the HCTC Program Kit in the mail, you should review it to determine if you are eligible. If you are eligible, you should complete the Registration Form provided in the kit and return it with the required documents attached.

You can choose to register by phone by calling the HCTC Customer Contact Center toll free at 1-866-628-HCTC (1-866-628-4282). TDD/TTY callers, please call 1-866-626-HCTC (1-866-626-4282). Hours of operation: 7:00 AM to 7:00 PM Central time, Monday through Friday.

If you choose to register by phone, you should still complete the Registration Form to make the registration process easier. You should also collect the appropriate documentation and have it available when you call, as it will be

required to complete your registration.

If you haven't received a kit, use this site to help you determine if you should have received it. In general, you may claim the HCTC if:

- You are receiving a Trade Readjustment Allowance (TRA), or will receive [Trade Adjustment Assistance \(TAA\)](#) benefits once your unemployment benefits are exhausted, or...
- You are receiving benefits under the [Alternative Trade Adjustment Assistance](#) (ATAA) program, or...
- You are receiving benefits from the [Pension Benefit Guaranty Corporation](#) (PBGC) and you are at least 55 years old.

Check the topic page titled [Eligibility](#) for more information on eligibility requirements.

Go to the [Health Coverage Tax Credit \(HCTC\) Overview](#) page.

REFER TO WEBSITE: <http://www.irs.gov/individuals/article/0,,id=109915,00.html>

Thank you for your order and your interest in the "Chrest Letters." Look for more new and exciting publication to come in the future. Check out the following websites:

www.chrestcpa.com

Sincerely,

Brian F. Chrest, CPA

To ensure compliance with requirements imposed by the IRS, Chrest CPA Tax & Financial PC informs you that, if any advice concerning one or more U.S. Federal tax issues is contained in this communication (including any attachments), such advice is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.