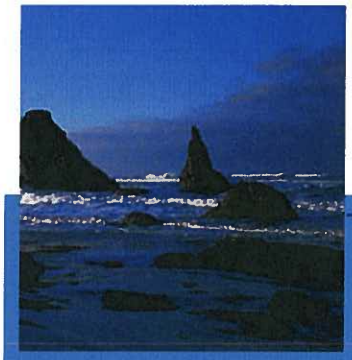

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Tax Planning & Updates 2010

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Tax Planning for the Self-Employed

Self-employment is the opportunity to be your own boss, to come and go as you please, and oh yes, to establish a lifelong bond with your accountant. If you're self-employed, you'll need to pay your own FICA taxes and take charge of your own retirement plan, among other things. Here are some planning tips.

Understand self-employment tax and how it's calculated

As a starting point, make sure that you understand (and comply with) your federal tax responsibilities. The federal government uses self-employment tax to fund Social Security and Medicare benefits. You must pay this tax if you have more than a minimal amount of self-employment income. If you file a Schedule C as a sole proprietor, independent contractor, or statutory employee, the net profit listed on your Schedule C (or Schedule C-EZ) is self-employment income and must be included on Schedule SE, which is filed with your federal Form 1040. Schedule SE is used both to calculate self-employment tax and to report the amount of tax owed. For more information, see IRS Publication 533.

Make your estimated tax payments on time to avoid penalties

Employees generally have income tax, Social Security tax, and Medicare tax withheld from their paychecks. But if you're self-employed, it's likely that no one is withholding federal and state taxes from your income. As a result, you'll need to make quarterly estimated tax payments on your own (using IRS Form 1040-ES) to cover your federal income tax and self-employment tax liability. You may have to make state estimated tax payments, as well. If you don't make estimated tax payments, you may be subject to penalties, interest, and a big tax bill at the end of the year. For more information about estimated tax, see IRS Publication 505.

If you have employees, you'll have additional periodic tax responsibilities. You'll have to pay federal employment taxes and report certain information. Stay on top of your responsibilities and see IRS Publication 15 for details.

Employ family members to save taxes

Hiring a family member to work for your business can create tax savings for you; in effect, you shift business income to your relative. Your business can take a deduction for reasonable compensation paid to an employee, which in turn reduces the amount of taxable business income that flows through to you. Be aware, though, that the IRS can question compensation paid to a family member if the amount doesn't seem reasonable, considering the services actually performed. Also, when hiring a family member who's a minor, be sure that your business complies with child labor laws.

As a business owner, you're responsible for paying FICA (Social Security and Medicare) taxes on wages paid to your employees. The payment of these taxes will be a deductible business expense for tax purposes. However, if your business is a sole proprietorship and you hire your child who is under age 18, the wages that you pay your child won't be subject to FICA taxes.

As is the case with wages paid to all employees, wages paid to family members are subject to withholding of federal income and employment taxes, as well as certain taxes in some states.

Establish an employer-sponsored retirement plan for tax (and nontax) reasons

Because you're self-employed, you'll need to take care of your own retirement needs. You can do this by establishing an employer-sponsored retirement plan, which can provide you with a number of tax and nontax benefits. With such a plan, your business may be allowed an immediate federal income tax deduction for funding the plan. You can also generally place pretax dollars into a retirement account to grow tax deferred until withdrawal. You may want to use one of the following types of retirement plans:

- Keogh plan
- Simplified employee pension (SEP)
- SIMPLE IRA
- SIMPLE 401(k)
- Individual (or "solo") 401(k)

The type of retirement plan that your business should establish depends on your specific circumstances. Explore all of your options and consider the complexity of each plan. And bear in mind that if your business has employees, you may have to provide coverage for them as well. For more information about your retirement plan options, consult a tax professional or see IRS Publication 560.

Take full advantage of all business deductions to lower taxable income

Because deductions lower your taxable income, you should make sure that your business is taking advantage of any business deductions to which it is entitled. You may be able to deduct a variety of business expenses, including rent or home office expenses, and the costs of office equipment, furniture, supplies, and utilities. To be deductible, business expenses must be both ordinary (common and accepted in your trade or business) and necessary (appropriate and helpful for your trade or business). If your expenses are incurred partly for business purposes and partly for personal purposes, you can deduct only the business-related portion.

If you're concerned about lowering your taxable income this year, consider the following possibilities:

- Deduct the business expenses associated with your motor vehicle, using either the standard mileage allowance or your actual business-related vehicle expenses to calculate your deduction
- Buy supplies for your business late this year that you would normally order early next year
- Purchase depreciable business equipment, furnishings, and vehicles this year
- Deduct the appropriate portion of business meals, travel, and entertainment expenses
- Write off any bad business debts

Self-employed taxpayers who use the cash method of accounting have the most flexibility to maneuver at year-end. See a tax specialist for more information.

Deduct health-care related expenses

If you qualify, you may be able to benefit from the self-employed health insurance deduction, which would enable you to deduct up to 100 percent of the cost of health insurance that you provide for yourself, your spouse, and your dependents. This deduction is taken on the front of your federal Form 1040 (i.e., "above-the-line") when computing your adjusted gross income, so it's available whether you itemize or not.

Contributions you make to a health savings account (HSA) are also deductible "above-the-line." An HSA is a tax-exempt trust or custodial account you can establish in conjunction with a high-deductible health plan to set aside tax-free funds for health-care expenses.

Exclusion of Capital Gain on the Sale of Your Home

Introduction

There may or may not be federal income tax consequences when you sell your home. If you sell your principal residence at a loss (i.e., for less than you purchased it), you can't deduct the loss on your federal income tax return. If you sell your principal residence at a gain, you may be taxed on the capital gain. If you're eligible, though, you may be able to exclude up to $250,000 (up to $500,000 for married couples filing jointly) from federal income tax. Your ability to exclude the capital gain depends on several factors.

Tip: The IRS has issued final regulations and temporary regulations explaining the circumstances under which a taxpayer may qualify for the full or partial homesale gain exclusion. These regulations apply to sales and exchanges after December 23, 2002.

Caution: The Housing and Economic Recovery Act of 2008 modifies the homesale exclusion beginning January 1, 2009. See Modified exclusion for sales and exchanges made after December 31, 2008 below for more information.

What is your principal residence?

The homesale exclusion applies only to the sale of your principal residence. Although you might own several homes, you can have only one principal residence. The home in which you spend most of your time during the year will ordinarily be considered your principal residence. However, the final regulations list other factors that are also relevant in determining your principal residence. These factors include (but are not limited to) the following:

- The address listed on your income tax returns, driver's license, and automobile and voter registrations
- Your place of employment
- Your mailing address for bills and correspondence
- The location of your family members
- The place you maintain your bank accounts
- The location of your memberships (e.g., places of worship, clubs, etc.)

Tip: For purposes of qualifying for the capital gain exclusion, you must have an ownership interest in the residence (i.e., legal title), rather than simply a right to occupy (as a tenant would have). Single family homes can qualify as principal residences, along with condominiums, co-ops, mobile homes, houseboats, and trailers (assuming they have living accommodations that include a sleeping space, toilet, and cooking facilities).

Tip: An investment in a retirement community will not qualify as your principal residence unless you receive equity in the property.

How do you calculate capital gain for purposes of the homesale exclusion?

If you own your principal residence, it will generally be considered a capital asset. The sale of a capital asset ordinarily results in either a capital gain or a capital loss. If the sale price of your residence exceeds your adjusted basis (the initial cost of your home, plus amounts you've paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes) in the home, you'll realize a capital gain. (For more information about adjusted basis, see IRS Publication 523, Selling Your Home.)

Tip: Capital improvements add value to your home, prolong its life, or adapt it to a new use. The installation of a deck or a built-in swimming pool would be an improvement. However, regular repairs and maintenance are not considered improvements and are not generally included in the tax basis of your home.

Example(s): Assume you bought a house for $150,000 and finished the basement three years later for $10,000. You sell the house 15 years later for $250,000. Your capital gain (which may be excluded from your income if you meet the necessary requirements) equals $90,000 ($250,000 - $160,000).

Tip: If the capital gain from the sale of your home is entirely excluded from federal income taxation, you don't have to report the sale transaction on your income tax return. However, if part or all of your capital gain is taxable, you must report the transaction on Schedule D of your federal income tax return.

If the sale price of your principal residence is less than your adjusted basis in the residence, you'll realize a capital loss. You generally can't claim such a loss as a deduction on your federal income tax return.

For information about additional tax issues surrounding the sale of your principal residence, see Sale of Principal Residence: Tax Considerations.

Under what conditions may you exclude gain from the sale of your principal residence?

In general

If you sell your principal residence at a gain, you may be able to exclude from federal income tax all or part of the capital gain. If you meet the requirements, you can exclude up to $250,000 (up to $500,000 for married couples filing jointly) of the capital gain, regardless of your age.

You can generally exclude the gain only if you owned and used the home as your principal residence for at least two out of the five years preceding the sale (the two years do not have to be consecutive).

Tip: Under the Military Family Tax Relief Act of 2003, members of the uniformed services and foreign service personnel may elect to suspend the 2-out-of-5-year requirement during any period of qualified official extended duty up to a maximum of ten years. This extension is effective for sales made after May 6, 1997. There is a minimum one-year window of time beginning November 5, 2003 for the purposes of filing a claim for refund or credit that might otherwise be barred.

Tip: Under the Tax Relief and Health Care Act of 2006, "employees in the intelligence community" (as defined in the Act) may elect to suspend the 2-out-of-5-year requirement during any period in which they are serving extended duty up to a maximum of ten years. To qualify, an employee must move from one duty station to a new duty station located outside of the United States. This extension is effective for sales made after December 14, 2006 and before January 1, 2011.

An individual, or either spouse in a married couple, can generally use this exemption only once every two years (but see below for partial exemption rules).

What if you are unmarried and own your principal residence jointly with another unmarried taxpayer? According to the final regulations, each of you may be eligible to exclude from gross income up to $250,000 of gain from the sale of the house.

Example(s): Assume you and your spouse bought a home for $200,000. Ever since, you lived in it as your principal residence, have not sold any other houses, and filed joint federal income tax returns each year. In addition, you've never used any portion of the house for business or rental purposes. Fifteen years later, you sell the house for $500,000. The entire $300,000 gain is excludable. That means you don't have to report your home sale on your income tax return.

Surviving spouse's home sale exclusion

Previously, a surviving spouse was entitled to the $500,000 exclusion only if he or she filed a joint return with the deceased spouse's estate, which can only occur for the tax year in which the deceased spouse dies. The Mortgage Forgiveness Debt Relief Act of 2007 extended the period of time in which the surviving spouse has to take the $500,000 home sale exclusion. For sales on or after January 1, 2008, the sale of a jointly-owned and occupied residence is entitled to the $500,000 exclusion provided the sale occurs no later than two years after the date of the deceased spouse's death.

Property acquired through a like-kind exchange

The American Jobs Creation Act of 2004 provides that the exclusion on the sale or exchange of a principal residence does not apply if the residence was acquired in a like-kind exchange within the prior five years. This provision applies to sales or exchanges after October 22, 2004.

Vacant land

The final regulations clarify the treatment of vacant land. According to the final regulations, gain on the sale of vacant land may be excluded in some cases. The homesale exclusion applies to the sale or exchange of vacant land that you owned and used as part of your principal residence if the following conditions are met:

- The vacant land must be adjacent to land containing the dwelling unit (i.e., your principal residence); and
- The sale or exchange of the dwelling unit occurs within two years before or after the sale or exchange of the vacant land.

For purposes of the homesale exclusion, sales or exchanges of the dwelling unit and the vacant land are treated as one transaction (even if the two sales take place at different times). Therefore, only one maximum limitation amount of $250,000 ($500,000 for qualifying joint filers) applies to the combined sales or exchanges of the vacant land and dwelling unit.

> **Example(s):** Assume that you purchased a house (which rested on one acre of land), along with a vacant lot adjacent to the property for a total price of $150,000. You've used the home (and both lots) as your principal residence ever since. On January 1 of last year, you sold your home for $250,000. On January 1 of this year, you sell the vacant lot adjacent to the property for $50,000. You've sold no other homes and are a single taxpayer. The two sales will be treated as one transaction. Therefore, your entire $150,000 gain may be excluded from taxation.
>
> **Tip:** Prior to issuance of the final regulations, the sale of vacant land that did not include a dwelling unit did not qualify as a sale of the taxpayer's residence unless the sale of vacant land was one of a series of transactions that included the sale of the house.

Ownership by a trust

If your principal residence is held by a trust, and you're treated as the owner of the trust for federal income tax purposes under the grantor trust rules, you'll be treated as the owner (and seller) of the home for purposes of the homesale exclusion rules.

> **Example(s):** Assume you establish a revocable trust and transfer your principal residence to the trust, naming yourself as trustee. (For federal income tax purposes, the grantor trust rules apply.) You continue to live in the home as your principal residence. After living in the home for a total of 15 years, you sell the home for a $100,000 gain. You haven't sold any other homes and you file as a single taxpayer. You'll be able to exclude the entire $100,000 gain.

For more information about grantor trusts, see Income Taxation of Trusts and Estates.

> **Tip:** In the case of grantor trusts and the homesale exclusion, the final regulations simply codified

the holdings of past revenue rulings.

Mixed-use property (principal residence used partly for business, investment, or rental purposes)

In the past, the IRS took the position that if a principal residence was used partially for residential purposes and partially for business purposes (mixed-use property), any capital gain on the sale of the house would have to be prorated. Only the part of the gain allocable to the residential portion was eligible for exclusion.

The final regulations, however, have adopted a more liberal position. So long as both the residential and non-residential portions of the property are within the same dwelling unit (e.g., one room in the home is used as a home office), all of the gain from the home sale (except for gain resulting from certain depreciation deductions) is eligible for the capital gain exclusion. However, gain is allocated if the business portion of the home is separate from the dwelling unit (e.g., an office in a converted detached garage).

Caution: Capital gain on the sale of your home will not qualify for the exclusion to the extent of any depreciation deductions attributable to the business use of your home after May 6, 1997.

Example(s): Assume a self-employed accountant buys a home and, 15 years later, sells the home at a $20,000 gain. Although the house was always used as his principal residence, the accountant used one room within the house as his business office. Over the years, the accountant claimed $2,000 of depreciation deductions for his office. Under the final regulations, $18,000 of the capital gain will be tax-free. Only the $2,000 of the gain equal to the depreciation deductions will be taxable. The taxable amount will be considered unrecaptured Section 1250 gain, which is taxed at a rate of 25 percent.

Example(s): If the accountant's office had been located in a converted detached garage on his property, he would have to treat the sale as two separate transactions and pay tax on the gain allocable to the converted garage.

Multi-family homes

Be careful if you rent part of your principal residence to tenants. If you converted part of your residence into an apartment, or if you sell a multi-family house, you may not be able to exclude the gain from the rental portion of your house.

Example(s): Suppose you buy a three-story townhouse and convert the basement level (which has a separate entrance) into a separate apartment by installing a kitchen and bathroom there. You also remove access from the interior stairway that leads from the basement to the upper floors. After the conversion, you use the first and second floors of the townhouse as your principal residence and rent the basement level to tenants for four years. During that period, you claim depreciation deductions of $2,000. You sell the entire property, realizing a gain of $18,000.

Example(s): Because the basement apartment was considered a separate dwelling unit, you must allocate the capital gain between the portion of the property that you used as your principal residence and the portion of the property that you rented. You may exclude from taxation only the non-rental portion. Assuming that the gain allocable to the rental portion of the property came to $6,000, you'd recognize the $6,000 as income ($2,000 of which is gain from depreciation deductions and $4,000 of which is adjusted net capital gain).

Caution: Capital gain realized on the sale of pure investment properties and residences other than your principal residence (for example, vacation homes) cannot be excluded from taxation under the homesale exclusion rules.

Modified exclusion for sales and exchanges made after December 31, 2008

Under the Housing and Economic Recovery Act of 2008, gain from the sale of a principal residence home will not be excluded from gross income for periods that the home was not used as the principal residence (i.e., "nonqualifying use"). Nonqualified use is a new concept that essentially means any period of time that the

property is not occupied as the principal residence by the homeowner or the homeowner's spouse. This requires a look back at the cumulative use of the property. The rule is meant to prevent the use of the homesale exclusion for appreciation that is attributable to periods during which a residence is used as a vacation home, second home, or rental property before its use as the principal residence.

The rule determines the amount of the exclusion on a pro rata basis. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate period of nonqualified use during which the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property. For the purpose of calculating capital gain, the period of nonqualifying use is any period of time, beginning on or after January 1, 2009, that the property is not used as a primary residence. Any period of what would otherwise be considered nonqualifying use that occurs prior to January 1, 2009 is disregarded for the the purpose of determining the capital gain allocation.

> **Example(s):** John buys a condo in 2009. John already owns a house that he uses as his primary residence. John lets his son, Mark, live in the condo for two years while he attends graduate school. John moves into the condo in 2011 and makes it his primary residence for the next three years. John sells the condo in 2014 after owning the property for five years. During the five-year period during which John owned the condo, there were two years of non-qualifying use (when Mark lived there) and three years of qualifying use (when John lived there). The ratio of nonqualifying use is 2/5, or 40 percent. Forty percent of the gain will be taxable, and 60 percent can be excluded, up to the exclusion limit of $250,000.
>
> **Tip:** Temporary absences not exceeding a total of two years in aggregate will not jeopardize qualifying use. A property can maintain its status as a primary residence even if the homeowner is absent due to change in employment, health conditions, or other unforeseen circumstances (see below for more information).
>
> **Tip:** Nonqualified use does not include any portion of the five-year period (used to determine eligibility for excluding capital gain) that is after the last date that the property was used as a principal residence. For example, a taxpayer who owns and lives in a home as a principal residence for the first two years of the five-year period will not have to treat the remaining three years as nonqualified use, even if the home is not the taxpayer's principal residence for the three years immediately preceding the sale of the home.

Can you qualify for a partial capital gain exclusion if you don't meet the relevant tests?

Partial or reduced exclusion available

To qualify for the homesale exclusion, you generally must own and use a home as your principal residence for at least two out of the five years preceding the sale. In addition, an individual (or either spouse in a married couple) can generally use this exemption only once every two years. However, a partial exclusion may be available even if you fail to meet these tests. You may claim a partial homesale exclusion if the primary reason for selling your house is a change in place of employment, for health reasons, or for certain other unforeseen circumstances. Generally, you must establish by the facts and circumstances of your situation that your home sale was for one of these reasons.

The IRS has issued temporary regulations that clarify the meaning of the above conditions (change in place of employment, health reasons, and unforeseen circumstances). In addition, the temporary regulations identify various "safe harbors" that will automatically establish that a sale is for one of these reasons. The temporary regulations apply to sales and exchanges on or after December 24, 2002.

Calculation of reduced exclusion

If you qualify for a reduced exclusion, the maximum exclusion amount of $250,000 ($500,000 for a married couple filing jointly) is limited to the percentage of the two years that you otherwise fulfilled the homesale exclusion requirements. You multiply the maximum $250,000 (or $500,000) exclusion by a fraction. The numerator of the fraction is the shorter of (a) the total time you owned and used your home as your principal

residence during the five years ending on the sale date, or (b) the period of time since you last used the homesale exclusion and before the date of the current sale. The denominator of the fraction is two years. The proportion may be figured in days or months.

> **Example(s):** Suppose you owned and used a home as your principal residence for one year before selling. (Therefore, you haven ' t met the two-out-of-five-years test.) You sell the home at a $40,000 gain. Assume you ' ve never used the homesale exclusion before and you ' re single. If you qualify for a reduced exclusion, you're eligible to exclude up to $125,000 of gain ($250,000 x ½). Therefore, you ' ll be able to exclude the entire $40,000.

Change in place of employment

The temporary regulations provide that a sale or exchange of a principal residence is by reason of a change in place of employment if the taxpayer's primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. (Qualified individuals include the taxpayer, the taxpayer's spouse, a co-owner of the home, or a member of the taxpayer's household.)

The temporary regulations adopt a safe harbor for satisfying the change-in-place-of-employment condition. A home sale will be considered related to a change in place of employment if a qualified person's new place of work is at least 50 miles farther from the old home (the principal residence that was sold) than the old workplace was from that home.

> **Tip:** This is the same distance rule that applies for the moving expense deduction.

> **Tip:** If a disposition does not satisfy this safe harbor, you may still qualify for a reduced exclusion if the facts and circumstances indicate that a change in place of employment is the primary reason for the sale or exchange of your principal residence.

Health

The temporary regulations provide that a sale or exchange of a principal residence is by reason of health if the taxpayer's primary reason for the disposition is:

- To obtain, provide, or facilitate the diagnosis, cure mitigation, or treatment of disease, illness, or injury of a qualified individual, or
- To obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury.

(Qualified individuals include the taxpayer, the taxpayer's spouse, a co-owner of the residence, a person whose principal place of abode is in the same household as the taxpayer, and certain family members of these individuals.)

> **Caution:** A sale or exchange that is simply beneficial to your general health or well-being will not suffice.

The temporary regulations adopt a safe harbor for satisfying the health condition. Health is deemed to be the primary reason for the sale or exchange of the home if a physician recommends a change of residence for reasons of health.

Unforeseen circumstances

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

The temporary regulations adopt several safe harbors for satisfying the unforeseen circumstances condition. A sale will be considered as occurring primarily because of unforeseen circumstances if any of the following events occur during the taxpayer's period of use and ownership of the residence:

- Damage to the residence resulting from a natural or man-made disaster, or an act of war or terrorism
- A condemnation, seizure, or other involuntary conversion of the property
- Death
- Divorce or legal separation
- Becoming eligible for unemployment compensation
- A change in employment that leaves the taxpayer unable to pay the mortgage or reasonable basic living expenses
- Multiple births resulting from the same pregnancy

The last five events listed above must involve a qualified individual (the taxpayer, spouse, co-owner, or member of the taxpayer's household).

Tip: If a disposition does not satisfy these safe harbors, you may still qualify for a reduced exclusion if the facts and circumstances indicate that the primary reason for the sale or exchange of your principal residence involves unforeseen circumstances.

For more information, see IRS Publication 523, Selling Your Home.

Retirement Plans for Small Businesses

As a business owner, you should carefully consider the advantages of establishing an employer-sponsored retirement plan. Generally, you're allowed a deduction for contributions you make to an employer-sponsored retirement plan. In return, however, you're required to include certain employees in the plan, and to give a portion of the contributions you make to those participating employees. Nevertheless, a retirement plan can provide you with a tax-advantaged method to save funds for your own retirement, while providing your employees with a powerful and appreciated benefit.

Types of plans

There are several types of retirement plans to choose from, and each type of plan has advantages and disadvantages. This discussion covers the most popular plans. You should also know that the law may permit you to have more than one retirement plan, and with sophisticated planning, a combination of plans might best suit your business's needs.

Profit-sharing plans

Profit-sharing plans are among the most popular employer-sponsored retirement plans. These straightforward plans allow you, as an employer, to make a contribution that is spread among the plan participants. You are not required to make an annual contribution in any given year. However, contributions must be made on a regular basis.

With a profit-sharing plan, a separate account is established for each plan participant, and contributions are allocated to each participant based on the plan's formula (this formula can be amended from time to time). As with all retirement plans, the contributions must be prudently invested. Each participant's account must also be credited with his or her share of investment income (or loss).

For 2010, no individual is allowed to receive contributions for his or her account that exceed the lesser of 100 percent of his or her earnings for that year or $49,000. Your total deductible contributions to a profit-sharing plan may not exceed 25 percent of the total compensation of all the plan participants in that year. So, if there were four plan participants each earning $50,000, your total deductible contribution to the plan could not exceed $50,000 ($50,000 x 4 = $200,000; $200,000 x 25 percent = $50,000). (When calculating your deductible contribution, you can only count compensation up to $245,000 (in 2010) for any individual employee.)

401(k) plans

A type of deferred compensation plan, and now the most popular type of plan by far, the 401(k) plan allows contributions to be funded by the participants themselves, rather than by the employer. Employees elect to forgo a portion of their salary and have it put in the plan instead. These plans can be expensive to administer, but the employer's contribution cost is generally very small (employers often offer to match employee deferrals as an incentive for employees to participate). Thus, in the long run, 401(k) plans tend to be relatively inexpensive for the employer.

The requirements for 401(k) plans are complicated, and several tests must be met for the plan to remain in force. For example, the higher paid employees' deferral percentage cannot be disproportionate to the rank-and-file's percentage of compensation deferred.

However, you don't have to perform discrimination testing if you adopt a "safe harbor" 401(k) plan. With a safe harbor 401(k) plan, you generally have to either match your employees' contributions (100 percent of employee deferrals up to 3 percent of compensation, and 50 percent of deferrals between 3 and 5 percent of compensation), or make a fixed contribution of 3 percent of compensation for all eligible employees, regardless of whether they contribute to the plan. Your contributions must be fully vested. Another way to avoid discrimination testing is by adopting a SIMPLE 401(k) plan. These plans are similar to SIMPLE IRAs (see below), but can also

allow loans and Roth contributions. Because they're still qualified plans (and therefore more complicated than SIMPLE IRAs), and allow less deferrals than traditional 401(k)s, SIMPLE 401(k)s haven't become a popular option.

If you don't have any employees (or your spouse is your only employee) a 401(k) plan (an "individual 401(k)" or "solo 401(k)" plan) may be especially attractive, Because you have no employees, you won't need to perform discrimination testing, and your plan will be exempt from the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). You can make a deductible profit-sharing contribution of up to 25 percent of pay (to $245,000) on your own behalf in 2010, and in addition you can make deductible pretax contributions of up to $16,500 in 2010 (plus an additional $5,500 of pre-tax catch-up contributions if you're age 50 or older). However, total annual additions to your account in 2010 can't exceed $49,000 (plus any age-50 catch-up contributions).

Note: A 401(k) plan can let employees designate all or part of their elective deferrals as Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pretax contributions to a 401(k) plan, there's no up-front tax benefit--contributions are deducted from pay and transferred to the plan after taxes are calculated. Because taxes have already been paid on these amounts, a distribution of Roth 401(k) contributions is always free from federal income tax. And all earnings on Roth 401(k) contributions are free from federal income tax if received in a "qualified distribution."

Note: 401(k) plans are generally established as part of a profit-sharing plan.

Money purchase pension plans

Money purchase pension plans are similar to profit-sharing plans, but employers are required to make an annual contribution. Participants receive their respective share according to the plan document's formula.

As with profit-sharing plans, money purchase pension plans cap individual contributions at 100 percent of earnings or $49,000 annually (in 2010), while employers are allowed to make deductible contributions up to 25 percent of the total compensation of all plan participants. (To go back to the previous example, the total deductible contribution would again be $50,000: ($50,000 x 4) x 25 percent = $50,000.)

Like profit-sharing plans, money purchase pension plans are relatively straightforward and inexpensive to maintain. However, they are less popular than profit-sharing or 401(k) plans because of the annual contribution requirement.

Defined benefit plans

By far the most sophisticated type of retirement plan, a defined benefit program sets out a formula that defines how much each participant will receive annually after retirement if he or she works until retirement age. This is generally stated as a percentage of pay, and can be as much as 100 percent of final average pay at retirement.

An actuary certifies how much will be required each year to fund the projected retirement payments for all employees. The employer then must make the contribution based on the actuarial determination. In 2010, the maximum annual retirement benefit an individual may receive is $195,000 or 100 percent of final average pay at retirement.

Unlike defined contribution plans, there is no limit on the contribution. The employer's total contribution is based on the projected benefits. Therefore, defined benefit plans potentially offer the largest contribution deduction and the highest retirement benefits to business owners.

SIMPLE IRA retirement plans

Actually a sophisticated type of individual retirement account (IRA), the SIMPLE (Savings Incentive Match Plan for Employees) IRA plan allows employees to defer up to $11,500 (for 2010) of annual compensation by contributing it to an IRA. In addition, employees age 50 and over may make an extra "catch-up" contribution of $2,500 for 2010. Employers are required to match deferrals, up to 3 percent of the contributing employee's wages

(or make a fixed contribution of 2 percent to the accounts of all participating employees whether or not they defer to the SIMPLE plan).

SIMPLE plans work much like 401(k) plans, but do not have all the testing requirements. So, they're cheaper to maintain. There are several drawbacks, however. First, all contributions are immediately vested, meaning any money contributed by the employer immediately belongs to the employee (employer contributions are usually "earned" over a period of years in other retirement plans). Second, the amount of contributions the highly paid employees (usually the owners) can receive is severely limited compared to other plans. Finally, the employer cannot maintain any other retirement plans. SIMPLE plans cannot be utilized by employers with more than 100 employees.

Other plans

The above sections are not exhaustive, but represent the most popular plans in use today. Recent tax law changes have given retirement plan professionals new and creative ways to write plan formulas and combine different types of plans, in order to maximize contributions and benefits for higher paid employees.

Finding a plan that's right for you

If you are considering a retirement plan for your business, ask a plan professional to help you determine what works best for you and your business needs. The rules regarding employer-sponsored retirement plans are very complex and easy to misinterpret. In addition, even after you've decided on a specific type of plan, you will often have a number of options in terms of how the plan is designed and operated. These options can have a significant and direct impact on the number of employees that have to be covered, the amount of contributions that have to be made, and the way those contributions are allocated (for example, the amount that is allocated to you, as an owner).

Business Use of Autos

If you use your car, truck, or other vehicle for business purposes, you can generally deduct the expenses associated with this use on your federal income tax return. This is true whether you're self-employed or you use a vehicle provided by your employer. To calculate the deduction, you may have a choice between two methods: (1) the standard mileage rate, or (2) actual expenses.

> **Tip:** If you have a choice, you should calculate the deduction using both methods to determine which results in the larger amount.

For more information about car and truck expenses in general, see IRS Publication 463.

The standard mileage rate

Each year the IRS designates a standard mileage rate, which allows a certain deduction for each mile a vehicle is used for business purposes. For tax year 2010, the standard mileage rate is 50 cents per business mile (down from 55 cents in 2009).

> **Tip:** Keep a record of your business mileage to support your deduction. See IRS Publication 583 for more information about record keeping.

Requirements for using the standard mileage rate

To use the standard mileage deduction, (1) you must own or lease the vehicle (i.e. you cannot be an employee using an employer-provided vehicle) and (2) you must have used the standard mileage deduction in the first year the vehicle was placed in service. After the first year, you can use either the standard mileage rate or actual expenses. However, if you lease the vehicle, you must continue to use the standard mileage rate for the term of the lease.

You cannot use the standard mileage rate if any of the following applies:

- The vehicle is for hire (e.g., as a taxi or limousine)
- You operate five or more vehicles (i.e., a fleet) at the same time
- You claimed actual expenses for a vehicle you leased
- You claimed depreciation on the vehicle using a calculation method other than straight line
- You claimed a Section 179 deduction on the vehicle (discussed further below)

Deducting other vehicle expenses

If you use the standard mileage rate, you cannot deduct actual expenses. You cannot deduct depreciation, lease payments, gas and oil, maintenance and repairs, insurance, or registration fees. However, you may be able to deduct the following expenses:

- Vehicle loan interest, reduced by any percentage of personal use
- Personal property tax, regardless of personal use (available to taxpayers who itemize only)
- Parking fees and tolls

Actual expenses

If you don't qualify or simply choose not to use the standard mileage rate, you can deduct the actual costs of using your vehicle including depreciation, parking fees and tolls, tires, repairs, gas and oil, rental fees, lease fees, licensing fees, and garage rental fees. If you use your vehicle for both personal and business use, only that portion used for business is deductible.

> **Tip:** Keep careful records of all expenses. See IRS Publication 583 for more information about record keeping.

Depreciation deduction in general

Depreciation is an allowance for wear and tear, deterioration, or obsolescence, which decreases a motor vehicle's value. There are two possible depreciation deductions for motor vehicles

- Annual depreciation
- Section 179 deduction (available in the first year of service only)

Each deduction has its own restrictions and limitations. And, for certain vehicles, there is also a cap on the total standard depreciation that can be taken in a given year. See IRS Publication 946 for more information about depreciation.

Annual depreciation deduction

Because motor vehicles have useful lives extending substantially beyond the first year they are placed in service, you cannot deduct the entire purchase price, including sales tax and improvements, in the year of purchase. However, you can deduct theses costs by taking annual depreciation deductions over a number of years as long as you use your vehicle for business more than 50 percent of the time.

Section 179 deduction

Alternatively, you may be able to elect to take a Section 179 deduction for the vehicle, which allows you to deduct a limited amount in the year the vehicle is put into service.

Total standard depreciation cap

Annual depreciation and Section 179 deductions are limited to certain maximums according to the type of vehicle. The maximum total depreciation deductions that can normally be claimed for vehicles placed in service during 2010 are as follows:

- Autos: $3,060 (up from $2,960 in 2009) for the first year the car is in service, $4,900 (up from $4,800 in 2009) for the second year, $2,950 (up from $2,850 in 2009) for the third year, and $1,775 (same for 2009) for each succeeding year
- Trucks and vans: $3,160, $5,100, $3,050, and $1,875 respectively ($3,060, $4,900, $2,950 and $1,775 respectively in 2009).

> **Tip:** The American Recovery and Reinvestment Act of 2009 extends the first-year 50-percent additional depreciation to property acquired in 2009, increasing the first-year auto limits by $8,000. As a result, the first-year depreciation limits for 2009 are $10,960 for autos and $11,060 for trucks and vans.

> **Caution:** These maximums are reduced if the vehicle is used less than 100 percent for business, or less than a full year.

The types of vehicles subject to the limitations described above are:

- Passenger automobiles weighing 6,000 pounds or less
- Trucks, vans (including minivans), and SUVs weighing 6,000 pounds or less unless the vehicle is exempt

Vehicles that are exempt from the limitations described above are:

- Trucks, vans (including minivans), and SUVs weighing more than 6,000 pounds
- Trucks, vans (including minivans), and SUVs weighing 6,000 pounds or less that have been modified to meet the description of a "qualified non-personal use vehicle."

Caution: Certain exempt vehicles placed into service on or after October 23, 2004 are subject to a $25,000 Section 179 deduction limit.

See IRS Publication 463 for more information about the total standard depreciation cap.

Employer reimbursements

You cannot deduct the cost of using your vehicle for business purposes if your employer reimburses you for these expenses. You do not have to report the reimbursement allowance or the expenses on your tax return, and your employer will not report the reimbursement as income on your W-2 form as long as you provide a record to your employer showing the time, place, and business purpose of the vehicle expense being reimbursed.

Tip: If you're reimbursed at a rate below the standard mileage rate, the difference may be deducted on Schedule A. If you're reimbursed at a rate above the standard mileage rate, the difference is treated as taxable wages to you.

Home Office

What is a home office for purposes of the home office deduction?

A home office may be defined as a room within your home, a portion of a room within your home, or a separate structure appurtenant to your home that you use exclusively and on a regular basis to conduct business activities. If you use a home office to run a business, either as an administrative office or as a place in which to make, assemble, or prepare items that you sell, you may be able to deduct part of your housing expenses (such as rent or utilities) on your federal income tax return. This deduction is known as a home office deduction. (To take this deduction, you will need to file Form 8829. This is generally true whether you use your home for business purposes as an employee or for a business of your own.) But be aware that the IRS has taken a strict stance towards home office deductions, establishing specific rules that, if not met, could disallow your taking a home office deduction.

What constitutes your home?

Your home can be your house, condominium, apartment, mobile home, or boat, so long as you live in it. It is important to note that your home office need not be located inside your home; a structure appurtenant to your home, such as a shed or garage, can qualify as a home office if all applicable requirements are met.

> **Caution:** To even consider the home office deduction, you must use the applicable portion of your home in an activity that qualifies as a trade or business.

For example, if you exclusively and regularly use a room in your home to read information and analyze stocks and mutual funds that you invest in, you will not be able to take a home office deduction, since your activity does not qualify as a trade or business.

What two tests must be satisfied before you can qualify for a home office deduction?

If you want to qualify for a home office deduction, you must meet two threshold tests:

- The place of business test
- The exclusive and regular use test

Place of business test

In order to meet this test, you must show that you use a portion of your home as:

- The principal place of business for any trade or business you conduct, or
- A place where, in the normal course of your business, you regularly meet with clients, customers, or patients, or
- In the case of a separate structure that is not attached to your dwelling unit, you must show that you use it in connection with your trade or business (i.e., it needn't be your principal place of business)

Your home office will qualify as your principal place of business for purposes of deducting expenses for its use if you meet the following requirements:

- You use it exclusively and regularly for administrative or management activities of your trade or business

- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business

However, if the preceding does not apply and you do business at more than one location, your principal place of business is determined using a two-part test:

- What is the relative importance of the activities performed at each business location?
- How much time do you spend conducting these activities at each place of business?

The IRS will look at the relative importance portion of this test first to decide which place of business is your principal place of business. If this is inconclusive, then it will look at the time portion of this test to determine where most of your business activities take place.

Example(s): Assume John is a doctor who works 40 hours per week at a local HMO, where he meets and attends to all of his patients. Since his employer provides him with examination space but not with office space, John uses a room in his home exclusively as an office 10 hours each week. John uses the office space to engage in billing and other business-related paperwork, to correspond with insurance companies, and to read medical journals. John could qualify for a home office deduction, since he conducts substantial administrative and management activities for his business on a regular basis and uses his home office exclusively for business purposes.

Exclusive and regular use test

In addition to the place of business test, you must also pass the exclusive and regular use test before you can take a home office deduction. To pass this test, you must show that you exclusively use a portion of your home for your trade or business on a regular basis.

Example(s): Example 1: You've set aside one room in your home as your office from which you manage the investment real estate you own. But, in addition, you use this room as your children's playroom. Here, you wouldn't meet the exclusive use test.

Example(s): Example 2: Assume the same facts as example one, except that you've taken a large room in your home and divided it in two with a room divider. Half you use exclusively for your office, half you use as your children's playroom. In this case, you would meet the exclusive use test. (And note, although the divider used in this example is helpful, it is not required to meet the exclusive use test.)

Example(s): Example 3: You've set aside a small room in your home that you use exclusively as an office to run a side business, selling insurance. However, since you engage in this business only intermittently--not on a regular basis--you will not be allowed the home office deduction. You don't pass the regular use portion of the test.

Tip: If your business involves selling a particular product or products and you run the business out of your home, you can take a home office deduction for that portion of your home that you regularly use to store inventory or samples of the product or products. This only applies if the space is a separate space that is suitable for storage, and your home is the sole fixed location of the business.

Tip: If the business use of your home is running a day-care center for children, elderly, or handicapped citizens and you have met state licensing rules, then you need not meet the exclusive use test, so long as a portion of your home is regularly used to provide the day-care services.

What if you conduct multiple businesses from your home or use your home to conduct only a sideline business?

Perhaps you use your home as an office or business space to conduct multiple businesses, or you use your home office for both a business you run and for business that you do for an employer. If so, you must be sure that each separate business use meets all of the required tests and rules relating to the home office deduction. Note

that you may not be able to satisfy the exclusive use test if you use the same home office to conduct more than one trade or business activity.

> **Example(s):** You run a T-shirt production and sales business out of your home's basement, which meets all of the tests and rules for the home office deduction. However, you also use the desk, computer, and copy machine portion of the basement to do the paperwork for your full-time job.

> **Example(s):** Because your employer at your full-time job provides you with an office, the use of your home does not qualify for the home office deduction. Furthermore, because of the mixed use of your basement, the IRS may also disallow the deduction for the T-shirt business (for failure to satisfy the exclusive use test).

Which home office expenses can you deduct?

You can deduct both direct and indirect expenses that apply to a portion of your home that you use for business purposes. Direct expenses are costs expended solely on the portion of your home you use for business purposes. These can be deducted in full.

> **Example(s):** You use one room in your home exclusively for business purposes. You spend $300 to have that room painted and $100 to have a separate phone line jack brought into that room. You can deduct the entire $400 as a home business expense.

Indirect expenses are costs that benefit your entire home, including the portion of your home that you use for business purposes. You can deduct the business percentage of these expenses.

> **Example(s):** You use a room in your home exclusively for business purposes. The square footage of the room equals 20 percent of the square footage of your home. You spend $3,000 to paint the exterior of your home. This is an indirect expense--you can deduct $600 (20 percent of $3,000) as a home office deduction.

How do you calculate your business percentage?

You can use any reasonable measure to calculate the percentage of your home that you use for business purposes. The two most common, however, are the:

Square foot method

Divide the square footage of the portion of your home that you use for business purposes by the total square footage of your home.

> **Example(s):** Your home is 2,000 square feet, and you use one room that is 200 square feet. Your business percentage is 10 percent (200 divided by 2,000).

Number of rooms method

If all the rooms in your home are relatively equal in size, divide the number of rooms you use for business purposes by the total rooms in your home.

> **Example(s):** Your home contains 10 rooms of relatively equal size, of which 2 are used exclusively for business purpose. Your business percentage is 20 percent (2 divided by 10).

Which expenses are deductible?

The following expenses are considered deductible expenses:

- Deductible mortgage interest --This is an indirect expense and also includes any interest you pay on a

second mortgage secured by a home you own and live in. (However, other rules may limit the amount of your home mortgage interest deduction.)

- Real estate taxes paid on a home you own and live in--This is an indirect expense.

Tip: After you calculate the business portion of your deductible mortgage interest on Form 8829, you should then subtract that amount from your total deductible mortgage interest. The remainder can be deducted on your Schedule A itemized deductions. The same applies to your real estate taxes.

- Rent--Rent you pay on a home you live in (this includes rental of a house, apartment, condominium, or any other qualifying residence if it includes a qualifying home office) is an indirect expense.

- Utilities--This includes electricity, gas, cleaning, and trash removal. These are almost always indirect expenses.

Tip: An expense such as the fee that is charged by an Internet service provider may be a direct expense, if you can show it is used exclusively for business purposes.

- Insurance--This would include homeowners insurance or apartment insurance. This is an indirect expense.

- Telephone--You cannot deduct the basic cost of the main telephone line into your home. However, you can deduct the cost of long-distance telephone calls for business purposes used on this or another phone line, as well as the cost of other phone lines brought into your home to be used for business purposes.

Tip: These expenses are reported separately from the home office deduction when reported on a Schedule C.

- Repairs--Repairs to your home that keep it in good working condition. For example, furnace repairs, painting, and a new roof are deductible. These are indirect expenses.

- Casualty losses--If part of your home (or its contents) is damaged or destroyed, you can deduct the value of the loss, minus any salvage value and/or insurance reimbursement you receive. Whether this loss is treated as an indirect or direct expense will depend on the part of the home and/or contents that are damaged or destroyed.

- Security systems--You can deduct the business percentage of this indirect expense if the security system protects all doors and windows and other entrances or exits into your home. In addition, you may be able to take a depreciation deduction for that part of the security system that relates to the portion of your home used for business purposes.

- Depreciation --Certain property that you can use for more than one year may be depreciated for income tax purposes. This can include (but is not limited to) a building (or permanent improvement to one), furniture, equipment (such as a computer or copy machine), or security system. You may be able to take a deduction for depreciation on such property.

Caution: If you're a homeowner and meet all requirements, you can generally exclude up to $250,000 of gain ($500,000 if you're married and file jointly) from federal income tax when you sell your home. You may end up paying some taxes, though, if you have a home office. The capital gain on the sale of your home will not qualify for this exclusion to the extent of any depreciation deductions you claimed after May 6, 1997. You should consult an attorney for more details.

Tip: If you are starting a new business, pay particular attention to determining whether the costs of property acquired for use in the trade or business can be recovered through depreciation deductions or through Section 179 deductions.

Tip: Claiming a home office as your principal place of business can also have implications for your

ability to deduct certain transportation expenses. If your principal place of business is your home, you may deduct daily transportation expenses incurred in traveling between your home and another work location.

Example(s): Jill is an architect whose principal place of business is in her home. During the week, she drives from her home to clients, construction sites, the post office, and office supplies stores. Her mileage for all of these trips is considered business mileage.

For related information, see Travel Expenses and Business Use of Autos.

Are there any limits on deductibility of home office expenses?

If the total amount of business expense for the business use of your home (including depreciation) is less than or equal to your total gross income from the business use of your home, you can deduct all of these expenses. However, if gross income is less than total expenses, your home office deduction may be limited. (You may, however, be able to carryover any excess deductions to the next tax year.)

Caution: The rules relating to limits on home office deductions (and on the deductibility of depreciation) are very complicated. Accordingly, if you have excess deductions or may be including depreciation as part of these deductions, it's wise to consult with your accountant and/or tax attorney.

What happens when you sell your home?

If you're a homeowner and meet all requirements, you can generally exclude up to $250,000 of capital gain (up to $500,000 if you're married and file jointly) from federal income tax when you sell your principal residence. You may end up paying some taxes, though, if you have a home office; capital gain on the sale of your home will not qualify for this exclusion to the extent of any depreciation deductions attributable to the business use of your home after May 6, 1997.

In the past, the IRS took the position that if a principal residence was used partially for residential purposes and partially for business purposes (mixed-use property), any capital gain on the sale of the house would have to be prorated. Only the part of the gain allocable to the residential portion was eligible for exclusion.

Final regulations issued by the IRS, however, have adopted a more liberal position. So long as both the residential and non-residential portions of the property are within the same dwelling unit (e.g., one room in the home is used as a home office), all of the gain from the home sale (except for gain resulting from certain depreciation deductions) is eligible for the capital gain exclusion. However, gain is allocated if the business portion of the home is separate from the dwelling unit (e.g., an office in a converted detached garage).

Example(s): Assume a self-employed accountant bought a home in 1998 and sold it several years later at a $20,000 gain. Although the house was always used as his principal residence, the accountant used one room within the house as his business office. Over the years, the accountant claimed $2,000 of depreciation deductions for his office. Under the final regulations, $18,000 of the capital gain will be tax-free. Only the $2,000 of the gain equal to the depreciation deductions will be taxable. The taxable amount will be considered unrecaptured Section 1250 gain, which is taxed at a rate of 25 percent.

Example(s): If the accountant's office had been located in a converted detached garage on his property, he would have to treat the sale as two separate transactions and pay tax on the gain allocable to the converted garage.

For more information, see Exclusion of Capital Gain on the Sale of Your Home. Also, read IRS Publication 587, Business Use of Your Home.

Meals and Entertainment Expenses and Business Gifts

What is it?

You can deduct 50 percent of your unreimbursed costs of entertaining clients and customers, including the costs of meals, as long as the entertainment is related to a business purpose. For employees, this deduction is further reduced by the 2 percent adjusted gross income floor on your Schedule A. However, the IRS scrutinizes these deductions very closely, so, as with all business expenses, you should keep detailed records. In addition, certain business gifts are deductible, subject to separate limitations.

Deductibility tests

For your entertainment costs (including the cost of meals) to be deductible, they must meet one of the two following tests:

"Directly related" test--the entertainment is necessary for and directly related to the active conducting of your business

To meet this test, you must:

- Actively engage in the business meeting, discussion, or activity with the person or persons being entertained
- Expect to derive income or some other specific business benefit (other than just good will)
- Intend the active conducting of your business as the purpose of the combined business-entertainment

Tip: Although it need not be so, if the entertainment occurs in a clear business setting (e.g., entertainment held for publicity purposes to herald the opening of a new store) or if you entertain people with whom you have no personal or social relationship, then the activity will generally be presumed to meet the directly related test.

Caution: Entertainment generally will not meet the directly related test if you are not present during the entertainment, if the distractions of the entertainment are substantial (e.g., a sporting event), or if you meet with a group that includes both business and nonbusiness associates at the place of entertainment. However, such entertainment expenses may qualify under the "associated" test.

"Associated" test--the entertainment is associated with the active conducting of your business

To meet this test, the following must apply:

- The entertainment activity must clearly have a business purpose
- The entertainment must directly precede or directly follow a meeting or discussion that has a clear, substantial, and bona fide relationship to your business

Tip: If you meet the "associated" test, the entertainment can be held in nonbusiness-related settings, such as restaurants, theaters, or sporting events. For instance, you might take a prospective client to lunch and then discuss the possibility of his or her company hiring your company to provide technical support.

Tip: The business discussion or meeting generally must be held on the same day as the entertainment that precedes or follows it. However, the IRS does recognize exceptions, as demonstrated by the following example:

Example(s): Say some prospective new business customers arrive from out of town on Tuesday for a new product presentation on Wednesday, and on Tuesday evening, you take them to dinner. You may deduct, as an entertainment expense, the cost of dinner on Tuesday.

Both the "directly related" test and the "associated" test include entertainment directed toward acquiring additional business clients or customers or toward furthering and continuing an existing business relationship.

Whom can you entertain and still deduct the costs?

If the entertainment meets either the "directly related" test or the "associated" test, you can deduct the costs if the entertainment pertains to any of the following:

- Present or prospective clients and customers
- Suppliers
- Employees or partners
- Agents
- Prospective or established professional advisors

Goodwill entertainment

If the purpose of business-related entertainment is strictly to promote goodwill, then the cost is not deductible. However, if the purpose is both goodwill and a related business purpose, then the entertainment is deductible.

Example(s): Suppose you invite a number of clients to an evening baseball game, during which business is not discussed. Here, your intention is to cultivate goodwill, so the entertainment cost is not deductible. However, if you hold a business meeting with the clients at your office during the afternoon preceding the baseball game, the entertainment costs of the game would qualify, even if no business is discussed at the game (assuming no part of the costs includes rental of a skybox or private luxury box).

Example(s): Suppose you hold a dinner party for prospective clients at a local hotel. The entertainment cost is not deductible. However, if, during the course of the evening, you present a 45-minute slide show of new products and services your company is debuting, then the entertainment costs of the dinner party would be deductible.

Entertaining at home

You can deduct the cost of having business clients or customers to your home for dinner or another meal if a business-related discussion takes place before, during, or after the meal.

Deducting for your meal-related entertainment costs

If you entertain business customers or clients when you are on business away from home, you can deduct the cost of your meal as part of your own travel expenses (see Travel Expenses), and deduct the cost of their meals as an entertainment expense (assuming the meal meets one of the qualifying tests).

Caution: If the entertainment meal is held in the area of your primary place of business, you generally can deduct the cost of your portion of the meal, unless the IRS finds an abusive pattern of taking such "close to home" personal meal deductions. Accordingly, it is best to consult with your accountant or tax attorney before deciding whether such deductions are justifiable.

Deducting your spouse's entertainment-related costs

If you can deduct the cost of entertainment under the "directly related" test and your spouse was present, the cost attributable to your spouse can also be deducted. Your spouse's share is also deductible for goodwill entertainment that qualifies for deduction.

Tip: The IRS recognizes that, in some instances, it is impractical not to have your spouse attend a business entertainment event. In those cases, the cost of your spouse's attendance is deductible.

Example(s): A business customer from out of town travels to your company on Monday to view your new product line. He is accompanied by his spouse. That evening, you and your wife take him and his wife to dinner. Here, the cost of dinner would qualify for deduction under the "associated" test. However, since it may be impractical not to have your wife accompany you to dinner, the cost of her dinner is also deductible.

Deducting for facilities used for entertainment

You typically cannot deduct the cost of maintaining an "entertainment facility" (e.g., a lodge or vacation home, a yacht, or a swimming pool) even if you regularly use it for business purposes.

Tip: Some of the costs of such facilities, however, may be deductible under other portions of the tax code (e.g., property taxes and mortgage interest on a second or vacation home).

Tip: The cost of food or other entertainment provided at an entertainment facility can be deducted if the entertainment qualifies under the "directly related" test or "associated" test.

Tip: Under the Internal Revenue Code, season tickets to sporting or theatrical events are not considered entertainment facilities and therefore may be deductible when used for a qualifying entertainment purpose (assuming the tickets are not for a skybox or private luxury box).

Caution: You may deduct only for the face value of the cost of tickets. Additional charges (e.g., processing fees, fees paid to ticket agencies, or a "scalping" fee) are not deductible.

Luxury boxes

There are limitations on the deductibility of rental payments made for "skyboxes" or private luxury boxes at sporting arenas, even when such boxes are used for entertainment that meets either the "directly related" or "associated" test. Skybox or luxury box seats at an entertainment or sporting venue are subject to a nonluxury box ticket price limitation.

Example(s): Suppose your company has a 10-seat skybox at a professional sporting arena and that the cost per seat per game in your luxury box equals $80 per seat. Similar nonluxury box seats cost $60 per game. In this case, you could only deduct $300 per game when the luxury box is used to entertain business clients or customers ($60 multiplied by 10, reduced by the 50 percent limitation on meal and entertainment costs), and the entertainment otherwise qualifies for deduction. The cost of food served in the luxury box is also deductible (assuming the entertainment qualifies); this cost is not subject to the luxury box limitation, but it is limited by the 50 percent rule.

Tip: Note: If you rent a luxury box for only one event, the luxury limitation does not apply.

Deducting club costs and dues

You cannot deduct the costs, including dues, of clubs such as golf clubs, athletic clubs, or business lunch clubs. You may, however, be able to deduct the costs of certain business-related associations (e.g., fees paid to a chamber of commerce or a bar association).

50 percent limit on deducting meal and entertainment costs

Meal and entertainment costs (including taxes and tips) that otherwise qualify for deduction are subject to a 50 percent deduction limitation. This includes all meals and entertainment costs discussed in this section. Moreover, if, instead of keeping strict records of your meal costs, you choose to use the daily IRS meal allowance, the 50 percent limitation applies to these amounts.

Exceptions to the 50 percent limitation rule

The 50 percent limitation on the deduction of meal and entertainment costs does not apply to you as an employee if your employer reimburses you under what is known as an accountable plan and does not treat the reimbursement as wages. If you are an employer, there are a number of exceptions to the 50% limitation rule that apply to reimbursements for meal and entertainment expenses made to your employees and for expenses related to certain charitable events.

> **Tip:** For more information on accountable plans and reimbursement exceptions, consult your accountant or tax attorney.

Business gifts

Gifts to business clients or customers are deductible, up to a maximum amount of $25 per recipient per year.

However, when figuring the $25 limitation per recipient, do not include the following items:

- Specialty advertising items (pens, key chains, and other items that have your or your company's name printed on them) that cost $4 or less
- Signs, displays, or other promotional items that you give to a business customer or client to be used at his or her place of business
- Related incidental costs, such as the cost of wrapping or sending the gift

> **Tip:** Gifts made to the spouse of a business customer or client, or gifts made to a corporation or company that are intended to be used by a specific business customer or client, are considered for business gift tax purposes to be gifts made to the business customer or client.

Entertainment or gift?

If an item can be considered either as a gift or as a qualifying entertainment expense, it can generally be considered and taken as an entertainment expense (subject to the 50 percent limitation). However, note the following conditions:

- Theater or sporting tickets must be considered a business gift if you do not accompany the business customer or client to the event
- Packaged food or drink, given to and intended for consumption at a later time by a business customer or client, must be considered a business gift

Exceptions to the $25 business gift limitation

There are two exceptions to the $25 business gift deduction limitation:

- Certain tax-free scholarships

- Certain tax-free prizes and awards

In addition, noncash awards made to employees for special achievements or dedicated service are subject to higher deduction limitations, as long as the awards are not disguised compensation. These higher deduction limits are subject to the following rules:

- There is a $1,600 deduction ceiling per year per employee if the awards are not disguised compensation and are under a qualified plan award. To be a qualified plan award, the plan must be in writing, each award must not average a cost of more than $400, and the plan must not discriminate in favor of highly compensated employees.

- If the awards do not come under a qualified award plan, there is a $400 deduction ceiling per year per employee.

Keeping Records of Travel, Meal, and Entertainment Expenses

What is it?

If you take deductions for travel, meal, or entertainment expenses and they are challenged or questioned by the IRS, you must have either written evidence, or written evidence from another person, to substantiate your deduction claim. Moreover, since the IRS tends to scrutinize such deductions closely, your travel, meal, and entertainment expenses, if examined, will generally be disallowed unless you have records that satisfy certain statutory and regulatory requirements.

What types of records of travel, meal, and entertainment expenses will comply with IRS rules?

In the event of an audit, the IRS generally requires that you have two types of evidence to back up your deductions for expenses. These are:

- A written record (this can be in the form of a diary, accounting book, or other written record) that details the time, place, and business-related purpose of the travel expense or entertainment expense
- Documentary evidence, which can include itemized payment slips, receipts, or other written records showing you paid for specific travel or entertainment expenses that cost $75 or more

Exceptions to IRS record rules

There are a number of exceptions to the rules listed, including the following:

- You will need a written record showing you paid for all lodging expenses, even if an expense was for less than $75.
- Transportation expense receipts are required only when such written receipts are readily available.
- You cannot use a canceled check alone to back up a deduction claim. If your only record is a canceled check, you may be required to obtain a copy of the bill from the payee or a written statement from a witness (such as a business partner) stating the business purpose of the expense.

Diary or accounting book records

Your diary or accounting book records of your travel, meal, and entertainment expenses need not exactly duplicate information shown by the required receipts and vouchers you retain to back up your deductions (although, the more detailed your written record, the better). You should note in your written record all business-related travel, meal, and entertainment charges paid via a credit card.

Special requirements for entertainment expenses

The records you keep of entertainment expenses should list the following:

- Cost
- Date of entertainment

- The names of the people entertained
- Your business relationship with those you entertained
- Where the entertainment took place
- The entertainment's business purpose
- The nature of the business discussion or activity

What constitutes an acceptable receipt?

For a receipt or voucher to be acceptable to the IRS, it must show the following:

- The date and amount of the expense
- Where the expense was incurred and the nature of the expense

Restaurant receipts

Receipts from restaurants must list the following:

- The restaurant's name and location
- The number of people served
- The date of and the amount of the expense
- An itemization of any additional nonfood or beverage expenses

Hotel receipts

Receipts from hotels or other places of lodging must list the following:

- The hotel's or other place of lodging's name and location
- The amount of the expense, including an itemization of lodging expenses and separate nonlodging expenses, such as phone calls, food, and beverages

How long should you keep your records and receipts of travel, meal, and entertainment expenses?

You should keep your travel, meal, and entertainment expense records for at least three years after the date on which you file the tax return on which the deductions are claimed.

What if you can't produce written records that meet IRS rules?

If you can show you made a good-faith effort to comply, the IRS will not necessarily disallow a deduction simply because all record requirements were not met.

If you keep a diary detailing all of your travel, meal, and entertainment expenses and you have retained the required receipts backing up most but not all of these expenses, the IRS may determine that you acted in good faith and may not disallow the few deductions for which you don't have required receipts.

Exceptions to record rules

If your records of travel, meal, and entertainment expenses are destroyed due to circumstances out of your control (e.g., in a fire), you can back up your deduction claims by reconstructing these records, as long as the reconstruction is deemed reasonable. In addition, if you can demonstrate that you were unable to comply with IRS record-keeping rules due to the inherent nature of the situation in which an expense is incurred, the IRS may accept evidence of the expense that does not strictly comply with their rules.

What if you are self-employed?

If you are self-employed, you must keep the same records detailing your travel, meal, and entertainment expenses as you would if you were an employee. However, rather than deduct these expenses on your Schedule A, you report them on your Schedule C.

> **Tip:** Reporting business expenses on Schedule C is more favorable, because travel, meal, and entertainment expenses reported on your Schedule C are not subject to the 2 percent adjusted gross income floor that these expenses would be subject to if reported on Schedule A.

> **Caution:** Your business-related meal and entertainment expenses may be subject to the 50 percent limitation.

Health-Care Reform: High-Income Individuals Face New Medicare-Related Taxes in 2013

The health-care reform legislation enacted in 2010 included new Medicare-related taxes. These new taxes take effect in 2013, and target high-income individuals and families. While additional details and clarifications will become available between now and 2013, here's what you need to know.

New additional Medicare payroll tax

If you receive a paycheck, you probably have some familiarity with the Federal Insurance Contributions Act (FICA) employment tax; at the very least, you've probably seen the tax deducted on your paystub. The old age, survivors, and disability insurance ("OASDI") portion of this FICA tax is equal to 6.2 percent of covered wages (up to $106,800 in 2010). The hospital insurance or HI portion of the tax (commonly referred to as the Medicare payroll tax) is equal to 1.45 percent of covered wages, and is not subject to a wage cap. FICA tax is assessed on both employers and employees (that is, an employer is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax, and each employee is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax on wages as well), with employers responsible for collecting and remitting the employees' portions of the tax.

Self-employed individuals are responsible for paying an amount equivalent to the combined employer and employee rates on net self-employment income (12.4 percent OASDI tax on net self-employment income up to the taxable wage base, and 2.9 percent HI tax on all net self-employment income), but are able to take a deduction for one-half of self-employment taxes paid.

Beginning in 2013, the health-care reform legislation increases the hospital insurance (HI) tax on high-wage individuals by 0.9 percent (to 2.35 percent). Who will be subject to the additional tax? If you're married and file a joint federal income tax return, the additional HI tax will apply to the extent that the combined wages of you and your spouse exceed $250,000. If you're married but file a separate return, the additional tax will apply to wages that exceed $125,000. For everyone else, the threshold is $200,000 of wages. So, in 2013, a single individual with wages of $230,000 will owe HI tax at a rate of 1.45 percent on the first $200,000 of wages, and HI tax at a rate of 2.35 percent on the remaining $30,000 of wages for the year.

Employers will be responsible for collecting and remitting the additional tax on wages that exceed $200,000. (Employers will not factor in the wages of a married employee's spouse.) You'll be responsible for the additional tax if the amount withheld from your wages is insufficient. The employer portion of the HI tax remains unchanged (at 1.45 percent).

If you're self-employed, the additional 0.9 percent tax applies to self-employment income that exceeds the dollar amounts above (reduced, though, by any wages subject to FICA tax). If you're self-employed, you won't be able to deduct any portion of the additional tax.

New Medicare contribution tax on unearned income

Beginning in 2013, a new 3.8 percent Medicare contribution tax will be imposed on the unearned income of high-income individuals (the new tax is also imposed on estates and trusts, although slightly different rules apply). The tax is equal to 3.8 percent of the lesser of your net investment income (generally, net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity or a business that trades financial instruments or commodities), or your modified adjusted gross income (basically, your adjusted gross income increased by any foreign earned income exclusion) that exceeds $200,000 ($250,000 if married filing a joint federal income tax return, $125,000 if married filing a separate return).

So, effectively, you'll only be subject to the additional 3.8 percent tax if your adjusted gross income exceeds the dollar thresholds listed above. It's worth noting that interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence that are excluded from gross income are not considered net investment income for purposes of the additional tax. Qualified retirement plan and IRA distributions are also not

considered investment income.

Together, these two new Medicare-related taxes are expected to provide a major source of revenue to finance other parts of health-care reform. The Joint Committee on Taxation projects that the combined revenue attributable to these two new taxes will exceed $210 billion over the ten-year period ending in 2019 (Source: Joint Committee on Taxation, Publication JCX-17-10, March 20, 2010).

2010 Health-Care Reform: Tax Considerations

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act (Patient Act) into law. On March 30, 2010, the president signed into law a reconciliation bill, the Health Care and Education Affordability Reconciliation Act of 2010, which included substantial changes to the Patient Act. Together, both pieces of legislation make sweeping reforms to health care in the United States.

Tax provisions--individuals

Adoption credit and employer-provided adoption assistance

Prior to the health-care reform legislation, the maximum tax credit allowed for qualified adoption expenses for tax year 2010 was $12,170 per eligible child (the credit phased out for taxpayers with modified adjusted gross income between $182,520 and $222,520). Additionally, the adoption credit was scheduled to revert to its pre-2001 level of $6,000 for special needs adoptions (there would be no credit for non-special needs adoptions) beginning in 2011. Prior to the health-care reform legislation, the same dollar limits and phaseout range applied to the exclusion of employer-provided adoption assistance from gross income, and no exclusion would be available beginning in 2011.

The health-care reform legislation increases the 2010 maximum credit for qualified adoption expenses, as well as the maximum amount of employer-provided adoption assistance that can be excluded from adjusted gross income to $13,170. As was the case before the new legislation, the credit (or the exclusion for employer-provided assistance) will be phased out for taxpayers with adjusted gross income between $182,520 and $222,520. The credit is also made refundable. These limits are also extended for one year, through 2011, and adjusted for inflation.

FSAs, HRAs, HSAs, and Archer MSAs

Tax treatment of over-the-counter medications

For tax years prior to 2011, over-the-counter medications are treated as qualified medical expenses for purposes of flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer MSAs. This means that, in the case of FSAs and HRAs, reimbursements can be made for expenses relating to such over-the-counter medications (such reimbursements are excludible from gross income). In the case of HSAs and Archer MSAs, distributions relating to over-the-counter medications are also excludible from gross income.

The health-care reform legislation modifies the definition of qualified medical expenses for purposes of employer-provided health coverage (including FSAs, HRAs, HSAs, and Archer MSAs) to match, generally, the definition of qualified medical expenses for purposes of itemized deductions for medical expenses. Beginning in 2011, FSAs and HRAs will not be able to make reimbursements for the cost of over-the-counter medications, and HSA and Archer MSA distributions used to pay for the cost of over-the-counter medications will not qualify for exclusion from income. The two exceptions will be insulin and over-the-counter medications that are prescribed by a physician.

Increase in additional tax for HSAs and Archer MSAs

Distributions from an HSA that are used for qualified medical expenses are excludible from gross income. Distributions from an HSA that are not used for qualified medical expenses are included in income. Unless an exception applies, an additional tax (equal to 10 percent in 2010) is assessed for all HSA disbursements not made for qualified medical expenses. Archer MSAs are also subject to an additional tax (equal to 15 percent in 2010) for disbursements not made for qualified medical expenses.

Beginning in 2011, the health-care reform legislation increases the amount of the additional tax that applies to HSA and Archer MSA distributions not made for qualified medical expenses to 20 percent.

Health FSAs in cafeteria plans--limit imposed

Beginning in 2013, in order for a health FSA to be a qualified benefit under a cafeteria plan, the amount available under the FSA for reimbursement of qualified medical expenses cannot exceed $2,500. The $2,500 amount is adjusted for inflation for years after 2013.

This change has no effect on health FSAs that are not part of a cafeteria plan, HRAs, dependent care FSAs, or adoption assistance FSAs.

Increase in Medicare-related taxes for high-income individuals

New additional Medicare payroll tax

There are two components of the Federal Insurance Contributions Act (FICA) employment tax imposed on wages. The old age, survivors, and disability insurance (OASDI) portion of the tax is equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2010). The hospital insurance or HI (commonly referred to as the Medicare payroll tax) portion of the tax is equal to 1.45 percent of covered wages, and is not subject to a wage cap. FICA tax is assessed on both employers and employees (that is, an employer is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax, and each employee is also subject to a 6.2 percent OASDI tax and 1.45 percent HI tax on wages as well), with employers responsible for collecting and remitting the employees' portion of the tax.

Self-employed individuals are responsible for paying an amount equivalent to the combined employer and employee rates above on net self-employment income (12.4 percent OASDI tax on net self-employment income up to the taxable wage base, and 2.9 percent HI tax on all net self-employment income).

Effective for tax years beginning after December 31, 2012, a new additional hospital insurance tax is imposed on high-wage individuals. These high-wage taxpayers will be subject to an additional hospital insurance tax of 0.9 percent (for a total HI tax rate of 2.35 percent) on wages received that exceed a specific threshold amount:

Threshold amount for purposes of additional HI tax	
Married filing joint or surviving spouse	$250,000
Married individual filing a separate return	$125,000
All others	$200,000

Caution: For married individuals filing a joint return, the additional tax is calculated based on the combined wages of both spouses.

Tip: While employers are responsible for collecting and remitting the additional HI tax, an employer will not consider wages received by an employee's spouse. An employer will withhold the additional HI tax on any portion of an employee's wages that exceeds $200,000. Employees are liable for the additional HI tax even if their employer does not withhold the tax from wages. The additional HI tax applies only to the employee portion of the HI payroll tax.

Example(s): (From the Joint Committee on Taxation's Technical Explanation of the legislation, JCX-18-10, March 21, 2010) If a taxpayer's spouse has wages in excess of $250,000 and the taxpayer has wages of $100,000, the employer of the taxpayer is not required to withhold any portion of the additional tax, even though the combined wages of the taxpayer and the taxpayer's spouse are over the $250,000 threshold. In this instance, the employer of the taxpayer's spouse is obligated to withhold the additional 0.9 percent HI tax with respect to the $50,000 above the threshold with respect to the wages of $250,000 for the taxpayer's spouse.

In the case of a self-employed individual, the additional HI tax applies to self-employment income in excess of the applicable threshold amount. The applicable threshold amount that applies to self-employment income is reduced by any wages taken into account in determining FICA tax for the individual. No deduction for self-employment

taxes paid is allowed for the additional HI taxes.

New unearned income Medicare contribution tax

Effective for tax years beginning after December 31, 2012, a new "unearned income Medicare contribution tax" is imposed on high-income taxpayers. The tax applies to individuals, estates, and trusts.

For individuals, the tax is equal to 3.8 percent of the lesser of:

- Net investment income, or
- The excess of modified adjusted gross income (adjusted gross income increased by any foreign earned income exclusion) over the applicable threshold amount

Threshold amount for purposes of unearned income Medicare contribution tax	
Married filing joint or surviving spouse	$250,000
Married individual filing a separate return	$125,000
All others	$200,000

Technical Note: In the case of an estate or trust, the tax is 3.8 percent of the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to the estate or trust begins. The tax does not apply to certain trusts, including trusts that are exempt from tax under IRC Section 501, and charitable remainder trusts exempt from tax under IRC Section 664.

Caution: The tax does not apply to nonresident aliens.

Tip: Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (2) other gross income derived from any business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

Tip: Interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence that are excluded from gross income are not considered net investment income for purposes of the additional tax.

Technical Note: In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities. The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

Technical Note: In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity that is not property attributable to an active trade or business is taken into account.

Tip: Income, gain, or loss on working capital is not treated as derived from a trade or business. Investment income does not include distributions from a qualified retirement plan or amounts subject to self-employment tax.

Itemized deduction for medical expenses

Effective for taxable years beginning after December 31, 2012, the threshold for the itemized deduction of unreimbursed medical expenses is increased from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI. In other words, beginning in 2013, unreimbursed medical expenses will be deductible on Schedule A of IRS Form 1040 only to the extent that they exceed 10 percent of AGI.

In 2013, 2014, 2015, and 2016, however, if a taxpayer or a taxpayer's spouse turns age 65 before the end of a taxable year, the 7.5 percent AGI threshold continues to apply. Beginning in 2017, the 10 percent AGI threshold will apply to individuals who have reached age 65 as well.

> **Tip:** The alternative minimum tax (AMT) threshold for the deduction of unreimbursed medical expenses, already 10 percent of AGI, remains unchanged.

Premium assistance credit

Effective in 2014, when state exchange programs have been established, a new refundable tax credit will be allowed for individuals and families who purchase health-care insurance through one of the exchanges:

- Eligible individuals who enroll in an exchange plan will provide required information regarding income to the exchange.
- Individuals who qualify will be entitled to a premium assistance credit--this credit will be paid directly to the individuals' insurance plans. Individuals may instead pay costs out-of-pocket and apply for the credit at the end of the year.
- Individuals are responsible for paying the insurance plan the difference between the total plan premium and the amount of the premium assistance credit.

To qualify for the credit, individuals must have household income between 100 and 400 percent of the Federal poverty level (FPL) determined according to family size, and cannot receive health insurance through an employer or a spouse's employer.

Household income is defined as the sum of the modified adjusted gross incomes of all individuals taken into account in determining family size (but only if such individuals are required to file a tax return for the taxable year).

> **Caution:** Individuals who are in the country illegally are not included when calculating family size. Individuals who are claimed as dependents on another individual's federal income tax return are ineligible for the credit. Premium assistance credits, or any amounts that are attributable to them, cannot be used to pay for abortions for which federal funding is prohibited, and are not available for months in which an individual has a free choice voucher.

Generally, the credit is calculated to pay for the cost of an exchange plan's premiums, up to the amount by which the cost of the second lowest-cost silver exchange plan (adjusted for age) exceeds a specified percentage of household income, using a sliding scale that goes from 2 percent of income at 100 percent of the FPL to 9.5 percent of income for those with income up to 400 percent of the FPL.

> **Tip:** The credit is available for any plan purchased through an exchange. However, the credit amount is limited to the amount by which the cost of the second lowest-cost silver exchange plan (adjusted for age) exceeds the relevant percentage of family income. If a plan's actual premiums are less than this calculated credit amount, the full amount of the premium may be covered by the credit. If the plan in which an individual enrolls offers benefits in addition to essential health benefits, the portion of the premium that is allocable to those additional benefits is disregarded in determining the premium assistance credit amount.

Individuals who are offered adequate health coverage through an employer plan are not eligible for the credit, unless:

1. The plan's share of provided benefits is less than 60 percent, or the coverage is considered unaffordable (unaffordable is defined as coverage with a premium required to be paid by the employee that is 9.5 percent or more of the employee's household income), and

2. The individual declines to enroll in the employer's coverage and satisfies the conditions for receiving a tax credit through an exchange

Cost sharing subsidies for individuals

Individuals with household income more than 100 percent but less than or equal to 400 percent of the federal poverty level (FPL) may qualify for a premium assistance credit (described above) beginning in 2014. Yet, out-of-pocket costs associated with a plan (e.g., co-payments, deductibles) may make it difficult for low-income individuals and families to receive adequate care.

For that reason, a cost-sharing subsidy is provided to reduce out-of-pocket cost for individuals and households that qualify for the premium assistance credit. For individuals with household income of more than 100 but not more than 200 percent of FPL, the out-of-pocket limit is reduced by two-thirds. For those with income of 201 to 300 percent of FPL, the out-of-pocket limit is reduced by one-half, and for those with income of 301 to 400 percent of FPL, the limit is reduced by one-third.

Cost-sharing subsidy basics:

- A program will be established for determining eligibility
- The plan is notified that the individual is eligible and the plan reduces the cost-sharing by reducing the out-of-pocket limit under the provision
- The U.S. Department of Health and Human Services will make payments to the plan equal to the value of the reductions in cost-sharing

Tip: Any premium assistance tax credits and cost-sharing subsidies provided to an individual are disregarded for purposes of determining that individual's eligibility for benefits or assistance, or the amount or extent of benefits and assistance, under any federal program or under any state or local program financed in whole or in part with federal funds. Specifically, any amount of premium tax credit provided to an individual is not counted as income, and cannot be taken into account as resources for the month of receipt and the following two months. Any cost sharing subsidy provided on the individual's behalf is treated as made to the health plan in which the individual is enrolled and not to the individual.

Caution: Special rules apply to American Indians and undocumented aliens.

Excise tax on individuals without adequate health coverage

Beginning 2014, U.S. citizens and legal residents will generally be required to maintain adequate health-care coverage, or face a penalty tax. Acceptable coverage will include:

- Government-sponsored programs including Medicare, Medicaid, Children's Health Insurance Program, coverage for members of the U.S. military, veterans health care, and health care for Peace Corps volunteers
- Eligible employer-sponsored plans including governmental plans, church plans, grandfathered plans, and other group health plans offered in the small or large group market within a state
- Plans in the individual market
- Grandfathered group health plans
- Other coverage recognized by the U.S. Department of Health and Human Services and the Treasury Department

Individuals who are exempt from the requirement include those who are incarcerated, those not legally present in the United States, and those who qualify for religious exemption. If an individual is a dependent, the person entitled to claim the individual as a dependent is liable for any penalty due.

The penalty excise tax will be equal to the greater of a percentage of income or a specific dollar amount. In 2016, when the penalty tax is completely phased in, the tax will be equal to the greater of:

- 2.5 percent of the amount of a taxpayer's household income for the taxable year that exceeds the threshold amount required to make it necessary to file an income tax return for the year (generally the threshold amount equals the standard deduction the taxpayer is entitled to plus personal exemption amounts)
- $695 per uninsured adult in the household (half that amount for each uninsured individual under age 18)

The total annual household penalty may not exceed either:

- 300 percent of the per-adult dollar amount (300% x $695 = $2,085 for 2016)
- The national average annual premium for bronze level health plans offered through the exchange that year for the household size

The tax is phased in as follows:

	Tax equals greater of:		
Year	**% of household income exceeding threshold**	**Specific dollar amount**	**Maximum household penalty**
2014	1%	$95	$285
2015	2%	$325	$975
2016	2.5%	$695	$2,085

For years after 2016, the $695 is indexed for inflation.

Tip: The penalty tax is assessed on a monthly basis. Therefore, the annual penalty tax would be divided by 12 to determine a monthly penalty tax amount.

Individuals who cannot afford coverage because their required contribution for employer-sponsored coverage (or the lowest cost bronze plan in the local exchange) exceeds 8 percent of household income for the year are exempt from the penalty. Taxpayers with income below the income tax filing threshold are also exempt from the penalty. All members of Indian tribes are exempt from the penalty as well.

Other provisions

- Indoor Tanning Tax: For services performed on or after July 1, 2010, a 10 percent tax is assessed on amounts paid for indoor tanning services. The tax is paid by the individual on whom the indoor tanning services are performed, but if the tax isn't paid by an individual at the time payment for the tanning service is received, the person performing the service must pay the tax.
- Medical care expenses for children under age 27: Effective March 30, 2010, the general income exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan, as well as the income exclusion for the value of employer-provided health insurance coverage, are extended to any child of an employee who has not attained age 27 as of the end of the taxable year. Self-employed individuals may take a deduction for the cost of health insurance coverage for any child who has not attained age 27 as of the end of the taxable year.

- Student Loan Repayment Programs: Effective retroactively to amounts received in tax years beginning after December 31, 2008, gross income exclusion rules are modified to allow the exclusion of amounts received under the National Health Service Corps (NHSC) repayment program and State student loan repayment programs intended to provide for the increased availability of health care services in underserved or health professional shortage areas.

Tax provisions--businesses

Small business tax credit

A new general business tax credit is established for qualified small employers who contribute at least 50 percent of the premium cost of a qualifying health plan offered to employees.

Qualified small business employers are defined as employers with fewer than 25 full-time equivalent employees (FTEs) employed during the taxable year, and whose employees have annual full-time equivalent wages that average less than $50,000. However, the full amount of the credit is available only to employers with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages of not more than $25,000.

Full-time equivalent employees (FTEs)- FTEs are calculated by totaling all hours worked by all employees during the tax year, and dividing the result by 2080. For purposes of the calculation, the maximum number of hours that can be attributed to an individual employee is 2080.

Average full-time equivalent wages- Average annual full-time equivalent wages are calculated by dividing total wages paid by the number of FTEs, and rounding down to the nearest $1,000.

Tip: Seasonal workers' hours and wages are not counted in determining FTEs and average annual wages of the employer unless they work for more than 120 days during the taxable year.

The $50,000 and $25,000 wage limits described above will be adjusted for inflation beginning in 2014.

Tip: The credit can be applied against alternative minimum tax (AMT) liability.

For taxable years beginning in 2010, 2011, 2012, and 2013:

- The credit applies to qualifying employers who purchase health insurance coverage for employees from a licensed insurance company
- The full credit is equal to 35 percent of the lesser of (1) the amount of contributions the employer made on behalf of employees during the taxable year for the qualifying health coverage and (2) the amount of contributions that the employer would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium

For taxable years beginning after 2013:

- The credit is available only to qualifying employers that purchase health insurance coverage for employees through a state exchange
- The credit is available for a maximum coverage period of two consecutive years, beginning with the first year in which the employer offers one or more qualified plans to employees through an exchange (not counting taxable years beginning before 2014)
- The full credit is equal to 50 percent of the lesser of (1) the amount of contributions the employer made on behalf of employees during the taxable year for the qualifying health coverage and (2) the amount of contributions that the employer would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium

Tip: The benchmark premium is the average total premium cost in the small group market for employer-sponsored coverage in the employer's state. The premium and the benchmark premium

vary based on the type of coverage provided to the employee.

Credit reduction

The credit is reduced for employers with more than 10 FTEs (employers with more than 25 FTEs are not eligible for the credit). The credit is also reduced for an employer when average wages per employee is more than $25,000 (if average wages are $50,000 or more, the employer doesn't qualify for the credit).

Where an employer has more than 10 FTEs, the otherwise allowable credit is reduced by an amount equal to the amount of credit determined before the reduction (1) multiplied by the number of FTEs in excess of 10, and (2) divided by 15.

Where average wages exceed $25,000, the amount of the reduction is equal to:

- The amount of the credit (determined before any reduction) multiplied by
- The average annual wages of the employer in excess of $25,000 divided by $25,000

For an employer with both more than 10 FTEs and average annual wages in excess of $25,000, the reduction is the sum of the amount of the two reductions.

Tip: There are special rules for tax exempt organizations. A 501(c) organization that is exempt under IRC Section 501(a) is eligible for the credit. However, for tax-exempt organizations, the credit percentage for 2010, 2011, 2012, and 2013 is 25 percent (rather than 35 percent), and the credit percentage for taxable years beginning in years after 2013 is 35 percent (rather than 50 percent). A tax-exempt organization is eligible to apply the tax credit against liability as an employer for payroll taxes for the taxable year, but is not eligible for a credit in excess of the amount of these payroll taxes.

Caution: Self-employed individuals, including partners and sole proprietors, 2 percent shareholders of S corporations, and 5 percent owners of an employer are not treated as employees for purposes of this credit. Sole proprietorships are not entitled to the credit by virtue of employing family members, and these individuals are not taken into account in determining the number of FTEs or average full-time equivalent wages.

"Simple" cafeteria plans

Beginning in 2011, a new safe harbor is established for eligible small employers who maintain a cafeteria plan. Under the safe harbor, a cafeteria plan and the qualified benefits available under the plan (including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program) are treated as complying with all nondiscrimination rules if the plan satisfies minimum eligibility and participation requirements, and minimum contribution requirements.

To be eligible for the safe harbor provision, an employer cannot have employed an average of more than 100 employees on business days during either of the two preceding years. If an employer is eligible for the safe harbor provision, establishes a cafeteria plan for employees, and maintains the plan without interruption, the employer will be deemed to be an eligible small employer for purposes of the safe harbor rule until the employer employs an average of 200 or more employees on business days during any preceding year.

Employee eligibility requirements

All employees must be eligible to participate in the cafeteria plan, and each eligible employee must be able to elect any benefit available under the plan (subject to the terms and conditions that apply to all participants).

Exceptions--a plan can exclude:

- Employees who have not attained the age of 21 (or a younger age provided in the plan) before the close of a plan year

- Employees who have fewer than 1,000 hours of service for the preceding plan year
- Employees who have not completed one year of service with the employer as of any day during the plan year
- Employees who are covered under a collective bargaining agreement if the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or
- Employees described in section 410(b)(3)(C) (relating to nonresident aliens working outside the United States)

An employer may have a shorter age and service requirement, but only if such shorter service or younger age applies to all employees.

Minimum contribution requirement

The employer must provide a minimum contribution for each employee who is not a highly compensated employee or a key employee that can be applied toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan. There are two methods to meet the minimum contribution requirement:

- Nonelective contribution method--An amount equal to at least 2 percent (a uniform percentage must be used) of each employee's compensation for the plan year, determined without regard to whether an employee makes a salary reduction contribution under the cafeteria plan
- Minimum matching contribution--The lesser of (1) 200 percent of the amount an employee elects to contribute via salary reduction for the plan year, or (2) 6 percent of the employee's compensation for the plan year.

Penalty tax for employers who fail to provide adequate health coverage

Beginning in 2014, an excise penalty tax will be assessed on an employer who meets all three of the following conditions:

1. The employer qualifies as an applicable large employer. An employer is an applicable large employer with respect to any calendar year if the employer had an average of at least 50 full-time employees during the preceding calendar year.
2. The employer fails to provide adequate health coverage. An employer will be considered to fail to provide adequate coverage if the employer: (a) does not offer coverage for all full-time employees, (b) offers coverage that is unaffordable, or (c) offers coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent.
3. Any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

Tip: An employer is not treated as employing more than 50 full-time employees if the employer's workforce exceeds 50 full-time employees for 120 days or fewer during the calendar year and the employees that cause the employer's workforce to exceed 50 full-time employees are seasonal workers.

Tip: In determining whether an employer is an applicable large employer, a full-time employee (for any month, an employee working an average of at least 30 hours or more each week) is counted as one employee and all other employees will be counted on a prorated basis.

Tip: The number of full-time equivalent employees that must be taken into account for purposes of determining whether the employer exceeds the threshold is equal to the aggregate number of hours worked by non-full-time employees for the month, divided by 120 (or another number as provided

by regulations).

Amount of the penalty excise tax--no health-care coverage offered to full-time employees

For employers *who fail to offer health-care coverage to full-time employees*, and receive certification that at least one full-time employee has enrolled in health insurance coverage purchased through a state exchange with a premium tax credit or cost-sharing reduction allowed or paid, the penalty excise tax is equal to the number of full-time employees over a 30-employee threshold during the applicable month multiplied by one-twelfth of $2,000:

(Number of full-time employees - 30) x ($2,000/12)

This is true regardless of how many employees are receiving a premium tax credit or cost-sharing reduction.

Amount of the penalty excise tax--health-care coverage offered to full-time employees

Employers *who offer health-care coverage to full-time employees*may also face a penalty excise tax for any full-time employee certified as having enrolled in health insurance coverage purchased through a state exchange with a premium tax credit or cost-sharing reduction allowed or paid to such employee. A full-time employee who declines to enroll in an employer's health-care coverage may be eligible for a premium tax credit and cost sharing reductions as a result of joining a state exchange in one of two circumstances:

1. The employer health-care coverage consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent.

2. The employer health-care coverage is considered unaffordable for that employee. Unaffordable is defined as coverage with a premium required to be paid by the employee that is more than 9.5 percent of the employee's household income.

In this case, the penalty, assessed on a monthly basis, equals one-twelfth of $3,000 for each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state exchange for any month. The penalty tax is, however, capped at an amount equal to the excise penalty tax that would be due if the employer did not offer health-care coverage at all.

Example(s): (From the Joint Committee on Taxation's Technical Explanation of the legislation, JCX-18-10, March 21,2010) In 2014, Employer A offers health coverage and has 100 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a state exchange offered plan. For each employee receiving a tax credit, the employer owes $3,000, for a total penalty of $60,000. The maximum penalty for this employer is capped at the amount of the penalty that it would have been assessed for a failure to provide coverage, or $140,000 ($2,000 multiplied by 70 (100-30)). Since the calculated penalty of $60,000 is less than the maximum amount, Employer A pays the $60,000 calculated penalty. This penalty is assessed on a monthly basis.

Free choice vouchers

Beginning in 2014, employers who offer an employer-sponsored health-care plan and pay a portion of the cost of coverage must provide qualified employees with a voucher to be applied to the cost of purchasing a health plan through a state exchange.

A qualified employee is an employee:

- Whose required contribution for his or her share of the cost of the employer-sponsored health-care coverage is greater than 8 percent of household income for the taxable year, but does not exceed 9.8 percent of household income

- Whose total household income does not exceed 400 percent of the poverty line for the family, and

- Who does not participate in the employer's health plan

The value of the voucher is equal to the dollar value of the employer contribution to the employer offered health plan The value of the voucher is for self-only coverage unless the individual purchases family coverage in the state exchange. In the case of years after 2014, the 8 percent and the 9.8 percent are indexed to the excess of premium growth over income growth for the preceding calendar year.

Excise tax on "Cadillac" plans

Beginning in 2018, an excise tax will be imposed on insurers if the aggregate value of employer sponsored health insurance coverage for an employee exceeds a threshold amount.

The tax is equal to 40 percent of the amount by which the value of coverage exceeds the threshold amount. For 2018, the threshold amount is $10,200 for individual coverage and $27,500 for family coverage, adjusted to reflect any actual growth in health-care costs exceeding projected growth, and adjusted for age and gender.

In the case of a self-insured group health plan, a health FSA or an HRA, the excise tax is paid by the plan administrator. Where the employer acts as plan administrator to a self-insured group health plan, a health FSA or an HRA, the excise tax is paid by the employer. Where an employer contributes to an HSA or an Archer MSA, the employer is responsible for payment of the excise tax.

The threshold amounts are increased for an individual who:

- Has attained age 55, is non-Medicare eligible, and is receiving employer-sponsored retiree health coverage, or
- Is covered by a plan sponsored by an employer, the majority of whose employees covered by the plan are engaged in a high-risk profession or employed to repair or install electrical and telecommunications lines

For these individuals, the threshold amount in 2018 is increased by $1,650 for individual coverage or $3,450 for family coverage.

Tip: Employees considered to be engaged in a high-risk profession are law enforcement officers, employees who engage in fire protection activities, individuals who provide out-of-hospital emergency medical care (including emergency medical technicians, paramedics, and first-responders), individuals whose primary work is longshoring, and individuals engaged in the construction, mining, agriculture (not including food processing), forestry, and fishing industries. A retiree with at least 20 years of employment in a high-risk profession is also eligible for the increased threshold.

Other provisions

- Beginning in 2011, employers must disclose on Form W-2 the value of an employee's health insurance coverage sponsored by the employer.
- Effective 2013, the current rule that allows the sponsor of a qualified retiree prescription drug plan to claim a deduction for retiree prescription drug expenses without regard to any subsidy payments received is eliminated; the deduction that would otherwise be allowed must be reduced by the amount of excludible subsidy payments received.
- Beginning in 2014, an annual fee will be assessed on health insurance providers. The aggregate amount of the fee ($8 billion for calendar year 2014) will be apportioned among providers based on market share.
- Reimbursements or premium payments for qualified health plans offered through a state exchange are not considered qualified benefits under a cafeteria plan. An exception will exist for "qualified employers" (generally, employers that employed an average of not more than 100 employees--not more than 50 employees, in some circumstances--and elect to make all full-time employees eligible for one or more state exchange health plans).

Converting or Rolling Over Traditional IRAs to Roth IRAs

What is it?

In general, you can transfer all or a portion of your traditional IRA funds to a Roth IRA. This can be accomplished in one of two ways: You can convert your traditional IRA to a Roth IRA, or you can roll over funds from your traditional IRA to a Roth IRA.

In the case of a conversion, you notify the trustee or custodian of your traditional IRA that you wish to convert your traditional IRA to a Roth IRA. The account is then renamed as a Roth IRA, and your funds never actually leave the account. In the case of a rollover, you actually transfer the funds from your traditional IRA to a Roth IRA. The income tax consequences of the two methods are identical.

However, the fact that you *can*convert or roll over funds from your traditional IRA to a Roth IRA doesn't necessarily mean that you *should*. There are a number of factors that you need to consider.

> **Tip:** Your employer may also allow you to make after-tax "Roth" contributions to your 401(k), 403(b), or 457(b) plan. Qualified distributions of these contributions and related earnings may be income tax free (and penalty free) at the federal level. This may be a factor in your decision of whether to convert funds from a traditional IRA to a Roth IRA. However, be sure to discuss your situation with a qualified professional before making any decisions.

> **Caution:** If you've inherited a traditional IRA (or SEP/SIMPLE IRA) from someone other than your spouse, you cannot convert that traditional IRA to a Roth IRA.

When can it be used?

You have a traditional IRA

It probably goes without saying, but you can't convert or roll over funds from a traditional IRA to a Roth IRA unless you already have a traditional IRA.

> **Tip:** In addition to traditional IRAs, SEP-IRAs, SAR-SEP IRAs, and SIMPLE IRAs (those that have existed for at least two years) are eligible to be converted to a Roth IRA. The rules that apply to conversions from traditional IRAs, as discussed in this article, also apply to SEP, SAR-SEP, and SIMPLE conversions.

Rollovers must follow IRA rollover rules

As mentioned, one of the two ways to transfer funds from a traditional IRA to a Roth IRA is to withdraw the funds from your traditional IRA, and then roll those funds over into a Roth IRA in your name. If you choose this method to transfer funds, you must comply with federal rules governing IRA rollovers. For example, if you roll over funds from a traditional IRA to a Roth IRA, the funds must be deposited in the Roth IRA within 60 days after you receive the distribution from the traditional IRA. If you do not meet the 60-day deadline, you may be subject to tax consequences and a penalty. There is no limit on the number of rollovers from traditional IRAs to Roth IRAs that you can do in a year.

> **Tip:** The 60-day deadline can be waived in certain circumstances. You may be eligible for an automatic waiver if you sent your rollover assets to a financial institution within the 60-day period, but the financial institution makes an error and fails to complete your rollover before the deadline. However, to be eligible to use this automatic waiver, your rollover must be completed within one year from the beginning of the 60-day period. The IRS also has the discretion to grant a waiver of the 60-day deadline in certain circumstances.

Strengths

Qualified distributions from Roth IRAs are tax free

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely tax free (and penalty free) if made at least five years after you first establish any Roth IRA, and if one of the following applies:

- You have reached age 59½ at the time of the withdrawal
- The withdrawal was made due to qualifying disability
- The withdrawal was made to pay for first-time homebuyer expenses ($10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

Tip: The five-year holding period begins on January 1 of the tax year for which you make your first contribution to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.

If these conditions aren't met your distribution is "nonqualified," and only the portion of a Roth IRA withdrawal that represents investment earnings will be subject to federal income tax (and potential 10% early distribution penalty unless an exception applies). The portion of a Roth IRA withdrawal that represents your contributions (including amounts converted to or rolled over from a traditional IRA) is never taxable, since those dollars were already taxed. Roth IRA withdrawals are treated as coming from your nontaxable contributions first and from investment earnings last.

Caution: If you convert or roll over funds from a traditional IRA to a Roth IRA, special penalty provisions may apply if you subsequently withdraw funds from the Roth IRA within five years of the conversion (and prior to age 59½).See "Tax considerations," below.

Roth IRAs are not subject to the lifetime required minimum distribution (RMD) rules

Federal law requires you to take annual minimum withdrawals (required minimum distributions, or RMDs) from your traditional IRAs beginning no later than April 1 of the year following the year in which you reach age 70½. These withdrawals are calculated to dispose of all of the money in the traditional IRA over a given period of time. Because Roth IRAs are not subject to the lifetime RMD rules, you are not required to make any withdrawals from your Roth IRAs during your life. This can be a significant advantage in terms of your estate planning and may be a good reason to consider converting funds.

Converting or rolling over funds may reduce your taxable estate and your countable assets for federal financial aid purposes

If you use non-IRA funds to pay the conversion tax that results from converting or rolling over funds from a traditional IRA to a Roth IRA, the funds that you use to pay the tax are removed from your taxable estate, potentially reducing your future estate tax liability. Also, the funds that you use to pay the tax are no longer part of your countable assets for purposes of determining your children's eligibility for federal financial aid. In contrast, if you use IRA funds to pay the conversion tax, there generally is no effect on financial aid eligibility, because the federal aid formula does not count retirement accounts when determining aid eligibility.

Qualified distributions from Roth IRAs are not included when determining the taxable portion of Social Security benefits

Converting or rolling over your funds from a traditional IRA to a Roth IRA could be beneficial when it comes time to begin receiving your Social Security benefits. The portion of your Social Security benefits that is taxable (if any) depends on your MAGI and federal income tax filing status in a given year. Under current law, qualified distributions from Roth IRAs are not included when determining the taxable portion of an individual's Social Security benefits.

A conversion can be used to overcome the income limit on annual Roth IRA contributions

Annual Roth contributions may be limited, or eliminated, depending on your income and filing status. If your ability to make annual Roth contributions is restricted because of these limits, and you want to make annual Roth contributions, a conversion may be the answer. You can simply make your annual contribution first to a traditional IRA, and then take advantage of the new liberal conversion rules and convert that traditional IRA to a Roth IRA. (You can make nondeductible contributions to a traditional IRA if you have taxable compensation and you haven't yet reached age 70½.) There are no limits to the number of Roth conversions you can make. (Note: you'll need to aggregate all traditional IRAs and SEP/SIMPLE IRAs you own (other than IRAs you've inherited) when you calculate the taxable portion of your conversion.)

Tradeoffs

You have to pay tax now on the funds that you convert or roll over

When you convert or roll over funds from a traditional IRA to a Roth IRA, the funds that you transfer are subject to federal income tax (to the extent that those funds represent investment earnings and tax-deductible contributions made to the traditional IRA). Even if it makes overall financial sense to convert funds from a traditional IRA to a Roth IRA, paying tax on your IRA funds now may not be desirable.

> **Tip:** Special rules apply to conversions made in 2010. The amount that must be included in income as a result of the conversion can be averaged over the next two years. That is, all of the resulting income from the conversion can be reported on your 2010 federal income tax return. Or, instead, half of the income may be reported on your 2011 tax return, and the remaining half on your 2012 tax return.

Using IRA funds to pay conversion tax has significant drawbacks

If using other IRA dollars is the only way that you can pay the conversion tax that results from converting or rolling over funds from a traditional IRA to a Roth IRA, the benefits of converting or rolling over funds are substantially reduced. Using IRA dollars to pay the tax reduces the amount of funds in your IRAs, potentially jeopardizing your retirement goals. In addition, the IRA funds used to pay the tax may themselves be subject to federal income tax and a premature distribution tax. If possible, paying the conversion tax with non-IRA funds is generally more advisable.

Special penalty provisions may apply to withdrawals from Roth IRAs that contain funds converted from traditional IRAs

If you're under age 59½ and take a nonqualified distribution from a Roth IRA, the 10 percent premature distribution tax generally applies only to that portion of the distribution that represents investment earnings. However, if you convert or roll over funds from a traditional IRA to a Roth IRA and then take a premature distribution from that Roth IRA within five years, the 10 percent premature distribution tax will apply to the entire amount of the distribution (to the extent that the distribution consists of funds that were taxed at the time of conversion).

> **Tip:** The five-year holding period begins on January 1 of the tax year in which you converted or rolled over the funds from the traditional IRA to the Roth IRA. When applying this special rule, a separate five-year holding period applies each time you convert or roll over funds from a traditional IRA to a Roth IRA.

Taxable income resulting from conversion can increase taxable portion of Social Security benefits being received

If you're currently receiving Social Security benefits or soon will be, consider the possible tax consequences of converting or rolling over funds from a traditional IRA to a Roth IRA. When you convert or roll over funds, those funds are generally considered taxable income to you for the year in which you transfer them. Remember that the portion of your Social Security benefits that is taxable (if any) depends on your income and tax filing status for the

year. This means that converting funds to a Roth IRA may increase the taxable portion of your Social Security benefits for that year.

Risk of future change in the law

One of the main reasons to consider converting or rolling over funds from a traditional IRA to a Roth IRA is that qualified distributions from Roth IRAs are completely tax free. Under current law, this is the federal tax treatment given to Roth IRAs. Some experts, however, are skeptical that this will always remain the case, given the uncertain status of Social Security and the projected lost federal revenue attributable to Roth IRAs.

States may differ in their treatment of Roth IRAs

Although most states follow the federal tax treatment of Roth IRAs, you should check with a tax professional regarding the tax treatment of Roth IRAs in your particular state.

Creditor protection

Federal law provides protection for up to $1,171,650 (as of April 1, 2010) of your aggregate Roth and traditional IRA assets if you declare bankruptcy. (Amounts rolled over to the IRA from an employer qualified plan or 403(b) plan, plus any earnings on the rollover, aren't subject to this dollar cap and are fully protected.) The laws of your particular state may provide additional bankruptcy protection, and may provide protection from the claims of your creditors in cases outside of bankruptcy. In some states the creditor protection available to Roth IRAs may be less than that available to traditional IRAs. (Inherited IRAs may be afforded less protection from creditors--seek professional guidance.)

How to do it

Calculate the tax that will result from converting or rolling over funds from your traditional IRAs to Roth IRAs

All or a portion of the funds that you convert or roll over from your traditional IRA to a Roth IRA will be subject to federal income tax in the year that you shift the funds. (Special rules apply to conversions in 2010--see above.) Consult a tax professional for an accurate calculation of the income tax liability that will result. This will help you decide if converting funds makes sense for you.

Decide where the dollars will come from to pay the resulting tax

Decide if you will use IRA funds or non-IRA funds to pay the conversion tax that will result from converting or rolling over funds, and make sure that you understand the tax consequences of either choice. For example, if you plan to sell stock to pay the tax, realize that your sale of stock will have tax consequences of its own. If you plan to use IRA funds to pay the tax, be aware that this may trigger additional income tax liability (and possibly a penalty). Again, consult a tax professional.

Decide whether to convert or roll over

If you have decided to transfer funds from your traditional IRA to a Roth IRA, your next step is to decide whether to convert your traditional IRA to a Roth IRA, or to roll over your traditional IRA funds to a Roth IRA. The income tax consequences are the same either way, so the question is: Do you want your IRA to stay at the same institution with the same custodian/trustee, or would you prefer to move your IRA dollars to another institution and have a different custodian/trustee?

If converting, contact the custodian of your traditional IRA

The custodian/trustee of your traditional IRA will provide you the paperwork you need to convert your traditional IRA to a Roth IRA with that same institution.

If rolling over, establish a Roth IRA and roll over your traditional IRA

First, you need to establish a Roth IRA in your name, if you don't already have one. Once you have a Roth IRA, you can have the funds in your traditional IRA transferred directly to your Roth IRA. The custodian of your Roth IRA can give you the paperwork that you need to do this. If you prefer, you can instead contact the custodian of your traditional IRA, have the funds in your traditional IRA distributed to you, and then roll those funds over into your Roth IRA within 60 days of the distribution.

Tax considerations

You include funds that are converted or rolled over from a traditional IRA to a Roth IRA in income

When you convert or roll over funds from a traditional IRA to a Roth IRA, those funds are subject to federal income tax in the year that you transfer them (to the extent that the funds consist of deductible contributions and investment earnings). If you have made only deductible contributions to your traditional IRAs, then the entire amount of any funds that you convert or roll over to a Roth IRA will be taxable. If, however, you have ever made nondeductible (after-tax) contributions to your traditional IRAs, then those contribution amounts will not be taxable when converted or rolled over to a Roth IRA (since they have already been taxed). In effect, the income tax consequences of converting funds are the same as those that apply when you make a withdrawal from a traditional IRA.

> **Caution:** You need to aggregate all traditional IRAs and SEP/SIMPLE IRAs you own (other than IRAs you've inherited) when you calculate the taxable portion of your conversion.

Application of the 10 percent premature distribution tax

The 10 percent premature distribution tax does not apply at the time that you convert or roll over funds from a traditional IRA to a Roth IRA, even if you convert the funds before reaching age 59½. However, if you convert or roll over funds from a traditional IRA to a Roth IRA and withdraw any portion of those funds from the Roth IRA within five years (and prior to age 59½), the withdrawal will be subject to the 10 percent premature distribution tax (to the extent those funds were taxed at the time of the conversion).

> **Tip:** Remember that withdrawals from Roth IRAs are treated as coming from contributions first and investment earnings second. Contributions are considered to consist first of regular contributions (i.e., contributions other than rollover contributions), and then of amounts converted or rolled over from a traditional IRA (on a first in, first out basis).

> **Tip:** All of your Roth IRAs (other than Roth IRAs you've inherited) are aggregated for this purpose.

> **Example(s):** John is age 40. John contributed $3,000 to his Roth IRA in 2008. In 2009, John converted $10,000 from his traditional IRA to his Roth IRA, and included this $10,000 in his 2009 gross income. He made no further contributions to his Roth IRA. In 2011, his Roth IRA has grown to $14,000, of which John withdraws $4,000. None of the exceptions to the 10 percent premature distribution tax apply to John. John's $4,000 withdrawal is considered to consist first of his $3,000 regular contribution made in 2008. John owes no premature distribution tax on this $3,000. The remaining $1,000 of John's $4,000 withdrawal is considered to consist of funds he converted from his traditional IRA, and is subject to the 10 percent premature distribution tax.

You can't convert or roll over RMDs into a Roth IRA

After age 70½, you are required to begin taking annual minimum withdrawals from your traditional IRAs (RMDs). You cannot roll over or convert these RMD amounts to a Roth IRA.

Special rules apply to conversions made in 2010

For Roth conversions made in 2010 only, the amount includible in gross income as a result of the conversion will be averaged over the following two years, unless the taxpayer elects otherwise. That is, no resulting income will

be reported on the individual's 2010 federal income tax return. Half the resulting income will be reported on the taxpayer's tax return for 2011, and the remaining half will be reported on the taxpayer's tax return for 2012. Alternatively, the taxpayer can choose to include all of the income on his or her 2010 federal income tax return.

Caution: Income inclusion will be accelerated if converted amounts are distributed before 2012. In that case, the amount included in income in the year of distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 if the distribution takes place in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion, and (2) the remaining portion of such amount not already included in income.

Example(s): [From Joint Explanatory Statement of the Committee of Conference] Taxpayer A has a traditional IRA with a value of $100, consisting of deductible contributions and earnings. A does not have a Roth IRA. A converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, $100 is includible in gross income. Unless A elects otherwise, $50 of the income resulting from the conversion is included in income in 2011, and $50 in 2012. Later in 2010, A takes a $20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, $20 is included in income in 2010. The amount included in income in 2011 is the lesser of: (1) $50 (half of the income resulting from the conversion), or (2) $70 (the remaining income from the conversion), in other words -- $50. The amount included in income in 2012 is the lesser of: (1) $50 (half of the income resulting from the conversion), or (2) the remaining income from the conversion, i.e., $100 - $70 ($20 included in income in 2010 and $50 included in income in 2011), in other words -- $30.

Questions & Answers

Should you convert or roll over funds from your traditional IRA to a Roth IRA?

Before you even begin to think about converting or rolling over funds from a traditional IRA to a Roth IRA, be sure that you understand what the Roth IRA is and how it works. If the Roth IRA seems like an appropriate retirement savings vehicle, be sure to consider the income tax consequences of converting funds, and how you will pay the resulting tax. Think about the following scenarios and factors before you act.

Scenario 1: You'll pay the resulting "conversion" tax with non-IRA funds, you have 10 years or more before you will be taking distributions from the Roth IRA, and you will be in the same or a higher tax bracket when you start taking those distributions. Converting funds probably makes overall sense.

Scenario 2: You'll pay the conversion tax with IRA funds, you need to take substantial distributions from the Roth IRA within a few years (5 years or less), and you will be under age 59½, or in a lower tax bracket when you begin taking distributions. You probably shouldn't convert funds to a Roth IRA.

Can you convert or roll over only a portion of the funds in your traditional IRAs to Roth IRAs?

Yes, you can convert or roll over whatever amount you want from your traditional IRAs to a Roth IRA. All or a portion of the funds that you convert or roll over to the Roth IRA will be subject to federal income tax. If you have ever made nondeductible (after-tax) contributions to your traditional IRAs, you have to calculate what portion of the funds that you convert represents nondeductible contributions. Because those amounts were already taxed, they will not be taxed again when converted to a Roth IRA.

How do you calculate the portion of your conversion that represents nondeductible contributions?

If you have made only deductible contributions to your traditional IRAs, the full amount that you convert or roll over from your traditional IRAs to a Roth IRA will be subject to federal income tax, since no portion of the funds represents nondeductible contributions. If you have ever made nondeductible contributions to your traditional IRAs, you calculate and report the taxable and nontaxable portions of the funds that you convert or roll over using IRS Form 8606. Basically, you calculate the ratio of all of your nondeductible contributions to the total balance of all of your traditional IRAs, including simplified employee pension plan IRAs and savings incentive match plan for

employees (SIMPLE) IRAs. That ratio is then applied to any withdrawal that you make from any of your traditional IRAs, including a conversion or rollover to a Roth IRA. So, if 50 percent of the total balance of all of your traditional IRAs represents nondeductible contributions, half of the funds that you convert to a Roth IRA would be taxable, and half would not.

Can you convert or roll over funds from your traditional IRAs to a Roth IRA if you're already receiving RMDs from your traditional IRAs?

Unlike traditional IRAs, you can contribute to a Roth IRA after age 70½, so the fact that you're receiving RMDs from your traditional IRAs doesn't by itself disqualify you from converting funds to a Roth IRA. You cannot, however, convert or roll over an RMD itself into a Roth IRA.

Can you "undo" or recharacterize a traditional IRA to Roth IRA conversion?

You may be able to undo or recharacterize a Roth IRA conversion by making a trustee-to-trustee transfer of the contribution (plus any related earnings) from the Roth IRA back to the traditional IRA within certain deadlines. You may want to consider undoing a Roth conversion if your IRA investments experience a significant decline after the conversion date. You may be able to minimize your tax hit by reversing (recharacterizing) your conversion. Generally, the deadline for recharacterizing an IRA contribution or Roth IRA conversion is the due date of your federal income tax return (including extensions) for the year of the original contribution.

> **Caution:** Prior to 2010 you could convert a traditional IRA to a Roth IRA only if your income was $100,000 or less. This income limit is repealed for conversions after 2009. You should consider undoing a 2009 Roth conversion if your income for 2009 ends up exceeding the $100,000 limit.
>
> **Tip:** In order to make it easier to calculate the amount (specifically, the allocable earnings) you need to transfer back to the traditional IRA in the event you wish to recharacterize (undo) a conversion, it generally makes sense to use a new Roth IRA (rather than an existing Roth IRA) to hold each conversion. It may also make sense to use separate Roth IRAs for each different investment you wish to make. (If you want, you can always combine two or more of your Roth IRAs after the deadline for recharacterizing has passed.)

When you withdraw funds from a Roth IRA, in what order are the funds considered withdrawn?

Withdrawals from Roth IRAs are considered made in the following order:

- Regular Roth IRA contributions (i.e., contributions other than rollover or conversion contributions).
- Rollover or conversion contributions, in the order made (i.e., first in, first out). If any rollover or conversion included nondeductible contributions, the withdrawal is considered made first from funds that were subject to federal income tax at the time of the rollover or conversion.
- Any investment earnings.

All Roth IRAs you maintain (other than Roth IRAs you've inherited) are aggregated (i.e., treated as a single Roth IRA) for purposes of classifying withdrawals.

Federal Estate Tax Rates At-a-Glance

The federal estate tax is repealed for 2010, although that is likely to change. It is scheduled to be reinstated in 2011 with a top rate of 55%.

2009 Estate Tax Rate Schedule

Taxable Estate		Tentative Tax Equals		
exceeds	**but does not exceed**	**base tax**	**plus**	**of amount over**
$0	$10,000	$0	18%	$0
$10,000	$20,000	$1,800	20%	$10,000
$20,000	$40,000	$3,800	22%	$20,000
$40,000	$60,000	$8,200	24%	$40,000
$60,000	$80,000	$13,000	26%	$60,000
$80,000	$100,000	$18,200	28%	$80,000
$100,000	$150,000	$23,800	30%	$100,000
$150,000	$250,000	$38,800	32%	$150,000
$250,000	$500,000	$70,800	34%	$250,000
$500,000	$750,000	$155,800	37%	$500,000
$750,000	$1,000,000	$248,300	39%	$750,000
$1,000,000	$1,250,000	$345,800	41%	$1,000,000
$1,250,000	$1,500,000	$448,300	43%	$1,250,000
$1,500,000		$555,800	45%	$1,500,000
2009 credit shelter amount $3,500,000		**2009 credit amount $1,455,800**		

2011 Tentative Estate Tax Rate Schedule

Taxable Estate		Tentative Tax Equals		
exceeds	**but does not exceed**	**base tax**	**plus**	**of amount over**
$0	$10,000	$0	18%	$0
$10,000	$20,000	$1,800	20%	$10,000
$20,000	$40,000	$3,800	22%	$20,000
$40,000	$60,000	$8,200	24%	$40,000
$60,000	$80,000	$13,000	26%	$60,000

$80,000	$100,000	$18,200	28%	$80,000
$100,000	$150,000	$23,800	30%	$100,000
$150,000	$250,000	$38,800	32%	$150,000
$250,000	$500,000	$70,800	34%	$250,000
$500,000	$750,000	$155,800	37%	$500,000
$750,000	$1,000,000	$248,300	39%	$750,000
$1,000,000	$1,250,000	$345,800	41%	$1,000,000
$1,250,000	$1,500,000	$448,300	43%	$1,250,000
$1,500,000	$2,000,000	$555,800	45%	$1,500,000
$2,000,000	$2,500,000	$780,800	49%	$2,000,000
$2,500,000	$3,000,000	$1,025,800	53%	$2,500,000
$3,000,000		$1,290,800	55%	$3,000,000
Special range for 5% surtax to phase out benefit of graduated tax rates				
$10,000,000	$17,184,000	maximum surtax: 5% x $7,184,000 = $359,200	5% surtax means a 60% marginal tax rate in this range	
2011 credit shelter amount $1,000,000		**2011 credit amount $345,800**		

2011 Tax Changes At-a-Glance

A host of tax provisions enacted in 2001 and 2003--commonly referred to collectively as the "Bush tax cuts"--expire at the end of the year. While it's possible that new legislation could extend some or all of these expiring tax provisions, election-year politics make it difficult to predict what action, if any, Congress will take. With that in mind, here's what you need to know about the major changes that are scheduled for 2011.

Federal income tax brackets

Right now, there are six income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. For 2010, these brackets apply to married couples filing joint federal income tax returns in the following manner.

2010 Income Tax Brackets--Married Filing Jointly

Taxable Income	Marginal Tax Rate
Not over $16,750	10%
Over $16,750 to $68,000	15%
Over $68,000 to $137,300	25%
Over $137,300 to $209,250	28%
Over $209,250 to $373,650	33%
Over $373,650	35%

As it stands now, there will be no 10% bracket for 2011, and the remaining bracket rates will return to their original 2001 levels: 15%, 28%, 31%, 36%, and 39.6%.

Long-term capital gains tax rates

For 2010, if you sell shares of stock that you've held for more than a year, any gain is a long-term capital gain, generally taxed at a maximum rate of 15%. If you're in the 10% or 15% marginal income tax bracket, however, you'll pay no federal tax on the long-term gain (a 0% tax rate applies). That means if you're a married couple filing a joint federal income tax return, and your taxable income is $68,000 or less, you pay no federal tax on the gain.

However, these rates expire at the end of 2010. Beginning in 2011, a 20% rate will generally apply to long-term capital gains. Individuals in the 15% tax bracket (remember, there won't be a 10% bracket in 2011) will pay the tax at a rate of 10%. Special rules (and slightly lower rates) will apply for qualifying property held for five years or more. Finally, while qualifying dividends are taxed in 2010 using the same capital gains tax rates described above (i.e., 15% and 0%), in 2011 they'll be taxed as ordinary income subject to the increased 2011 tax brackets.

The estate tax

There is currently no estate tax for 2010, and special rules are in place that govern the way basis is calculated for property passing upon death. The estate tax reappears in 2011, however, with a $1 million exclusion amount (meaning that up to $1 million of assets will be exempt from estate tax) and a top tax rate of 55%. To put that in context, for 2009, the top estate tax rate was 45%, and estates received an exclusion of $3.5 million.

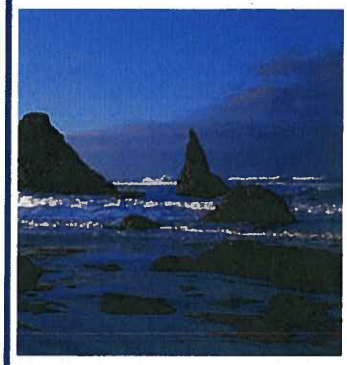
Year	2009	2010	2011
Estate tax exclusion	$3.5 million	N/A	$1 million
Top estate tax rate	45%	No tax	55%

Other important changes

Other changes for 2011 include:

- *Phaseout of itemized deductions and exemption amounts*--Itemized deductions and personal exemption amounts will once again be phased out for higher-income individuals

- *The "marriage penalty" returns*--Changes made to correct the federal income tax "marriage penalty" expire at the end of 2010, resulting in a reduced standard deduction amount and lower tax bracket thresholds (i.e., higher rates will apply at lower income levels) for married couples filing jointly in 2011
- *Tax credits get cut*--The child tax credit will be reduced and both the Hope education tax credit and the earned income tax credit become less generous (the Making Work Pay tax credit also disappears)
- *Section 179 small business expensing*--The increased IRC Section 179 expense limit ends (Section 179 allows small businesses to elect to expense the cost of qualifying property rather than recover the cost through depreciation deductions); the amount that a small business may expense will drop from $250,000 in 2010 to $25,000 in 2011



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