TAX HIGHLIGHTS

To Our Clients and Friends:

A SECA tax hike looms for S firm owners:
The tax will nail all profits of service firms, starting next year. The revenue raiser, a late addition to a bill that reinstates a set of expired tax breaks, helps offset a portion of the measure's tax relief. The increase in SECA tax on S corporation owners will be part of the measure when it finally passes. Small personal service S firms will be hit…Businesses where the principal asset is the reputation and skill of three or fewer workers. The same for owners of S firms that are partners in a service partnership. Currently, the tax is 15.3% of the first $106,800 in profits and 2.9% above that. The profits of small S firms in these fields will be subject to SECA tax: Accounting. Law. Health. Actuarial science. Engineering. Architecture. Lobbying. Consulting. Brokerage services. Investment management. Sports. Performing Arts.

The change will end a popular SECA tax saver for personal service S firms. Taking a modest salary and receiving the rest of the profit as a dividend. S corporation profits flow through to the owners' individual income tax returns as dividends. Those dividends are exempt from self-employment tax, but they are hit with income tax. A few years ago, Treasury inspectors found massive tax avoidance in this area. More than 35,000 one-owner S companies with profits of $100,000 or more paid no payroll taxes on the profits because the owners didn't take a salary. The same for owners of about 40,000 S firms with profits in the $50,000-$100,000 range. So tax writers decided to take action to end any possibility of gaming the system.

No exception will be allowed for amounts left in the firm for working capital, at least for small professional service S firms. Dividends passed through to owners of larger S service firms or of S corporations that aren't in professional service fields, such as manufacturers, will continue to be exempt from self-employment tax.

Another coming change will force more firms to reexamine their S status: The expiration of the Bush tax curs for upper incomers. Later this year, we expect Congress to extend the 2001 tax rate cuts, but not for upper incomers. It is likely that the top marginal income tax rate will return to 39.6% for 2011. When the reinstated phaseouts of personal exemptions and itemized deductions are factored into the mix, high incomers face a marginal tax rate in excess of 40%. That is significantly higher that the 35% maximum rate on regular corporations, so upper income shareholders will face a larger tax bite on the S firm's profits. But the favorable 15% top rate on dividends paid out by regular corporations is likely to go up in 2011 as well, possibly to as high as 39.6%, ending one factor favoring regular corporations.

Small businesses can double dip on tax breaks for offering health coverage. State subsidies won't reduce the federal credit, the Revenue Service says. About 20 states offer tax credits or subsidies to small firms to provide insurance. Payments by the state to the employer or to the insurance company are counted as a payment by the employer for calculating whether the employer pays at least 50% of the premium, a prerequisite for the federal credit. The only exception to this rule is that the credit the employer gets can't exceed what it actually pays for insurance. The maximum credit is 35% of the health plan's cost or the average group premium for small firms in the employer's state, whichever is lower. The full credit is available to firms with 10 or fewer full-time workers in the payroll and average yearly wages of less than $25,000. The break phases out for larger firms and is not available to companies with 25 or more employees or average annual wages of $50,000. The credit also applies for dental, vision and other limited coverage plans. It is not limited to standard medical coverage, according to IRS.

If you plan on selling your primary home at a substantial gain, take note: High profit sales after 2012 can trigger the special 3.8% Medicare surtax. Starting in 2013, the new health care law imposes a 3.8% levy on investment income of singles with adjusted gross incomes over $200,000 and married above $250,000. The surtax is levied on the smaller of the filer's net investment income or the excess of AGI over the thresholds. Capital gains are treated as investment income. Thus, if you expect the surtax will hit you after 2012 and the gain on the sale of your home will exceed $25,000 if you're single or $500,000 if married, gain over these amounts will bear an extra 3.8% tax. So it may pay handsomely to sell before the end of 2012. The surtax can bite even harder on sales of second homes after 2012. The home-sale exclusion doesn't apply to them, so the surtax can hit the entire gain.

Guaranteeing a loan to an S company won't give an owner a tax break. A guarantee does not increase the owner's deductible losses until the shareholder makes good on it, the Tax Court says. The losses are deductible up to the amount the owner invested in the firm, plus any advances.

Planning to convert more than one of your IRAs to a Roth this year? You will have to choose the same tax treatment for all your conversions. An individual converting in 2010 can elect to defer the tax and report half the income from the conversion on the 2011 tax return and the rest on it on the 2012 return. Or a person can report 100% on the 2010 return. But you can't defer the tax on one Roth conversion and pay the tax up front on another of your conversions. In effect, that would let you spread the tax over three years…2010, 2011 and 2012. Couples who each do a Roth conversion have a different rule: One spouse can elect to defer the tax bill, while the other one can choose to pay the tax up front.

If you plan to cash in on the favorable Roth conversion rules in 2010, consider using separate Roth IRAs for different asset classes. That way, if one segment of your Roth investments drops while the others increase in value, you can switch the underperforming account back to an IRA tax and penalty free. This strategy gives you maximum flexibility. If you timely file your 2010 returns, you will have until October 17, 2011 to decide whether you are better off unconverting. The $100,000 adjusted gross income limit on conversions ended after December 31, 2009, and anyone converting this year can elect to defer the income tax bill on the switch.

Be especially careful if you name a trust as the beneficiary of an IRA. A probate court can't fix a defective trust to stretch out payouts. A decedent named a trust for the benefit of his adult daughters to be the beneficiary of his IRA. But the trust failed to state that the daughters were required to receive all the distributions form the IRA, so they did not qualify as designated beneficiaries of the IRA. The daughters got a probate court judge to allow them to revise the trust to satisfy these rules, but IRS says this modification is ineffective for tax purposes. Since the IRA has no official designated beneficiary, the daughters must empty it by the end of the fifth full year after their father's death.

IRS is ramping up effort to police the home buyer credit to stop fraud. It plans to launch 200,000 audits this year of folks who took the credit. Remember, first time buyers must enclose a copy of the settlement statement with Form 5405. Those who are claiming the $6,500 credit for taxpayers who previously owned a home should attach documentation showing they owned a home for five consecutive years out of the last eight…records of property taxes, insurance coverage and the like.

A tax break for homeowners plagued by problems with Chinese drywall: The decline in their homes' value is eligible for casualty loss treatment, now that the government has determined that the drywall emits noxious fumes that corrode pipes and air-conditioning coils. In many cases, the amount of the loss equals the cost of replacing the drywall and repairing damaged pipes and appliances. Although the stench can render a home uninhabitable, the cost of temporary lodging is not allowed to be claimed as part of the casualty loss.

Unmarried co-owners of a house can claim the full home-sale exemption. Each can exclude up to $25,000 of profit is the residence was their main home for two out of the last five years. The IRA auditor had allowed the two 50% owners to exclude only $125,000 apiece.

IRS will greatly restrict use of federal tax deposit coupons after 2010. Only very small businesses will be permitted to use them…employers that have $2,500 or less in quarterly employment taxes and that pay their liability when filing their returns. All other firms will have to deposit their taxes by wire.

A new IRS campaign to collect unpaid FICA tax on tips is in the works. IRS is sending out bills to employers for their share of FUCA tax on unreported tips, using data collected from Form 4137, which employees use to report tip income that they didn't disclose to their employers. IRS will send letters to these firms telling them how much they owe and instructing them to include that amount with their next scheduled payroll tax deposit. Those that do so will be exempt from any interest or penalty on the back taxes. IRS was able to find these firms by changing the Form 4137 to require reporting of the employer's tax ID number.