CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

April/May/June 2012

IRS Offers a Deal to Companies Claiming Contractors

Many companies make payments to independent contractors. The IRS, however, prefers to see workers classified as employees. Over the years, such disputes have triggered tax audits and court cases. Recently, the IRS has offered amnesty to companies with questionable claims of hiring contractors.

The issues

When companies pay employees, income taxes are withheld from each paycheck. In addition, employers pay certain payroll taxes, such as contributions to Medicare and Social Security, on behalf of employees. As a result, the IRS receives a steady stream of revenues from employers with employees.

Employers treat independent contractors differently. Generally, companies pay contractors for the work they do, and they do not withhold taxes. Then, it's up to the contractors to pay the taxes they owe, including self-employment taxes for Medicare and Social Security. Because taxes are not withheld upfront, the IRS may find it challenging to collect all the taxes legitimately owed by independent contractors. In addition, contractors can take business deductions against their income more easily than employees can, so federal revenues may be reduced.

The potential for losing significant amounts of revenues due to worker misclassification has led to frequent IRS audits of employers to determine whether they are properly classifying their workers. In many cases, the IRS has ruled that independent contractors are really employees, so their employers owe taxes, interest, and penalties on the payments they have made to the contractors. Along with the IRS, the federal Department of Labor (DOL) and many state agencies are stepping up audit activity, looking to see which companies are improperly classifying employees as independent contractors. In some cases, government agencies are assessing penalties.

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What's Inside

Nest Eggs

In mid-2011, Americans held over $18 trillion in retirement plans, or 37% of all their financial assets.

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The offer

The IRS has announced a voluntary classification settlement program for this issue. To settle the matter, companies will pay a certain amount. The calculation is fairly complicated, but it usually turns out that companies will pay about 1% of the wages paid to each worker covered by the settlement in the past year. If a worker was paid $50,000, for instance, the company's obligation under this program might be about $500.

In order for companies to settle in this manner, they must meet certain conditions:

- They must have consistently treated workers as nonemployees.
- They must have filed all required Form 1099s for those workers in the past three years, reporting taxable earned income.
- They must not currently be undergoing an IRS audit, or undergoing an audit on this issue by any federal or state agencies.

In addition, a taxpayer who was previously audited by the IRS or DOL concerning the classification of the workers will only be eligible if the taxpayer has complied with the results of that audit.

Assuming companies qualify, make the required payments, and agree to treat the covered workers as employees in the future, they will owe no interest or penalties related to this issue. In addition, the IRS will not initiate payroll tax audits for any prior years on workers covered by this settlement. Companies agreeing to these terms also agree to extend the statute of limitations on payroll tax issues for an additional three years; this portion of the agreement will cover the three calendar years after the settlement.

Business owners considering this settlement should realize this is not an all-or-nothing proposal. An employer may reclassify certain classes of workers as employees while continuing to treat other classes as contractors.

Example: Company ABC has treated all of its telephone salespeople and its software designers as independent contractors. It decides to reclassify its software designers as employees, under the IRS settlement program, but continues to treat its telephone salespeople as independent contractors. Going forward, ABC agrees to treat all of its software designers as employees.

Making the decision

According to the courts that have ruled on this issue, the difference between an employee and an independent contractor is a matter of control. The more that a company can tell a worker what to do and how to do it, the more likely that worker deserves to be classified as an employee.

Therefore, business owners who hire contractors and grant them a great deal of leeway in the way they operate may have a solid case for classifying them as independent contractors. On the other hand, companies that exercise control over workers now classified as contractors may decide to take the IRS offer and pay the relatively modest amount to avoid future challenges.

There may be other issues facing companies that agree to this settlement, such as employee benefits and state and local taxes. Business owners who wish to participate in this program must apply on Form 8952 at least 60 days from the date the company wants to begin treating its workers as employees. ■

Did You Know?

Fixed income exchange traded products grew from less than 125 offerings in 2007 to nearly 600 at the end of 2011. Over 110 new fixed income exchange traded funds (ETFs) and exchange traded notes (ETNs) were launched last year alone. Fixed income ETFs and ETNs use an indexed approach to investing in bonds.

Source: www.etftrends.com

Correction

The article "Trim the Tax on Your Social Security Benefits" in the January/February/March 2012 issue of the *CPA Client Tax Letter* contains an error in the example under the heading "Numbers Crunch." The third paragraph in the example, which states that $2,000 will be added to Kim's taxable income, is incorrect. The paragraph actually should read as follows:

> Therefore, part of Kim's Social Security benefit is taxable. The taxable amount can be calculated using the Social Security Benefits Worksheet in the Instructions to Form 1040. In Kim's case, she must include $1,000 of the $14,000 in benefits she received in taxable income. ■

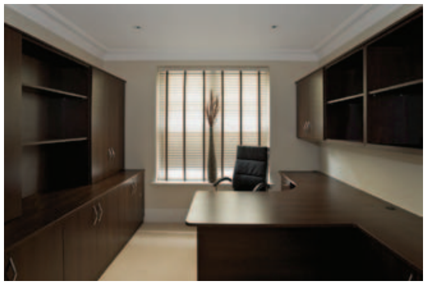
Home Office Deductions Demand Exclusivity

In order to take deductions for an office in your home, you must meet several requirements. For instance, you must use the space "regularly and exclusively" for business. A recent decision by the U.S. Tax Court indicates that exceptions won't be tolerated.

In this case, an accountant used one bedroom in his home as an office. He built a bathroom across the hall from this bedroom for clients to use. On his tax return for the year in question, he took over $9,000 in deductions for his home office, which the IRS denied.

The accountant brought the case to the Tax Court, which took a close look at the deduction. The accountant testified that he used the bedroom, the bathroom, and the hallway in between exclusively for business. He also said, however, that his children and some personal guests (that is, nonclients) occasionally used the bathroom. Because the hallway and bathroom were not used exclusively for business purposes, the Tax Court limited the home office deduction to the bedroom used as an office.

According to the opinion in the case, the total area of the accountant's residence, including a garage and a guest house, was 2,677.34 square feet. The bedroom used as an office had 226.3 square feet. Dividing 2,677.34 by 226.3, the court determined that 8.45% of the accountant's residence was his home office, so he could deduct 8.45% of his allowable expenses.



Home sweet home

As this case indicates, if you use part of your home as an office and wish to take tax deductions, you should refrain from any personal use there. Don't let your kids use your office computer to update their Facebook pages, for instance.

Still, this decision illustrates the potential advantages of claiming a home office. Despite the IRS denial, the Tax Court upheld an 8.45% deduction of "allowable" expenses. That could mean deducting 8.45% of everything this taxpayer spent on utilities and home insurance, for example, in addition to depreciation deductions for 8.45% of the residence.

In order to qualify for these deductions, several paths can be taken. You can claim the deductions if you meet with clients regularly in your home office, if you work from a separate structure such as a detached garage, or if the home office is your principal place of business. Often, taxpayers who claim home office deductions assert that the office is their principal place of business—it's where the most critical activities of a business take place, or it's the only fixed location for conducting substantial business activities. Regardless of which path you take, you must use the space regularly and exclusively for business in order to take proportionate deductions.

As a bonus tax benefit, if you have a home office that is your principal place of business, you won't have commuting trips. That is, every trip you make from your home to see a customer, prospect, supplier, and so on, is considered a business trip, so your expenses are deductible. In some cases, the transportation deductions may be larger than your other home office deductions. ■

Making Sense of Mutual Fund Taxation

When you gather up all the paperwork for filing your 2011 tax return, you may notice some surprising information from your mutual funds. Last year was marked by volatility in the financial markets, with losses as well as gains. Yet you may owe tax on capital gains from your mutual funds, no matter how well or how poorly they performed.

Indeed, investors may not be aware of how mutual funds are taxed. If you know the rules, you might be able to improve your after-tax results.

Passing through

Under the tax code, mutual funds can avoid paying income tax by distributing all of their income and capital gains to shareholders each year, so that's a common practice. Some of the tax results are straightforward. The interest income that a bond fund receives can be distributed to shareholders who will owe income tax on ordinary income if the fund holds taxable bonds. A stock fund can distribute the dividend income it receives from the stocks in its portfolio; shareholders

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who receive those dividends generally owe tax at the special low rate now in effect for qualified dividends.

In addition, many mutual funds buy and sell securities throughout the year as they change their holdings. If a fund winds up with net gains at the end of its tax year, those gains will be passed through to shareholders. Net gains may be short-term, long-term, or a combination. In many down years for stocks or bonds, investors wind up owing tax on capital gains distributions.

Example 1: Mutual Fund XYZ invests in large-company stocks. During its current tax year, economic news is dreadful, and many investors flee the stock market. Some of those investors redeem their shares of XYZ, which must sell some assets to raise cash in order to meet the redemptions. Once all of the selling has been done for the year, XYZ discovers that it has more gains from selling stocks than it has losses from other stock sales, thus, winding up with net capital gains.

Suppose that XYZ has 1 million shares outstanding. In its current tax year, it winds up with $3 million of net long-term capital gains (on stocks held for more than one year) and $2 million of net short-term capital gains. Therefore, XYZ has $5 million of gains to distribute to shareholders: $5 per share. XYZ distributes those gains to shareholders, reporting $3 per share of long-term gains and $2 per share of short-term gains, which pass through as ordinary income. So, for this example, the fund would make those capital gains distributions even though the fund has posted a 10% loss for the year.

Tales of taxation

These distributions may affect different investors in different ways.

Example 2: Anne Young holds 100 shares of XYZ in her traditional IRA. She receives the $500 distribution ($5 per share) within her IRA and reinvests the money in accordance with her asset allocation. Anne owes no tax because she holds the shares in her IRA. When she takes the money out, Anne will owe tax at her ordinary income tax rate.

Example 3: Brandon Wells holds 100 shares of XYZ in his taxable account. He collects the $500 and pays the required income tax. Brandon owes 15% on $300 worth of long-term gains but owes tax at his ordinary 28% rate on $200 in short-term gains. After paying $101 in tax ($45 plus $56) Brandon has $399 left to reinvest.

Example 4: Claire Vincent holds 100 shares of XYZ in her taxable account. She has chosen to reinvest all her distributions. If XYZ then trades at $50 per share, Claire acquires 10 additional shares of XYZ with her $500 distribution.

Even though she has not received any money, Claire still owes tax on a $500 capital gains distribution. Assuming that Claire also is in a 28% ordinary income tax bracket, she will owe the same $101 in tax as Brandon does, but with no cash from XYZ from which to make the payment.

Savvy strategies

Once you know these tax rules, you may be able to adapt your mutual fund investment strategies. Before you buy a fund, examine its history of capital gains distributions. A fund that historically has made large distributions in relation to its trading price might be a fund that trades heavily and realizes capital gains regularly. You may decide to hold such a fund in your IRA, where taxes are deferred.

For your taxable account, consider funds that have been tax efficient over the years, making relatively small capital gains distributions. Some funds are "tax managed," meaning that they try to minimize taxes to shareholders by taking losses as well as gains when they sell securities. ■

Make Disability Insurance Less Taxing

Disability insurance can be a valuable part of your risk management plan. If you cannot work because of an illness or injury, you might lose income. Disability insurance benefits can make up the difference.

Few insurers will offer to replace 100% of your income. As a rule, disability policies will replace no more than 60% or 70% of your income.

Example 1: Kevin Connors earns $60,000 per year ($5,000 per month). He has disability coverage that will pay up to 60% of his income: $3,000 per month. If Kevin should suffer a stroke, for example, and lose the ability to work, he'd receive a maximum of $3,000 per month.

If Kevin were able spend the full $3,000 each month, he might be able to maintain a comparable lifestyle. However, if Kevin owes, say, 20% in federal and state income tax, he would only have $2,400 per month ($28,800 per year) and face more financial challenges.

Tax treatment

A basic rule governs the taxation of disability benefits. If you pay for disability insurance with your own after-tax dollars, your benefits will be tax free. However, if your employer pays the premiums, you will owe income tax on any disability benefits that you receive. That's the federal income tax treatment, which typically is followed by states, as well.

Many people have some form of disability coverage at work. If you have group coverage there, and you pay for it, you'll receive tax-free benefits in case you're disabled. Even if you pay for your coverage through payroll withholding, as long as you pay income tax on the money that's withheld, you'll qualify for tax-free disability benefits.

Some employers have a cost-sharing arrangement. If so, employees will receive partially tax-free income pro rata.

Example 2: Michael Dobbs has group disability that costs $40 per month. His employer pays $20 per month, and Michael has $20 withheld from his paycheck each month. Because Michael pays for half the cost of the insurance, any disability benefits that he receives from the policy will be 50% taxable and 50% tax free.

If Michael's employer pays half or even all of the disability insurance premiums, and Michael wants totally tax-free benefits, he can see if his company will enter into an arrangement with him. Michael can ask his employer to treat the disability premiums that it pays as additional taxable compensation.

Example 3: As in example 2, Michael pays $20 per month for disability insurance, and his company pays the other $20 per month. In this scenario, Michael's company adds $20 to his taxable compensation, even though the money goes to the insurance company. Michael might pay an additional $5–$7 per month in tax, depending on his bracket, but any disability benefits will be tax free.

Going solo

You might not be able to convince your employer to treat its disability insurance premiums as taxable compensation. Even if you can arrive at such an arrangement, you might feel that your group coverage is inadequate. In either situation, you may want to purchase individual disability insurance, in addition to your group coverage.

As long as you pay for individual disability insurance with your own after-tax dollars, which typically will be the case, you'll owe no tax on any benefits that you'll receive. Individual policies can have other advantages: they might offer additional benefit amounts and longer payout periods than group policies. Also, you can take your individual insurance with you if you change jobs. Individual disability policies may be expensive, though, so shop carefully and work with a well-recommended agent. ■

Trusted Advice

Coping With Cafeteria Plans

- Many companies offer disability coverage via so-called "cafeteria plans," under Section 125 of the tax code.
- Employees can withhold some of their salary and buy selected benefits on a pretax basis, with a cafeteria plan. If employees use this tactic to buy disability insurance, any benefits will be taxable.
- Employees who would prefer any benefits to be tax free may be able to ask for cafeteria outlays to be included as taxable compensation for the money that is used for disability insurance. If so, they'll be using after-tax dollars to acquire coverage, so any benefits won't be taxed.

Offering an Educational Assistance Program Can Be a Smart Move

For business owners, attracting and retaining talented employees can be vital. To enhance your company's appeal to key workers, consider offering valuable fringe benefits. For example, you might establish an educational assistance program.

As the name suggests, companies with such programs will pay for employees' educational expenses. Graduate level courses can be included, so your company can pay for employees' MBA courses through the program. For each covered employee, your company can pay up to $5,250 per year; such payments are tax deductible for your company and tax free for the employee. Alternatively, your company can reimburse employees for their educational outlays with

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payments that are tax deductible for the company and tax free to the employee.

Covered costs

To establish an educational assistance program, your company must create a written plan and notify eligible employees. The plan can't favor highly compensated employees. Generally, highly compensated employees include anyone who owns 5% of the company's shares during the year or preceding year, as well as people who received compensation in excess of a threshold amount in the preceding year ($115,000 in 2012). The actual calculation can be complicated; our office can help you set up an educational assistance program that complies with this requirement. Once an educational assistance program is operating, it can't provide more than 5% of the program's annual benefits to shareholders or owners (or their spouses or dependents) that separately own more than 5% of the company on any day of the year.

When you have an acceptable educational assistance program in place, it can cover tuition, fees, books, supplies, and equipment. Your educational assistance program can't pay for meals, lodging, or transportation. Similarly, the plan can't cover education involving sports, games, or hobbies unless such courses are related to your company's business or are required for a degree.

Setting standards

If your company is going to pay for employees' schooling, it can include some requirements in the educational assistance program. For example, you might say that participating employees must provide evidence that they've attended the classes and done the necessary schoolwork. The plan can state that covered courses must be related to the participating employee's careers. You can require certain grades, as reported on a transcript, and you can require employees not to leave your company for a certain length of time after they've finished the course for which your company has paid.

Over the limit

As mentioned, the maximum payment or reimbursement from an educational assistance program is $5,250 per year. What if an employee signs up for a course that costs more, and your company pays the excess amount? If the excess amount can be considered a "working condition benefit" (see the **Trusted Advice column, "Favorable Fringe"**), the same tax rules apply. Your company will get a tax deduction, and the employee reports no taxable income. However, employees will have to report compensation for other types of paid education.

Example: Megan Palmer is an executive assistant at your company. Megan, who has not attended college, signs up for some courses that will eventually lead to a degree. Your company, which offers an educational assistance program, pays $7,000 in 2012 for Megan's tuition, fees, books, and supplies.

In addition, Megan pays $1,000 to take a course on a new computer software program, which she uses at work. Your company reimburses her for this outlay.

Of the $7,000 that your company pays for Megan's college costs, the first $5,250 is covered by its educational assistance program, so Megan reports no taxable income from the company's $5,250 outlay. The additional $1,750 is not a working condition benefit, so Megan must count that amount as taxable income this year. Conversely, the $1,000 reimbursement for the software course is related to Megan's job, so it counts as a working condition benefit. Thus, your company can deduct the payment, and Megan will not have to report that $1,000 as taxable income. ■

Trusted Advice

Favorable Fringe

- Companies can deduct the money spent on working condition fringe benefits.
- Employees who receive such benefits aren't taxed on their value.
- These benefits consist of property and services provided to employees, so they can do their jobs.
- The favorable tax treatment applies to the extent the employee could deduct the cost as a business expense if he or she had paid for it.
- Examples of working condition benefits include an employee's use of a company car for business and job-related education provided to an employee.

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