

Cohen Smith & Company, P.A.

NEWSLETTER



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Law Changes And New Developments

For the new year, IRS has greeted individual and business taxpayers with tax law changes and other developments that affect the filing of their 2010 return. A few of the more significant changes that will affect most taxpayers follow.

Three extra days to file and pay

Because of the Emancipation Day holiday in the District of Columbia, the due date of Form 1040 for 2010 is April 18, 2011, instead of April 15, 2011. The April 18th deadline applies to any return or payment normally due on April 15th, and to the deadline for requesting a tax-filing extension and for making 2010 IRA contributions.

Special charitable contributions for certain IRA owners

Taxpayers who are age 70 ½ or older can make qualified charitable distributions (QCDs) - tax-free distributions to a charity from an Individual Retirement Account (IRA) of up to \$100,000. QCDs are counted in determining whether the owner has met the IRA's required minimum distribution (RMD). These distributions aren't subject to the charitable contribution percentage limits, since they are neither included in gross income nor claimed as a deduction on the taxpayer's return. These rules are available for charitable IRA transfers made in tax years beginning before January 1, 2012. Distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pension (SEP) plans, aren't eligible to be treated as a QCD.

Personal exemptions and itemized deductions are no longer phased out

For 2010 (and for 2011 and 2012), no overall income limits for personal and dependency exemptions and itemized deductions apply. Limitations continue to apply to particular itemized deductions, such as medical and dental expenses, certain miscellaneous itemized deductions, and casualty and theft losses.

Tax breaks extended.

Several tax breaks that expired at the end of 2009 were renewed and can be claimed on 2010 returns, including:

- State and local general sales tax deduction in lieu of state and local income taxes, claimed on Schedule A, Line 5.
- Higher education tuition and fees deduction, claimed on Form 8917.
- Educators' \$250 expense deduction, claimed on Form 1040, Line 23 or Form 1040A, Line 16.

Electronic filing (E-filing)

This tax season (2010) marks the first year that e-filing is mandatory for all individual returns prepared by professional firms.

Alternative minimum tax (AMT)

The 2010 Tax Relief Act included a patch of the AMT exemption amounts for 2010 and 2011. For 2010, the AMT exemption amounts are \$47,450 for unmarried individuals and \$72,450 for married individuals filing jointly. The 2010 Tax Relief Act also extended (through 2011) the ability to use nonrefundable personal credits to offset AMT (under IRC § 26 (a)).

Cell phones



The Small Business Jobs Act removed cell phones from the definition of listed property. Thus, the heightened substantiation requirements and special depreciation rules that apply to listed property under IRC § 280A will no longer apply to cell phones.

Up-to-\$1,000 credit for "retained workers" in 2011.

For any tax year ending after March 18, 2010, Sec. 102 of the Hiring Incentives to Restore Employment Act (HIRE Act, P.L. 111-147) provides an up-to-\$1,000 increase (retention credit) to the general business credit for "retained workers." A retained worker is any qualified individual who makes a proper certification on Form W-11 and:

- 1) Who was employed by the taxpayer on any date during the tax year,
- 2) Who was employed by the taxpayer for a period of not less than 52 consecutive weeks, and
- 3) Whose wages for that employment during the last 26 weeks of the period equaled at least 80% of the wages for the first 26 weeks of that period. (Hire Act § 102(b)).

The retained worker must have begun employment with a qualified employer after February 3, 2010 and before January 1, 2011.

Information reporting for rental real estate (Form 1099-Misc.)

As we went to press, the Senate has approved a measure that would repeal the expanded 1099 requirements of last year's health care law (and presumably those contained in the Small Business Jobs Act). The move has broad support because the 1099 rules, which are set to require businesses (and landlords) to report ANY purchases of more than \$600 of goods and services from vendors in a year to the IRS, are expected to increase accounting costs for small businesses (previously, payments for inventory items and payments to corporations were exempt from reporting, and many rental properties were exempt).

While we expect the repeal to be ultimately passed and signed by the President, businesses and landlords should continue to follow this issue closely and remain prepared to file 1099s in case the repeal efforts fail.

Under the Small Business Jobs Act of 2010, for payments made after December 31, 2010, except as provided below, a person receiving rental income from real estate will be considered to be engaged in a trade or business of renting property. Thus, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making

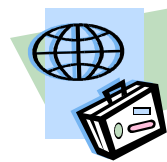
payment of \$600 or more during the tax year to a service provider (such as a plumber, painter, maintenance person, etc.) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to IRS and to the service provider.

The rental property expense payment reporting doesn't apply to:

- ...any individual who receives rental income of not more than a minimal amount, as determined under IRS regs;
- ...any individual (including one who is an active member of the uniformed services or an employee of the intelligence community) if substantially all rental income is derived from renting the individual's principal residence on a temporary basis;
- ...any other individual for whom the Code Sec. 6041 requirements would cause hardship, as determined under IRS regs. (Code Sec. 6041 (h)(2))

Preserving Tax Deductions For Business Travel

If a taxpayer's trip is undertaken solely for business reasons, reasonable and necessary travel expenses, including travel fares, lodging, meals, and incidental expenses in getting to and from the destination are generally deductible on federal tax returns (subject to the 50% disallowance for meals and entertainment). Transportation, lodging, meals, and incidental expenses incurred while at the destination should also qualify as federal tax deductions. However, if the taxpayer's trip involves both business and personal activities, a portion of the travel expenses may be nondeductible personal expenses, rather than deductible business expenses.



If a taxpayer travels on business in the United States and while at the business destination extends his or her stay for a vacation, makes a nonbusiness side trip, or has other nonbusiness activities, the proper treatment of the taxpayer's travel expenses depends on how much of the trip was business-related. The following guidelines generally apply:

- a. If the trip was *primarily for business*, the deductible travel expenses include the costs of getting to and from the business destination and any business-related expenses while at the business destination. Personal (vacation) costs incurred while at the destination are not tax-deductible.
- b. If the trip was *primarily for personal reasons*, such as a vacation, the costs of getting to and from the destination are personal (nondeductible) travel costs. Personal costs incurred while at the destination are also nondeductible. However, any business costs incurred while at the destination are tax-deductible expenses.

Whether a trip is primarily business or personal depends on the facts and circumstances of each case. The amount of time spent on business activities compared to the time spent on personal activities is an important factor. It is essential to note that time spent is only one factor to consider and may not be the dominant factor given the facts and circumstances. If the taxpayer would not have taken the trip except to achieve the business purpose, a strong argument can be made that the trip was primarily for business.

Combining business and personal travel often is an excellent way of obtaining deductions, while enjoying time away from home. However, the proper allocation of travel expenses between business and

nonbusiness categories is often difficult to determine. Should you have any questions regarding specific travel expense allocation issues or any other tax planning or compliance matter, please give me a call.



Baby Boomers' Medicare Sign-up

For many older Baby Boomers, it may be difficult to believe that age 65 and the time to sign up for Medicare is either here or fast approaching. There are numerous options and decisions to be made, but it is important to note that if you don't sign up when first eligible, future Medicare premiums could be higher than normal.

If you began receiving social security retirement benefits before age 65, the Social Security Administration will automatically enroll you in Medicare Part A and Part B effective the month you turn age 65. For example, if your 65th birthday is September 20, 2011, your Medicare effective date will be September 1, 2011. Your Medicare card will be mailed approximately three months before your 65th birthday.

If you are close to age 65 and not yet receiving social security retirement benefits or Medicare, you can apply for both at the same time. To ensure your Medicare Part B coverage start date is not delayed, you should apply three months before the month you turn age 65. This is the beginning of the seven-month initial enrollment period. If you wait until age 65, or in the last three months of the initial enrollment period, your Medicare Part B coverage start date will be delayed. You can apply for Medicare at a local Social Security office or online at www.ssa.gov.

Avoiding Constructive Dividend Treatment


Payments made by a corporation primarily for the benefit of a shareholder, as opposed to the business interests of the corporation, will often be treated as constructive dividends. Constructive dividends generally occur in closely-held corporations where dealings with shareholders are often informal. Constructive dividends have the same general federal tax consequences as true dividends. That is, the dividend is income to the shareholder, but not deductible by the corporation (as reasonable compensation would be). Such treatment can cause unexpected and adverse tax consequences.

Corporate management should be aware of the various constructive dividend scenarios in an effort to avoid an unfavorable tax outcome. For example, amounts paid to a shareholder in excess of what the IRS considers reasonable may give rise to a constructive dividend. Payments may include not just salary, but also directors' fees and rent for property leased to the corporation. Where the corporation ties compensation to the amount of shares owned, rather than the value of any services provided, the IRS may treat such compensation as a nondeductible dividend. The courts have also treated excessive amounts paid to family members for services provided to the corporation as constructive dividends.

Likewise, personal shareholder expenses paid by the corporation without expectation of repayment can be constructive dividends to the shareholder in an amount equal to the fair market value (FMV) of the benefit received.

Depending upon the facts and circumstances of the transaction, the IRS may attempt to treat a shareholder advance that is not a bona fide loan (e.g., poor or nonexistent documentation) as a constructive dividend.

Interest on shareholder loans with below-market interest rates can also constitute a constructive dividend. Likewise, if a corporation, without adequate consideration, assumes a debt or other legal obligation of a shareholder, or makes payments on such a debt, a constructive dividend may result.

Use of corporate property by shareholders can also result in a constructive dividend. Typical situations include the use of corporate-owned autos, boats, airplanes, vacation homes, and other property if the shareholder  does not repay the value of such usage to the corporation, or the corporation does not include the value in a shareholder/employee's salary or wages. The amount of the constructive dividend equals the fair rental value of the property.

In addition, the value of improvements made by the corporation to property leased from a shareholder that were in excess of normal lessee improvements (based on the type and value of the property, and the term of the lease) can be a constructive dividend.

Finally, bargain purchases of corporate property by a shareholder can also result in a constructive dividend to the extent the FMV of the property exceeds the purchase price.

As you can see, there are a number of instances where corporate shareholders and management must be vigilant to prevent unexpected constructive dividends and the accompanying adverse tax consequences. Please do not hesitate to contact us to discuss constructive dividends or any other tax compliance or planning matter.

Converting a Residence to Rental Property

For various reasons, including the generally depressed real estate market, homeowners may consider converting their personal residence to rental property. The process for making this decision should include an analysis of economic factors, such as the homeowners' marginal tax rate and the potential loss of the ability to exclude up to \$250,000 (\$500,000, if married) of gain from the sale of their principal residence for federal income tax purposes.



Other economic factors to consider include the expected growth rate for rental property in the area, length of time the house will be rented before being sold, cash flow from renting, effect of passive activity rules (which limit and defer tax deductions), and expected rate of return available on other investments.

Generally, the economic advantage of converting a personal residence to a rental rather than selling it is increased as the growth rate of the rental property increases and the rate of return on alternative investments decreases. But, each situation should be thoroughly analyzed given its particular facts and circumstances.

If selling a personal residence would result in a nondeductible loss, the homeowner can seriously consider converting the residence to a rental property. Tax savings opportunities generally are limited for residential rental conversions, primarily because of the passive activity loss rules and the fact that pre-conversion decline in value remains non-deductible. Nevertheless, converting a personal residence into rental property may allow the homeowner to eventually recognize a loss for tax purposes on the property's subsequent sale if the property continues to decline in value, but provide cash flow in the interim.

The fact that a residence is rented at the time of the sale does not automatically preclude gain attributable to such use to be excluded under the gain residential exclusion rules. Instead, the exclusion of gain depends on whether the homeowner meets the ownership and use requirements and the one-sale-in-two-years test at the time of the sale. In all cases, however, gain exclusion cannot be claimed to the extent of depreciation adjustments attributable to periods after May 6, 1997.

The decision to convert a residence to rental or investment property is complex, and the ramifications of this decision are far-reaching. Please contact us to carefully explore the numerous tax and economic issues related to such a conversion before making any decision.



TAX CALENDAR

FEBRUARY 2011

February 10

Employee who work for tips. If you received \$20 or more in tips during January, report them to your employer. You can use Form 4070.

February 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

February 28

The government's copy of Form 1099 series returns (along with the appropriate transmittal form) should be sent in by today. However, if these forms will be filed electronically, the due date is extended to March 31.

File Form W-3 (Transmittal of Wage and Tax Statements) along with Copy A of all the Forms W-2 you issued for 2010. If you file Forms W-2 electronically, your due date will be extended to March 31.

March 2011

March 10

Employees who work for tips. If you received \$20 or more in tips during February, report them to your employer. You can use Form 4070.

March 15

2010 income tax returns must be filed or extended for calendar-year corporations. If the return is not extended, this is also the last day for calendar-year corporations to make 2010 contributions to pension and profit-sharing plans.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

Other helpful line services



www.IRS.gov www.MyFlorida.com

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www.Volusia.org