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Report

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Tax Tips
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Get ready, get set, hire!

Jobs bill offers tax incentives for hiring (and keeping) the unemployed

Back in March, health care reform grabbed most of the headlines, but it wasn't the only legislation enacted that month. About a week earlier, President Obama signed the Hiring Incentives to Restore Employment (HIRE) Act.

The act offers payroll tax breaks for employers that hire unemployed workers, plus additional credits for qualified workers they retain for at least 52 consecutive weeks. It also extends the enhanced Section 179 expensing allowance and makes several other tax changes. (See "Tax Tips" on page 7.)

Who's eligible?

Businesses and nonprofit organizations of all types and sizes are eligible for the hiring and retention breaks. But these breaks aren't available to federal, state or local governments, except for state colleges and universities.

An employee qualifies for payroll tax breaks if he or she:

- Starts work after Feb. 3, 2010, and before Jan. 1, 2011,
- Wasn't employed for more than 40 hours during the 60-day period before the start date (and signs an affidavit to that effect),
- Doesn't replace an existing employee (except one who quits voluntarily or is fired for cause), and
- Isn't related to the employer or to an individual who owns more than 50% of the employer.

Qualified employees include previously laid-off workers that you rehire, provided they meet the above requirements. Employment can be full-time or part-time, but the more hours a qualified employee works, the greater the benefits.

What are the benefits?

If you hire qualified employees, you're exempt from the 6.2% Social Security portion of Federal Insurance Contributions Act (FICA) taxes on wages you pay them for work performed after the HIRE act was enacted (March 18, 2010) through the end of the year. Based on the current Social Security taxable wage base of $106,800, the maximum tax benefit is $6,622 per qualified employee.

What about the retention break?

For each employee qualifying for the payroll tax break whom you keep on the payroll for at least 52 consecutive weeks, you're entitled to a tax credit of up to $1,000 on your 2011 income tax return. To qualify for the credit, an employee's wages for the second half of the 52-week period must be at least 80% of his or her wages for the first half of the period. Even if a new hire leaves *voluntarily* before 52 consecutive weeks, no retention credit is received for that hire.

To prevent employers from claiming the full $1,000 credit for employees who do minimal part-time work, the amount of the credit is the *lesser* of $1,000 or 6.2% of a qualified employee's wages during the 52-week period. Put another way, new hires who earn more than $16,129 during that period qualify for the full $1,000 credit.

Retained worker credits are claimed as part of the general business credit under Internal Revenue Code Sec. 38(b). Under the HIRE act, however, no portion of an employer's unused Sec. 38(b) credit that is attributable to retained worker credits may be carried back to tax years beginning before the HIRE act's enactment date.

Act sooner rather than later

If you're thinking about adding to your workforce, keep in mind that the HIRE act's payroll tax incentives are available for wages paid through the end of 2010, so the sooner you act, the greater the benefits. And the retained worker credit is limited to employees hired this year, so you must hire employees by Dec. 31 to benefit. Also, be sure to compare the HIRE act's payroll tax break to the Work Opportunity Tax Credit (WOTC), because you can't claim both for the same employee. (See "Payroll tax exemption vs. WOTC: How to choose" at right.) ◎

Payroll tax exemption vs. WOTC: How to choose

Wages you pay to a worker who qualifies for the Hiring Incentives to Restore Employment (HIRE) Act's payroll tax exemption (see main article) don't qualify for the Work Opportunity Tax Credit (WOTC) unless you elect not to claim the payroll tax exemption. So it's important to select the tax break that provides the greater benefit.

The WOTC is a dollar-for-dollar reduction in federal tax liability for companies that hire people from certain disadvantaged groups. Generally, the maximum credit is 40% of first-year wages up to $6,000, or $2,400 (though credits may be higher or lower for certain groups).

For some new employees, the WOTC will provide a greater benefit than the HIRE act's payroll tax exemption. Suppose, for example, that you hire a new employee on July 1, 2010, at an annual salary of $50,000, and the employee qualifies for both tax breaks. The payroll tax exemption would provide tax savings of $25,000 × 6.2%, or $1,550. In this case, you'd be better off opting out and claiming the $2,400 WOTC.

Planning necessary to bequeath a retirement plan

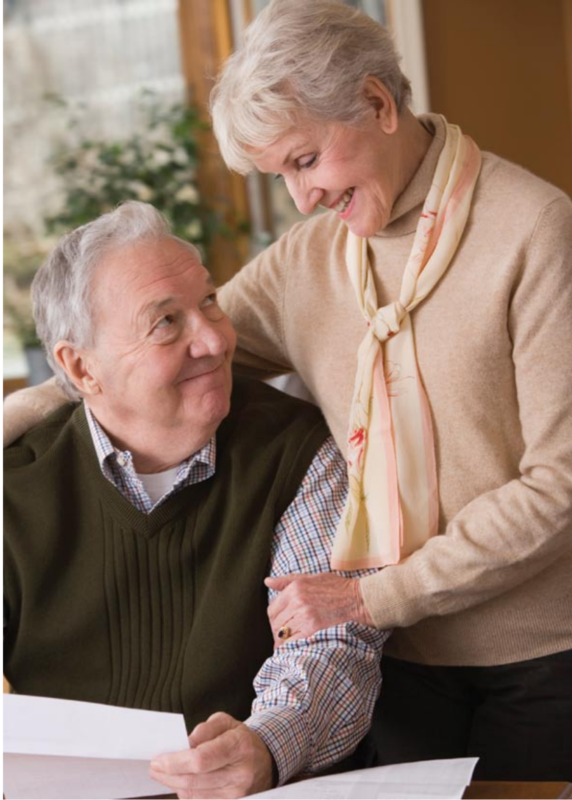
Planning the execution of your estate may not be the most pleasant task, what with having to consider your death and how loose ends of your affairs will be tied up.

If you've had the good fortune to leave your retirement funds untouched, there's at least one upside to estate planning: the fact that you can share your considerable tax-deferred wealth with family members. But who should be the beneficiary? Before you make a decision, consider the income and estate tax implications of your choice.

Tax-deferred retirement plans and heirs' income tax

IRAs and employer-sponsored "qualified" plans, such as 401(k)s, can effectively build wealth for your family because no taxes are due until funds are withdrawn, which allows you to take advantage of tax-deferred compounding. (In the case of Roth accounts, no taxes are *ever* due on growth — as long as all distributions are qualified.)

When it comes to estate planning, though, tax-deferred retirement plans are a double-edged



sword. Most inherited assets, such as stocks and real estate, receive a step-up in basis on the death of the owner of the assets, which means that heirs will owe income tax only on income or capital gains generated *after* they inherit the asset.

(Note that, as of this writing, an estate tax repeal is in effect for 2010 and during the repeal the step-up in basis is limited. However, the estate tax is scheduled to return in 2011, and the generally unlimited step-up in basis is set to return with it. Plus the repeal, along with the step-up in basis limits, may be repealed. Check with your tax advisor for the latest information.)

But, for family members who inherit funds from your traditional 401(k) plan, traditional IRA or most other qualified plans, no step-up in basis is available (regardless of whether the estate tax repeal and its accompanying step-up in basis limits are in effect). So the beneficiaries will have to pay income tax on 100% of the distributions they receive, except to the extent that you used nondeductible contributions to fund the account.

3 factors affecting income tax liability

To minimize the income tax bite — and maximize the wealth-building power of a tax-deferred retirement plan — consider three factors that will affect your beneficiary's income tax liability: 1) how long the beneficiary will be able to defer distributions, 2) how large any required minimum distributions (RMDs) will be and 3) the beneficiary's likely tax bracket.

Generally, for inherited retirement plans, annual RMDs must begin immediately. The size of the RMDs will depend on the size of the account and the age of the beneficiary — the younger he or she is, the smaller the RMDs will be. Because the account will be depleted more slowly with smaller RMDs, there's a greater opportunity for tax-deferred growth. Plus, a younger beneficiary may well be in a lower tax bracket, at least for the early years of RMDs.

IRAs and employer-sponsored "qualified" plans can effectively build wealth for your family because no taxes are due until funds are withdrawn, which allows you to take advantage of tax-deferred compounding.

However, there also may be deferral benefits to naming your spouse as beneficiary. Your spouse has more flexibility in deferring distributions because he or she can treat your IRA as his or her own and delay any distributions until age 70½. Although this rule doesn't generally apply to other retirement plans, your spouse can roll the plan into an IRA for him- or herself and then take advantage of this deferral.

Designating your estate as beneficiary is likely a bad idea because the retirement plan will have to be distributed within five years after you die.

Estate tax consequences

From an estate tax perspective, naming your spouse as the beneficiary may or may not make sense. The advantage (when the estate tax is in effect) is that you'll avoid any estate tax liability on the retirement plan assets at your death because transfers to your spouse (provided he or she is a U.S. citizen) are free of estate tax. However, the IRA will increase the size of your spouse's estate, which may result in increased estate tax at his or her death.

If you name a beneficiary other than your spouse, the retirement plan generally will be included in your estate. Whether it will cause any estate tax liability will depend on a variety of factors, such as the size of the plan, the size of your estate, and the estate tax exemption available for the year of your death. (Of course, if the estate tax repeal is in effect, there will be no federal estate tax liability, though there could be state estate tax liability.)

Educate yourself before making a choice

Choosing who should be the beneficiary of your retirement plan shouldn't be taken lightly. It's important to consider the income and estate tax consequences your bequest may trigger. Your tax advisor can help you with all of the details. ◎

Refinancing? Know the tax rules

Have you recently refinanced a mortgage or are you considering doing so? If you answered "yes," it's worth your while to familiarize yourself with the rules for deducting mortgage interest.

General rules

The mortgage interest deduction is available for interest on loans secured by your principal home or a second home. A "home" includes a house, condo or co-op, as well as a mobile home, trailer or boat with sleeping, cooking and toilet facilities.

The tax code allows you to deduct interest on up to $1 million in "acquisition indebtedness" — that is, debt used to buy, build or substantially renovate a home — plus interest on up to $100,000 in home equity debt used for any purpose. These limits apply to the combined principal of all loans secured by your principal and second homes. If you're married filing separately, the limits are cut in half to $500,000 and $50,000, respectively.

Recently, the IRS clarified that homeowners with more than $1 million in acquisition indebtedness may deduct interest on the excess as home equity debt (subject to the $100,000 limit).

Refinancing rules

When you refinance a mortgage, the tax treatment of interest on the new loan depends on whether you do a straight replacement loan or a cash-out refinancing. With a replacement loan, you borrow an amount equal to the outstanding balance on the old mortgage. Interest on the new mortgage is fully deductible, provided your total acquisition indebtedness is no more than $1 million.

With a cash-out refinancing, in which you borrow more than you need to cover your outstanding mortgage balance, the tax treatment depends on how you use the excess cash. If you use it for home improvements, it's considered acquisition indebtedness, and the interest is deductible (subject to the $1 million limit). If you use it for another purpose, such as buying a car or paying tuition, it's considered home equity debt subject to the $100,000 limit.

Deducting points

When you buy a home, prepaid interest — or "points" — is deductible immediately. When you refinance, however, points are amortized and deducted ratably over the life of the loan. For example, let's say you refinance a $500,000 mortgage with a new, 30-year loan, paying two points ($10,000). Even though you pay the points up front, you must deduct them over 30 years at a rate of $333 per year. (First and last year deductions, however, will be less.)

When you refinance a mortgage, the tax treatment of interest on the new loan depends on whether you do a straight replacement loan or a cash-out refinancing.

If you're already amortizing points — from a previous refinancing, for example — and you refinance with a *new* lender, you can deduct the unamortized balance in the year you refinance. But if you refinance with the *same* lender, you must add the unamortized points from the old loan to any points you pay on the new loan and deduct the total over the life of the new loan.

There's an exception for certain cash-out refinancings. You can immediately deduct points attributable to the portion of the new loan used to improve your principal residence. In the previous example, if you use $100,000 of the $500,000 loan for home improvements, you can deduct one-fifth of the points, or $2,000, up front.

Maximize your tax benefits

A basic understanding of these rules can help you make the most of interest deductions and avoid tax surprises. If you're unsure of the proper tax treatment of a refinancing, consult your tax advisor. ◎

tax TIPS

Keep an eye on Congress

The HIRE act didn't extend the 50% bonus depreciation that expired at the end of 2009, nor did it address several other individual and business tax incentives that expired last year. But keep an eye on Congress, which is considering legislation that would revive some of these tax breaks. Among other things, as of this writing bills pending in Congress would extend:

- The deduction for state and local sales taxes,
- The additional standard deduction for real estate taxes,
- Tax-free IRA distributions to charities,
- The research tax credit,
- Deductions for qualified leasehold improvements and qualified restaurant property, and
- Several energy tax incentives.

Check with your tax advisor for the latest information.

Will your taxes be higher in 2011?

Unless lawmakers take action, in 2011 the top capital gains tax rate will jump from 15% to 20% and the 25%, 28%, 33% and 35% individual income tax rates will increase to 28%, 31%, 36% and 39.6%, respectively. Additionally, the top rate on qualified dividends will jump from 15% to 39.6%.

Talk to your tax advisor about how these and other potential tax increases affect your tax planning for the remainder of 2010 — or to find out if the 2010 rates have been extended since this writing.

Health care help for small businesses

Many of the Patient Protection and Affordable Care Act's provisions don't kick in until 2013 or later, but one important change takes effect immediately: This year, eligible small businesses are entitled to a maximum 35% tax credit for purchasing group health coverage. Contact your tax advisor for details.

Expense it!

The Section 179 expensing election is one way for small-business owners to boost cash flow. It allows you to deduct immediately the entire cost of qualifying business equipment and other depreciable property rather than spreading depreciation deductions over several years. In 2008 and 2009, an enhanced Sec. 179 election allowed you to expense up to $250,000, with the benefits phased out on a dollar-for-dollar basis after your total investment in qualifying property tops $800,000.

These limits were set to drop down to their previous levels — $134,000 and $530,000, respectively — but the Hiring Incentives to Restore Employment (HIRE) Act extended the enhanced election for one more year. The $250,000 limit applies to new and used property (including off-the-shelf computer software) that you purchase through the end of your tax year *beginning* in 2010. So, if you're on a fiscal year, you can take advantage of the enhanced expensing election well into 2011.

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Developments Affecting California Taxpayers

California Conformity Act of 2010 — On April 12, 2010, the Governor signed the California Conformity Act. Generally, California now conforms to the Internal Revenue Code as of January 1, 2009.

California partially conforms to the federal cancellation of debt (COD) income exclusion for principal residences for discharges occurring on or after January 1, 2009 and before January 1, 2013 with these major differences:

- Qualified principal residence indebtedness is limited to $800,000 ($400,000 for married filing a separate return) instead of the federal $2 million ($1 million for married filing a separate return), and
- The maximum COD income exclusion is further limited to $500,000 ($250,000 for married filing a separate return).

California conforms to federal insolvency rules. If a taxpayer is insolvent, the COD income not excluded due to the above limitations may be excluded under the insolvency rules.

Some of the other significant conformity provisions, most of which take effect as of January 1, 2010, include:

- Surviving spouse may exclude up to $500,000 of gain on the sale of a principal residence within two years of a spouse's death;
- Gains from sale of principal residence attributable to nonqualified use (for example, use of a principal residence as a rental property or as a vacation home) can't be excluded;
- Increases penalty for failure to file partnership returns;
- Imposes a new per-shareholder penalty for late-filing S corporations returns;
- Increases minimum penalty for failure to file individual returns from $100 to $135;
- Increases Kiddie tax age limit from 17 to 23; and
- Inflation indexing for the active participation limitations on traditional IRA contributions.

California does not conform to any of the federal legislation enacted in 2009 and 2010. Here is a partial list:

- Residential energy credit (California has none);
- Five-year carry back of Net Operating Losses;
- Exclusion from gross income of the $3,500 or $4,500 voucher received in the "Cash for Clunkers" program (California will treat it as amount realized in a sale or exchange of the used car); and
- Reduction of 2009 required estimated tax payments for certain small businesses from 110 percent to 90 percent of their previous year's taxes.

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