

WINTER 2010 NEWSLETTER

FOR QUARTER ENDED

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Announcement

As of January 1, 2011, the firm name will be Thomas E. Singleton, CPA, LLC.

Note

The information contained in the newsletter below is current as of December 31, 2010. It is general in nature and is subject to change. Please contact me prior to implementing any plan that places reliance on material in this newsletter.

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1. Overview of 2010 Tax Relief Act

The recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” is a sweeping tax package that includes, among many other items, an extension of the Bush-era tax cuts for two years, estate tax relief, a two-year “patch” of the alternative minimum tax (AMT), a two-percentage point cut in employee-paid payroll taxes and in self-employment tax for 2011, new incentives to invest in machinery and equipment and a host of retroactively resuscitated and extended tax breaks for individuals and businesses. Here’s a look at the key elements of the package:

- The current income tax rates will be retained for two years (2011 and 2012), with a top rate of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.
- Employees and self-employed workers will receive a reduction of two percentage points in Social Security payroll tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.
- A two-year AMT “patch” for 2010 and 2011 will keep the AMT exemption near current levels and allow personal credits to offset AMT. Without the patch, about 21 million additional taxpayers would have owed AMT for 2010.
- Key tax credits for working families that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 will be retained. Specifically, the new law extends the \$1,000 child tax credit and maintains its expanded refundability for two years, extends rules expanding the earned income credit for larger families and married couples, and extends the higher education tax credit (the American Opportunity tax credit) and its partial refundability for two years.
- Businesses can write off 100% of the cost of equipment and machinery purchases, effective for property placed in service after September 8, 2010 and through December 31, 2011. For property placed in service in 2012, the new law provides for 50% additional first-year depreciation.
- Many of the “traditional” tax extenders are extended for two years, retroactively to 2010 and through the end of 2011. Among others, the extended provisions include the election to take an itemized deduction for state and local general sales taxes in place of the itemized deduction for state and local income taxes and the \$250 above-the-line deduction for certain expenses of elementary and secondary school teachers..
- The estate tax will be reinstated for 2011 and 2012, with a top rate of 35%. The exemption amount will be \$5 million per individual in 2011 and will be indexed to inflation in following years. Estates of persons who died in 2010 can choose to follow either 2010’s or 2011’s rules.
- Omitted from the new law: repeal of a controversial expansion of the Form 1099 reporting requirements.

- Also not included: extension of the Build America Bonds program, which permits municipalities to issue federally subsidized municipal bonds.

2. Alternative Minimum Tax Relief

Two key provisions in the recently enacted “Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010” extend partial relief to individual taxpayers from the alternative minimum tax, or AMT. Earlier temporary measures to deal with the unintended creep on the AMT’s reach expired at the end of 2009, meaning that about 21 million additional taxpayers would have faced paying the tax on their 2010 returns without the new relief.

The AMT is a parallel tax system which does not permit several of the deductions permissible under the regular tax system such as property tax. Taxpayers who may be subject to the AMT must calculate their tax liability under the regular federal tax system and under the AMT system taking into account certain “preferences” and “adjustments”. If their liability is found to be greater under the AMT system, that is what they owe the federal government. Originally enacted to make sure that wealthy Americans did not escape paying taxes, the AMT has started to apply to more middle-income taxpayers, as the AMT parameters are not indexed for inflation.

In recent years, Congress has provided a measure of relief from the AMT by raising the AMT “exemption amounts” – allowances that reduce the amount of alternative minimum taxable income (AMTI), reducing or eliminating AMT liability. (However, these exemption amounts are phased out for taxpayers whose AMTI exceeds specified amounts.) For 2009, the AMT exemption amounts were \$70,950 for married couples filing jointly and surviving spouses; \$46,700 for single taxpayers; and \$35,475 for married filing separately. However, for 2010, those amounts were scheduled to fall back to the amounts that applied in 2000; \$45,000, \$33,750, and \$22,500, respectively. This would have brought millions of additional middle-income Americans under the AMT system, resulting in higher federal tax bills for many of them, along with higher compliance costs associated with filling out and filing the complicated AMT tax form.

To prevent the unintended result of having millions of middle-income taxpayers fall prey to the AMT, Congress has once again relied on a temporary “patch” to the problem, this time a two-year extension of the 2009 exemption amounts, increased slightly. Under the new law, for tax years beginning in 2010, the AMT exemption amounts are increased to: (1) \$72,450 in the case of married individuals filing a joint return and surviving spouses; (2) \$47,450 in the case of unmarried individuals other than surviving spouses; and (3) \$36,225 in the case of married individuals filing a separate return. For tax years beginning in 2011, the AMT exemption amounts are increased to: (1) \$74,450 in the case of married individuals filing a joint return and surviving spouses; (2) \$48,450 in the case of unmarried individuals other than

surviving spouses; and (3) \$37,225 in the case of married individuals filing a separate return.

Another provision in the new law provides AMT relief for taxpayers claiming personal tax credits. The tax liability limitation rules generally provide that certain nonrefundable personal credits (including dependent care credit and the elderly and disabled credit) are allowed only to the extent that a taxpayer has regular tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against the AMT. Temporary provisions had been enacted which permitted these credits to offset the entire regular and AMT liability through the end of 2009. The new law extends this temporary provision to 2010 and 2011.

3. Return of the Estate Tax

The estates of wealthy individuals who died in 2010 didn't pay any federal estate tax, but that situation is about to change. Under the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," the federal estate tax, which disappeared for 2010, comes back to life in 2011 and is imposed at the top rate of 35% of the estate's value after the first \$5 million.

The estate tax dates back to 1916, when it was imposed at a rate of 10% on the portion of estates over \$50,000. The rates and exemption amounts have varied, reaching a high of 77% from 1941 to 1976 with a \$60,000 exemption amount.

Congress passed the "Economic Growth and Tax Relief Reconciliation Act of 2001" (EGTRRA), the first of the two large legislative packages that contain most of what are now commonly referred to as the "Bush tax cuts". EGTRRA gradually lowered the maximum estate tax rate and substantially raised the applicable exclusion amount over the years 2002 through 2009. The maximum tax rate fell from 60% under prior law in 2001 (a 55% marginal rate on taxable estate values over \$3 million plus a 5% surtax from \$10 million to \$17 million) to 45% in 2007-2009. EGTRRA repealed the estate tax completely for decedents dying in 2010. That led to several well-publicized instances in which famous people died in 2010 leaving multibillion-dollar estates that will pass to their heirs without paying any federal estate tax. However, all of those provisions were scheduled to sunset on December 31, 2010, meaning that if Congress had not acted, starting January 1, 2011; the estate tax would have come back at a level that no one seemed to want. Where the exclusion was \$3.5 million (\$7 million for couples) in 2009 – a level at which it affected relatively few households – it would have been \$1 million (\$2 million for couples) in 2011. The tax rate would also have risen, from a top rate of 45% in 2009 to a top rate of 55% in 2011. The new law brings back the estate tax, for 2011 and 2012 anyway. During 2011 and 2012, the top rate will be 35%. For 2011, the exemption amount will be \$5 million per individual (indexed for inflation after 2011). At those levels, most

estates (all but an estimated 3,500 nationwide in 2011) will not be subject to any federal estate tax, and the tax will raise about \$11.4 billion for the government. By way of comparison the 55% tax with a \$1 million exemption would have resulted in about 43,540 taxable estates in 2011 and raised about \$34.4 billion. Tax historians would also note that except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation that actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than the price at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis". While most heirs would choose the 2011 regime (\$5 million exemption from both estate and generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the 2010 law (limited step-up in the basis of assets and no estate tax). If the executor makes the election to have the 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date.

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the \$5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a \$3.5 million lifetime exemption for estates, but only \$1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to \$5 million from the \$1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%. From a planning standpoint, a nice feature of the new law is that it makes it easier to transfer the \$5 million exemption to a surviving spouse, so married couples can shield \$10 million of their assets from taxes.

4. Other Changes for 2010 and Beyond

The following tax benefits expired at the end of 2009 and were not extended to 2010:

- The waiver of minimum required distributions (RMDs) rules for IRAs and defined contribution plans. However, the waiver for 2009 RMDs applies through April 1, 2010. For example, if you reach age 70 ½ in 2009, you are not required to receive your first distribution by April 1, 2010 due to the

special waiver for 2009. Your first required distribution must be made for 2010 by December 31, 2010.

- The exclusion from income of up to \$2,400 in unemployment compensation,
- Increased standard deduction for real estate taxes or net disaster losses, and
- Itemized deduction or increased standard deduction for state and local sales or excise taxes on the purchase of a new motor vehicle. However, if the payment was made in 2010 but the qualifying vehicle was bought after February 16, 2009 and before January 1, 2010, the deduction is available in 2010.

2010 and 2011 Standard Mileage Rates

- For 2010, per mile: 50 cents for business; 16.5 cents for moving and medical and 14 cents for charitable activities.
- For 2011, per mile: 51 cents for business; 19 cents for moving and medical and 14 cents for charitable activities.

Limit on Itemized Deductions and Personal Exemptions

The limit on itemized deductions and personal exemptions for higher income taxpayers expired in 2010 and are not set to return until after 2012.

First-Time Homebuyer Credit

With the exception of members of the armed forces and certain other federal government employees, 2010 is the final year to claim the first-time homebuyer credit. In order to claim the credit, the taxpayer must have purchased the home:

- Before May 1, 2010 or
- After April 30, 2010 and before September 1, 2010 and entered into a binding contract before May 1, 2010 to purchase the home before July 1, 2010.

Sale of Main Home

Gain from the sale or exchange of the main home is no longer excludable from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period after 2008 when neither you nor your spouse (or former spouse) used the property as a main home.

A period of nonqualified use does not include:

- Any portion of the 5 year period ending on the date of the sale or exchange that is after the last date you or your spouse use the property as a main home or
- Any period not to exceed 10 years in total during which you or your spouse is serving on a qualified official extended duty in the uniformed services or
- Any other period of temporary absence not to exceed an aggregate of 2 years due to change of employment, health conditions or other unforeseen circumstances as may be specified by the IRS.

Residential Energy Credits

In 2009 and 2010, you may be able to claim a credit of 30% of the cost of energy-efficient property or improvements you placed in service in either one of those years. This property or improvements can include high-efficiency heat pumps, air conditioners and water heaters. The credit can also include energy-efficient windows, doors, insulation materials and certain roofs. The total amount of the credit is limited to \$1,500 for 2009 and 2010.

5. Noncash Charitable Contribution Rules

The following covers the rules for the itemized deduction for donations other than money, including out-of-pocket expenses for providing services to a not-for-profit. This material does not address the special rules for donations of vehicles which will be covered in the spring 2011 newsletter.

A. Property Donations – all noncash donations must meet the following requirements to establish deductibility:

- Be supported by a donee receipt with the following information: name of donee, date and location of contribution, and a reasonably detailed description of the item. This is true unless the contribution was made in circumstances where it is impractical to get a receipt. This exception does not apply to donations over \$5,000.
- Be documented by donor records that contain the following information:
 - a. Name and address of the donee,
 - b. Date and location of the contribution,
 - c. A reasonably detailed description of the property,
 - d. The fair market value of the property and the method used to determine it,
 - e. The cost basis of the property and how acquired and
 - f. Any agreements that restrict the use or disposition of the property.

B. Noncash donations over \$500 must be supported by the attachment of a Form 8283 to the tax return which claims the deduction. All noncash donations over \$5,000 must meet all the requirements noted above plus the following:

- Be supported by a qualified appraisal as defined below and
- Have an appraisal summary attached to the tax return on which the deduction for the donation is claimed.

A qualified appraisal shall include:

- A description of the property,
- The physical condition of the property,
- The date of contribution,
- The terms of any agreements limiting the use or disposition of the property,
- Name, address and taxpayer identification number of the appraiser,
- The professional qualifications of the appraiser,
- A statement that the appraisal was done for income tax purposes,
- The date of the appraisal which should be no earlier than 60 days prior to the donation and no later than the due date of the tax return, with extensions,
- The fair market value of the donated property,
- The method of valuation and the basis used and
- The signature of the appraiser.

An appraisal summary shall include:

- Dated signature of the donee,
- Dated signature of the appraiser,
- The name and taxpayer identification number of the donor,
- A description of the property,
- How the property was acquired.
- The cost or other basis of the property,
- The name, address and taxpayer identification number of the donee,
- The date of the donation,
- Information on any consideration received by the donor or whether a bargain sale was involved,
- Name, address and taxpayer identification number of the appraiser,
- The appraiser's declaration that he understands there are IRS penalties for intentionally false or fraudulent appraisal overstatements, that the fee charged is not prohibited by IRS regulations and that his appraisal may be disregarded by the IRS.

A qualified appraiser is one who:

- Holds himself out to the public as an appraiser and performs appraisals on a regular basis,
- Is qualified to perform the specific appraisal,
- Is not the donor or the donee nor is related to or employed by either and performs most of his appraisals for persons other than those two parties, and
- Is not party to the transaction in which the donor acquired the property, with certain exceptions.

C. Tax Breaks for Volunteer Charity Work

A volunteer worker for a charity may be entitled to some tax breaks. Although no tax deduction is allowed for the value of services performed for a charitable organization, some deductions are permitted for out-of-pocket costs incurred while performing the services (subject to the deduction limit that generally applies to charitable contributions). This includes:

- Away from home travel expenses while performing services for a charity (out-of-pocket round trip travel cost, taxi fares and other costs of transportation between the airport or station and hotel, plus lodging and meals). However, these expenses are not deductible if there is a significant element of personal pleasure associated with the travel or the services for the charity involve lobbying activities.
- The cost of entertaining others on behalf of the charity such as the costs of taking a potential large contributor to dinner. The cost of the volunteer's meal and entertainment are not deductible.
- Use of a car while performing services for the charity would allow the volunteer to deduct either the actual operating expenses or a flat 14 cents per mile for the charitable use of the car. With either method, parking fees and tolls may be deducted.
- The cost of the uniform worn to perform volunteer work for the charity is deductible as is the cost of cleaning the uniform.

No charitable deduction is allowed for a contribution of \$250 or more unless it is substantiated by a written acknowledgment from the charity. The acknowledgment generally must include the amount of cash, a description of any property contributed and whether the donor got anything in return for the contribution. This presents a problem where a donation is made on behalf of rather than directly to a charity. One way around this is for the charity to pay for the expenses and then be reimbursed by the volunteer. If this is not possible then:

- The charity should be requested to provide an explanation of why the volunteer is needed at the location out-of-town, the nature of the work, and an explanation for why the payment of the expenses is needed.
- If the volunteer is out-of-pocket for large amounts, he/she should submit a statement of expenses and a copy of the receipts to the charity to acknowledge in writing the amount.
- The volunteer should maintain detailed records of the out-of-pocket expenses, plus written records of the time, place, amount and charitable purpose of the expense.

6. 2011 Tax Season Notes

As required by the IRS, the firm will be filing all of the federal income tax returns we prepare electronically beginning in 2011, with certain exceptions.

On December 23, 2010, the IRS announced that taxpayers who itemize their deductions and/or claim the higher education tuition and fees deduction or the educator expense deduction will need to wait until middle to late February, 2011 to file their returns. This is due to the IRS needing to reprogram its computers for the effects of the late adoption of the 2010 Tax Relief Act noted in 1 above.

7. S-Corporation Compensation

When computing compensation for employees and shareholders, S-corporations may run into a variety of issues. S-corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

Distributions and other payments by an S-corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for the service rendered to the corporation. The instructions to the Form 1120S, U.S. Income Tax Return for S Corporation, state “distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.”

The key to establishing reasonable compensation is to determine what the shareholder-employee did for the S-corporation. As such, we need to look at the source of the S-corporation’s gross receipts.

The three major sources are:

- Services of shareholder,
- Services of non-shareholder employees, or
- Capital and equipment.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employees personal services and not be allocated to compensation. On the other hand, if most of the gross receipts and profits are associated with the shareholders personal services, then most of the profit distribution should be allocated as compensation. The shareholder-employee should also be compensated for administrative work done.

Health and accident insurance premiums paid on behalf of the greater than 2 percent shareholder-employee are deductible and reportable by the S-corporation as wages for income tax withholding purposes on the shareholder-employee's Form W-2. These benefits are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. The additional compensation is included in box 1 (Wages) of the Form W-2 issued to the shareholder-employee but would not be included in boxes 3 and 5 of the Form W-2.

A 2-percent shareholder-employee is eligible for an Adjusted Gross Income (AGI) deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S-corporation and the shareholder meets the other self-employed medical insurance deduction requirements. If, however, the shareholder or the shareholder's spouse is eligible to participate in any subsidized health care plan then the shareholder is not entitled to the AGI deduction.

The result of these rules is that the shareholder-employee must have compensation (earned income) other than just the corporation paid health insurance premiums to claim the AGI deduction. As the instructions to the Form 1040, line 29 state: "if you are a more than 2% shareholder in the S corporation under which the insurance plan is established, earned income is your Medicare wages (box 5, Form W-2) from that corporation."

8. High Risk Health Insurance Pool

One of the elements of the Obama health care reform that is now in effect is the High Risk Health Insurance Pool. Subsidized by \$5 billion of federal money, this plan is available in Florida and other states. Since the pool became available on July 1, 2010, very few of the thousands of eligible persons in Florida have joined. To qualify for coverage:

- You must be a citizen or national of the US and be lawfully present,
- You must have been uninsured for at least the last six months and
- You must have a pre-existing condition or have been denied coverage because of your health condition.

Coverage is very broad and the premiums are fairly reasonable. Application is done on line. Start at www.healthinsurance.org and look up High Risk Insurance Pools.

9. Condominium Association FHA Re-certifications

Condominium owners in Florida and else where may have their ability to sell or re-finance jeopardized due to a federal government deadline. Thousand of condominium associations nationwide face a March, 2011 deadline for re-certification in order for their units to be acceptable for guaranteed mortgages from the FHA on sales and refinancings. If you are affected by this deadline you should contact your homeowners association immediately. Re-certification applications can be completed in as few as 5 days according to industry experts but may require up to 60 days to be processed at FHA.

10. Transfers of S-Corporation Stock

When S-corporation stock is sold, the buyer usually asks the seller to make a joint IRC Sec. 338(h) (10) election. If the corporation has been an S-Corporation since inception and has not acquired any assets from any C corporations in any tax-free transactions, the effect of that election is described below.

This election causes the sale of the stock to be treated as if the S-Corporation sold all its assets while owned by seller and then distributed the proceeds in liquidation to the seller. The buyer wants this election since the deemed sale will cause the corporation to increase the tax basis of its assets. The deemed sale will result in gain being recognized by the corporation and passed through to the seller. The gain will increase the seller's stock basis and the seller will be treated as receiving the sale proceeds in liquidation of the S-Corporation. The election will not typically increase the seller's gain on the sale but it may cause part of the gain to be ordinary rather than capital. This is not to the seller's advantage but the buyer may be willing to pay more for the stock in consideration for the buyer joining in the election.

Also, the buyer and seller should consider at the time the stock price is set the effects of other available elections such as under IRC Sec. 1377 (a) (2) and Regs. Sec. 1.1368-1(g). These elections relate to the close of the tax year and the allocation of income and expense between the buyer and the seller for the year of sale.