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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Business Property Expenditures

Many businesses continually make expenditures to improve and maintain business property. However, it is not always clear whether the amount incurred to repair or refurbish that business property is a capital expense or an incidental repair. Proper classification is critical because, for federal tax purposes, capital expenditures (see below) must be added to the property's tax basis and recovered (expensed) through depreciation over a period of years. If the property is not subject to depreciation, capitalized costs are only recovered when the property is sold. Incidental repairs are not considered capital expenditures and can be deducted as incurred, providing a more immediate tax benefit.

Capital expenditures include (1) costs of permanent improvements or betterments to increase the value of the property or (2) amounts expended in restoring property. In addition, capital expenditures include amounts paid or incurred to add value to or prolong the useful life of property or adapt property to a new or different use. Capital expenditures also include the cost of title defense or perfection, architects' fees, and purchase commissions.

Incidental repairs are deductible currently as ordinary and necessary business expenses. These costs do not materially add to the value of property or appreciably prolong its life. Rather, they keep the property in an ordinarily efficient operating condition.

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Costs of acquiring property generally are capitalized as part of the property's basis. However, expenses for repairs immediately after the property is acquired might be either capitalized or deducted. These repairs can be deducted if the expense would ordinarily qualify for deduction as a repair. If, however, the repairs are required as a condition of the purchase, their cost is capitalized.

It is often difficult to determine the proper classification for capital and repair expenditures. So, please contact us concerning capital expenditure classification matters or any other tax compliance or planning issue.

Tax Calendar

January 17—Individual taxpayers' final 2010 estimated tax payment is due unless Form 1040 is filed by January 31, 2011, and any tax due is paid with the return.

January 31—Most employers must file Form 941 (Employer's Quarterly Federal Tax Return) to report Medicare, social security, and income taxes withheld in the fourth quarter of 2010. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return. Employers who have an estimated annual employment tax liability of $1,000 or less may be eligible to file Form 944 (Employer's Annual Federal Tax Return).

—Give your employees their copies of Form W-2 for 2010. If an employee agreed to receive Form W-2 electronically, have it posted on the website and notify the employee.

—Generally, give annual information statements to recipients of certain payments you made during 2010. You can use the appropriate version of Form 1099 or other information return.

—File Form 945 (Annual Return of Withheld Federal Income Tax) for 2010 to report income tax withheld on all nonpayroll items, including backup withholding and withholding on pensions, annuities, IRAs, etc. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the year in full and on time, you have until February 10 to file the return.

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 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.

College Financial Aid Changes for 2011–2012

The Department of Education recently announced numerous adjustments to the Federal Need Analysis Formula. This is the calculation that takes information from the Free Application for Federal Student Aid (FAFSA) and determines the expected family contribution (EFC). The EFC is the amount each college uses to award federal need-based financial aid.

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For 2011–2012, the Income Protection Allowance for a dependent student has jumped from $4,500 (for 2010–2011) to $5,250 (for 2011–2012). This is the amount of income a dependent student may earn in the 2010 calendar year before excess income impacts the EFC. Parents of a dependent student are also permitted an Income Protection Allowance based on the family size and the number of dependents in college.

Certain students qualify for a zero EFC, meaning their families are not expected to contribute anything toward the cost of higher education, and thus they are eligible for more financial aid. For the 2011–2012 award year, the income threshold to be eligible for a zero EFC is $31,000, up from $30,000 in 2010–2011.

Sole Proprietors Can Benefit from Employing a Spouse

Many sole proprietors benefit from family members assisting with their business, especially in the start-up phase. While these services are often uncompensated, tax-saving opportunities are available if a formal compensation arrangement is created. However, for wages paid to a spouse to provide tax advantages, the overall compensation arrangement for a spouse must be reasonable. When measuring reasonable compensation, both direct wages and nontaxable fringe benefits must be considered.

As a self-employed individual, a proprietor can deduct annual health insurance premiums for income tax purposes. However, a self-employment tax benefit is also available. By creating a formal employee relationship with a spouse and paying the medical insurance premiums and other medical costs of the spouse (and family members, including the proprietor) as a tax-free fringe benefit, 100% of the cost is deductible for both income and self-employment tax purposes.

Generally, it is not economically beneficial to employ a spouse and incur the annual FICA costs associated with compensation solely for the purpose of enhancing his or her social security retirement benefits. Not only is the rate of return on social security contributions relatively low, but a nonworking spouse automatically will receive a retirement benefit equal to 50% of the higher earning spouse's retirement benefits. However, social security does add disability benefits, as well as monthly survivor benefits for the pre-age 18 children of a deceased worker. For these two reasons, it may be economical to provide a small salary subject to FICA from a family proprietorship for a spouse who is otherwise not employed outside of the home if there are young dependent children in the family.

In some cases, a spousal salary may enhance the ability to fund a contribution to a qualified retirement plan. For example, a proprietor who provides a Savings Incentive Match Plan (SIMPLE) for all employees may only have one voluntary reduction contribution for the year (plus, of course, the employer matching contribution). However, if that proprietor pays a spouse sufficient annual compensation, a second SIMPLE contribution can occur. While this strategy works well with a SIMPLE because of its low maximum, it is not as effective for many other qualified retirement plan arrangements, such as defined-contribution plans.

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Keep in mind that the ability to make an IRA contribution is not a motive for employing a spouse within a sole proprietorship, unless the salary is used to create the only earned income. This is because a nonearning spouse can make an IRA contribution if the other spouse has sufficient *earned income*.

These are some of the opportunities available when employing a spouse in a sole proprietorship. Employing a child in a sole proprietorship can also be an effective method in reducing the overall family tax burden. However, each situation is unique, so please contact us to discuss the tax-advantaged opportunities available to owners of sole proprietorships or any other tax planning or compliance issue.

Retirement Plan Review

Your retirement plan savings (that is, qualified plans and IRAs) are important to your financial well-being for several reasons.

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Right now, you can accumulate income without currently paying tax, and the power of compounding pretax dollars makes a retirement plan one of the most powerful investment vehicles available. When you reach retirement age, the assets in your retirement plan(s) may be a significant portion of your overall savings. Therefore, it is important that you do everything you can to get the most out of one of the best investment opportunities you have. So, listed below is information to consider when conducting a review of your retirement plans.

Generally, when you begin to withdraw funds from your retirement plans, you will be subject to tax on the distributions. If you made after-tax contributions to your plan, a portion of each distribution will be tax-free. Also, special rules apply to Roth IRAs. If distributions begin prematurely (before age 59½) you may be hit with a 10% penalty tax, but exceptions are available.

When you reach age 70½ (or in some cases, retire) you must start withdrawing a minimum amount from your traditional IRAs and qualified plans each year. Severe penalties can result if required minimum distributions are not made on a timely basis. However, distributions from Roth IRAs are not required during your lifetime.

At the time of your death, the beneficiary designation in effect at the date of death will determine not only who gets the retirement plan assets, but also how quickly your account must be paid out to your beneficiary (and, therefore, how quickly the benefits of tax deferral are lost). So, beneficiary designation adjustments may be necessary as family and beneficiary conditions change (e.g., divorce).

Your retirement plan savings may be critical for you and your dependents' future well-being. With proper planning, you can maximize tax-deferred earnings, avoid penalty taxes, choose a desired beneficiary, and minimize the amount your heirs are required to withdraw (and pay taxes on) after your death.

Please contact us to assist with your retirement plan checkup and ensure you are doing everything you can to get the most out of your retirement savings.

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