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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

August 2012

One-person 401(k) Plans

One-person 401(k) plans provide a valuable source of retirement savings for successful entrepreneurs. Given the right circumstances, such plans allow large contributions on behalf of a business owner and maintain flexibility for making contributions in future years.

For 2012, a business owner can make an elective deferral contribution of up to $17,000 (add an additional $5,500 catch-up contribution if he or she is age 50 or older at year-end) plus an employer contribution of up to 20% of self-employment (SE) income or 25% of compensation. In calculating the allowable employer contribution, the owner's SE income or compensation is not reduced by the owner's elective deferral contribution.

The total contributions (elective deferrals of up to $17,000, plus the employer contribution) cannot exceed the lesser of 100% of the participant's compensation or $50,000 for 2012. Catch-up contributions to 401(k) plans of up to $5,500 in 2012 are not included in the annual additions limit.

Example: Maximizing contributions with a one-person 401(k) plan.

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Kevin, age 63, is the sole owner and employee of Training Solutions, a sole proprietorship. Training Solutions is the sole source of his earned income. Kevin earns $145,000 (net of the SE tax deduction) in the current year and wishes to maximize contributions to a retirement account. He believes the business will probably continue to be profitable, but would like the flexibility of determining on a year-to-year basis how much to contribute. Kevin does not expect to hire employees and will remain a one-person company.

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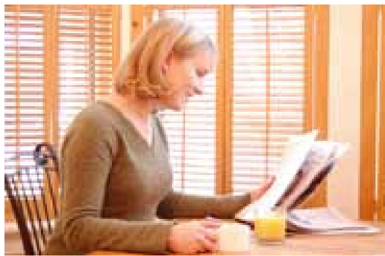
The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

IRS Limits Employer Identification Number Requests

The IRS is now only issuing one employer identification number (EIN) per responsible party each day. Previously, it would issue up to five EINs per day. The new limit applies to all requests for an EIN whether online, or by phone, fax, or mail. The IRS says that the new policy was implemented to ensure fair and equitable access to all applicants with legitimate tax administration-related needs. It will also ensure that the EIN system continues to operate effectively. Employers may apply for an EIN online at **https://sa1.www4.irs.gov/modiein/individual/index.jsp.**

Social Security Statements

The Social Security Administration (SSA) recently announced that Social Security statements may now be viewed online at **www.ssa.gov/mystatement.** The statements provide workers with an estimate of benefits under current law and an earnings record with Social Security and Medicare for taxes paid over their working career. A printable version of the Social Security statement is available. To get an online statement, a person must be 18 or older and able to provide information that matches their SSA file. After verification, an account is created with a unique user name and password to access the online statement.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Boomer Alert: Approximately 3 million baby boomers are turning 65 each year. According to the Social Security Administration, social security was the major source of income for most beneficiaries.

One-person 401(k) Plans

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The following table reflects the maximum amount that Kevin can contribute to a 401(k) plan for 2012.

25% (20% for self-employed individuals) profit-sharing contribution ($145,000 × 20%)	$29,000
Elective 401(k) deferrals	17,000
Contributions subject to annual addition limit	46,000
Catch-up contribution	5,500
Total contributions for 2012	$51,500

As an additional benefit, a business owner can borrow from his or her 401(k) plan if the plan document so permits. The maximum loan amount is 50% of the account balance or $50,000, whichever is less.

When the business employs someone other than just the owner, 401(k) contributions may be required for the other employees, in which case the plan would become a standard 401(k) plan with all the resulting complications. However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period. Because this exclusion rule allows the business owner to avoid covering young and part-time employees, the plan may still qualify as a simple and easy one-person 401(k) arrangement.

Also, if the business's only other employees are the owner's spouse and/or children, a 401(k) plan covering those individuals may be even more attractive than a one-person 401(k) plan, especially for owners hitting the $50,000 contribution limit.

New Tax Rule for Local Lodging Expenses

The IRS recently issued long-awaited regulations that permit certain not-away-from-home lodging expenses to be deducted by workers if they are not reimbursed by their employer. Alternatively, if paid for by the employer, the expense can be treated as a tax-free working condition fringe benefit (WCFB) or tax-free accountable-plan reimbursement.

Thanks to prior IRS guidance, the value of an employer-provided WCFB is excluded from the recipient employee's gross income for federal income and employment tax purposes. A WCFB is defined as any property or service provided to an employee to the extent that, if the employee paid for the property or service, it would be deductible by the employee as an unreimbursed employee business expense. Employer-paid lodging for an employee who is out of town on the employer's business counts as a tax-free WCFB.

Prior regulations provide that the cost of an individual's lodging that is not incurred while traveling away from home on business is generally a personal expense and is therefore generally not deductible by the individual. An individual is not considered away from home unless he or she is away from home overnight, or at least long enough to require rest or sleep.

The new regulations stipulate that an individual's local lodging expenses can be deducted by the individual as business expenses if the applicable facts and circumstances dictate that such treatment is appropriate. In turn, expenses that would qualify for deductions if paid for by an employee will qualify as a tax-free WCFB if paid by the employer, or if advanced or reimbursed by the employer under an accountable plan. However, local lodging expenses will not qualify for the aforementioned tax-favored treatment if the lodging is lavish or extravagant, or if it is primarily to provide the individual with a social or personal benefit.

Safe Harbor Rule. Under the new regulations, local lodging expenses are automatically treated as ordinary and necessary business expenses if all of the following conditions are met: (1) the lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other business function; (2) the lodging is for a period that does not exceed five calendar days and does not occur more frequently than once per calendar quarter; (3) in the case of an employee, the employer requires the employee to remain at the activity or function overnight; and (4) the lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

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Example: Tax-favored treatment allowed for employees.

Distant Corporation puts on periodic employee training sessions at a hotel near its main office. Distant requires all attending employees, including employees from the local area, to remain at the hotel overnight for the bona fide business purpose of maximizing the effectiveness of the training sessions.

If Distant directly pays the lodging costs for attending employees, the costs qualify as tax-free WCFBs for the attending employees, including those who live in the local area, and Distant can deduct the costs as business expenses. If Distant reimburses attending employees for the lodging costs under an accountable plan, the reimbursements are tax-free to the employees, including those who live in the local area, and Distant can deduct the reimbursements as business expenses.

Please contact us if you have questions concerning business travel expenses or any other tax compliance or planning issue.

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Age-55 Qualified Retirement Plan Exception

The taxable portion of a pre-age 59½ withdrawal taken from a qualified retirement plan or traditional IRA can be hit with a 10% early withdrawal penalty unless one of several exceptions applies. However, the list of exceptions is not identical for qualified plans and IRAs. For example, one exception for qualified plans is available if you are age 55 or older and have separated from service with respect to the sponsoring employer. This age-55 exception is not allowed for early IRA withdrawals.

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This age-55 exception is available if both of the following conditions are met:

1. The withdrawal is made after the employee has separated from service with respect to the employer that maintains the qualified plan in question.

2. The separation occurs during or after the calendar year in which the employee attains age 55.

The Seventh Circuit Court recently confirmed that a taxpayer who could have withdrawn funds penalty-free from his former employer's qualified retirement plan under the age-55 exception was hit with the 10% early withdrawal penalty when he rolled over his retirement plan money into an IRA and then took an early withdrawal. The taxpayer argued that the differing lists of penalty exceptions for qualified plans and IRAs were illogical. Not so, said the Court. The tax law says what it says, even though it may not necessarily be logical.

Even worse, the Court also concluded that the taxpayer's failure to pay the early withdrawal penalty triggered the 20% accuracy-related penalty. Taken together, the 10% early withdrawal penalty and the 20% accuracy-related penalty cost the taxpayer over $24,000. The penalties could have been completely avoided with a little advance planning.

In this specific situation, if a taxpayer separates from service in or after the year he or she turns age 55 and is not yet age 59½, he or she should not roll over funds they will soon need into an IRA. Instead, withdraw the needed funds penalty-free from the employer plan and roll over the balance into an IRA. Once funds are in the IRA, the taxable portion of any withdrawals taken from the IRA before age 59½ will be hit with the 10% early withdrawal penalty unless one of several exceptions for early IRA withdrawals applies.

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