

# Ideas for Your Success

Fourth Quarter 2010

## Preparing for the unexpected

### Year end tax planning in an uncertain environment requires flexibility

Year end tax planning likely has never been more complicated or more necessary. Why? Some tax breaks enacted this year are only temporary, while others have expired but could still be extended. Plus, many tax rates are scheduled to increase in 2011 unless Congress takes action. (See “Individual income tax rates” at right.) With all of this uncertainty, flexibility will be an essential part of your tax plan.

#### Higher tax rates?

Begin your planning by working with your tax advisor to project your income, deductible expenses and tax liabilities for 2010 and 2011 — and beyond, if possible. You may have opportunities to shift income and expenses between tax years to minimize your overall tax burden, or at least to defer taxes.

The right strategy depends in large part on your projected marginal tax rate for each year. As a general rule, you should shift income, if possible, into a year when your marginal rate is lower, because it will save taxes. And, in most cases, deductions are more valuable when your marginal rate is higher, so shifting deductible expenses into a high-rate year often makes



Individual income tax rates	
2010	2011 <sup>1</sup>
10%	15%
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%

<sup>1</sup> If Congress doesn't act.

sense. With tax rates scheduled to rise, you may want to accelerate income into 2010 and defer expenses to 2011.

There are many ways to shift income and expenses between tax years. If you're a business owner or self-employed — and a cash basis taxpayer — you can defer income by waiting to bill for your products or services until after Dec. 31. If you're a homeowner, you can accelerate deductions by paying 2010 property taxes due in early 2011 before Jan. 1.

#### Disappearing and reappearing income limits

There are additional factors to consider, so consult with your tax advisor before shifting income or expenses. For example, income and expense shifting could cause you to become subject to the reduction that sometimes applies to itemized deductions (except medical expenses, casualty and theft losses, gambling losses and miscellaneous itemized deductions) once income reaches a certain level.

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## Are your independent contractors properly classified?

Employers have been taking whatever steps necessary to cut costs in the midst of the struggling economy — including making staff reductions. To compensate for the diminished workforce, some companies are replacing laid-off workers with independent contractors (ICs).

The advantages of using an IC over an employee are that employers don't have to withhold income and payroll taxes; make Social Security, Medicare and unemployment insurance contributions; pay overtime; or provide employee benefits. The disadvantage is an increased risk of IRS scrutiny as the agency continues to crack down on businesses that misclassify employees as ICs. Thus, it's critical to ensure that your IC classifications pass muster with the IRS.

### Classifying ICs properly

To properly classify ICs, begin by reviewing your relationships with workers who receive Form 1099. Consider that, when the IRS assesses worker classifications, it looks at the level of behavioral control.

This means the extent to which the company instructs a worker on when and where to do the work, as well as what tools or equipment to use. If the business has considerable control over these areas, the worker will likely be categorized as an employee; if the level of control is minimal or nonexistent, the worker is more likely to be an IC.

The level of financial control is also important. ICs are more likely to invest in their own equipment or facilities, incur unreimbursed business expenses, and market their services to other clients.

Finally, consider the relationship of the parties. ICs are often engaged for a discrete project, for example, while employees are typically hired permanently (or at least for an indefinite period).

### Learning the risks of misclassification

Generally, the biggest risk in worker misclassification is liability for unpaid federal and state income tax withholding; unpaid Social Security, Medicare and unemployment insurance contributions; and penalties and interest. As an employer, you can be held liable for both the company's share and the employee's share. And if you don't have the money, the government may attempt to collect from "responsible persons." They may include certain owners, partners, officers, directors, limited liability company (LLC) members and key employees (such as bookkeepers).

There's a popular misconception that, as an employer, you'll avoid liability so long as you've filed Form 1099 and the worker has paid all taxes due. But when the IRS concludes that a worker should have been treated as an employee, you can get hit with a 20% penalty (among other consequences) even if all the taxes have been paid.

### Minimizing IRS exposure

Once you've completed your review, there are several strategies you can use to minimize your exposure. When in doubt, reclassify questionable ICs as employees. This may increase your tax and benefit costs, but it will eliminate reclassification risk. Alternatively, consider modifying your relationships with ICs to help ensure they're considered ICs. For example, you might exercise less behavioral control by reducing your level of supervision or allowing workers to set their own hours or work from home.

### Substantiating your ICs' status

Using ICs can be a good way to reduce costs, but if you don't take the time to ensure they're properly classified, the IRS could levy costly penalties. If the IRS does question your ICs' classification, accurate records of all work performed by and money paid to them can help you substantiate their status.

## Time is running out!

### Hire before Jan. 1 to enjoy HIRE Act tax incentives

If your company plans to hire new employees, consider doing so before year end. Why? Because two valuable tax breaks included in the Hiring Incentives to Restore Employment (HIRE) Act apply only to hires made by Dec. 31, 2010:

- 1. Payroll tax breaks.** Qualified employers are exempt from having to pay the 6.2% Social Security portion of Federal Insurance Contributions Act (FICA) taxes on certain new hires through year end. To qualify, you must hire the employee after Feb. 3, 2010, and before Jan. 1, 2011. In addition, the new hire must have been unemployed — defined as not having worked more than 40 hours — for the 60-day period ending on his or her start date.

- 2. Qualified employee retention credit.** This credit is an incentive to keep workers who qualify for payroll tax forgiveness on your payroll for at least 52 consecutive weeks. The tax savings per qualified retained worker are equal to the lesser of 6.2% of the wages paid to the worker during the 52-week retention period or \$1,000. But, during the last 26 weeks of the 52-week period, you must pay the retained worker wages equal to at least 80% of what you paid him or her during the first 26 weeks. Bear in mind that, because of the credit's 52-week requirement, you generally won't benefit from it until you file your 2011 tax return.

## The battle to curb employee theft

No one said operating your own business would be easy, but like many companies suffering through difficult economic times, you may be fighting to keep the business afloat. While your focus is on your clients and your bottom line, you may be facing an internal threat as well: Your employees may be stealing from you.

Most employees who commit fraud aren't your typical criminals. In fact, they often are trusted employees, who commit fraud because they've gotten into financial trouble (especially true in tough economic times) or they see a window of opportunity and the temptation is too hard to resist. Or they may simply be motivated by a desire to live a more extravagant lifestyle.

Curtailing employee theft isn't easy, but it's wise to pay attention to vulnerable areas of your company — primarily where cash is being handled. These areas include accounts payable and accounts receivable. For the former, employees may forge checks to themselves,

accept kickbacks from vendors, pay personal bills with company funds, or create and pay bills to fictitious suppliers. For the latter, workers may grant fake credits, take fraudulent write-offs for bad debts, divert cash receipts or alter bank deposits.



Noncash areas of the company are also worth watching, especially inventory and fixed-asset management. Workers might steal company assets; divert and sell shipments; or use job materials, tools or other assets for non-job-related purposes.

Payroll is another red flag area to focus on. Workers might pay nonexistent employees, pad time records, falsify salaries or commit withholding fraud.

## A wrench in your estate plan

### How you hold title to your assets can have unexpected consequences

When you create your estate plan, you expect that your assets will be passed to your family according to your wishes. However, the manner in which you own your assets, or “hold title” to them, can alter who receives them and potentially increase tax liability. Let's review two options for holding title to assets.

#### 1. Joint tenancy with the right of survivorship

Among the simplest ways to hold title to assets is “joint tenancy with the right of survivorship.” Here the owner of an asset legally agrees to co-own the asset with another party, typically his or her spouse, with ownership ceding to the surviving owner upon the other's death.

On the plus side, this is a relatively easy way to hold title to an asset such as a house. And if you have a clear-cut, amicable relationship with the co-owner, joint tenancy with right of survivorship can simplify the process of passing an asset to the survivor — you won't even need a will to do so.

But there are many dangers to it as well. Jointly held property will override the provisions of a will or trust, and may thwart the plans intended by those documents.

#### 2. A trust

A more complex but often more effective option for holding title to your assets is a trust. Let's take life insurance, for example. These policies can become quite valuable in terms

of cash proceeds. Although the proceeds are income-tax free for beneficiaries, the proceeds will be included in your estate if you owned the policy.

To keep life insurance out of your estate, you can create an irrevocable life insurance trust (ILIT) to own the policy. You name the beneficiaries and the terms along with a trustee, after which you can begin making cash deposits into the trust.

The dollars you put into the trust, which essentially cover the policy's premiums, are usually considered taxable gifts, so you may have to file a gift tax return.

But, depending on how you structure the trust, you may be able to minimize or even eliminate gift taxes by using the annual gift tax exclusion.

Remember, though, that the ILIT must wholly own the policy. You can't, for example, retain the right to change beneficiaries or borrow personally against the policy's cash value.

#### The right solution for you

Knowing that your assets will be distributed according to your wishes is a prime reason to create an estate plan, but it's also important to consider how you're holding title to your assets during your life. The two options mentioned here may be right for you, but before taking action, consult your estate planning advisor.



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For 2010, the income-based limits on itemized deductions have been eliminated. But for 2011, the limits are scheduled to return in full force.

As you weigh your income- and expense-shifting options, also factor in the time value of money — the principle that a dollar you receive today is worth more than a dollar you receive later. The tax savings may not be worth the lost earnings on the income you're deferring or the money you're spending.

#### Prepare for any scenario

The situation surrounding certain tax laws is fluid and depends greatly on congressional action. This makes year end tax planning essential — and difficult. Consider working with your tax advisor to create a plan that includes multiple scenarios so you're prepared for any tax law changes.

### Will you become ensnared in the AMT this year?

Throwing an added degree of difficulty into your tax planning is the fact that, unless Congress takes action, the alternative minimum tax (AMT) exemptions will be significantly lower this year. As a result, many more taxpayers may be subject to the AMT.

Because of the AMT uncertainty, it's important for you and your tax advisor to determine whether you could be subject to the AMT before timing income and expenses. Indeed, many deductions used to calculate regular tax aren't allowed under the AMT and can trigger AMT liability.