



PPC's Practitioners Tax ***ACTION*** Bulletins®

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Five-Minute Tax Briefing®

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Five-Minute Tax Briefing Editors

No. 2010-10
May 18, 2010

Highlights

Collection against Sole Owner of LLC: The Tax Court sustained the IRS's efforts to collect employment taxes owed by taxpayer's single member Limited Liability Company (LLC) from taxpayer rather than from the LLC. Although the IRS assessed the tax liability against the LLC under its Employer Identification Number (EIN) rather than under taxpayer's Social Security Number (SSN), the court noted that an individual who is an employer is instructed to apply for and use an EIN for use in the employment context. Taxpayer "put the LLC's EIN on the returns, thereby inducing the IRS to record the employment tax assessments under that number. She could not, by that act, frustrate the principle that a disregarded entity's employment tax liability is the liability of the LLC's sole member Consequently, when the IRS assessed the employment taxes under the LLC's EIN, [taxpayer] became liable." *Medical Practice Solutions LLC*, TC Memo 2010-98 (Tax Ct.).

Dependent Health Coverage of Children: Temporary regulations under new IRC Sec. 9815 (see TD 9482), issued in conjunction with regulations issued by the Depts. of Labor and Health And Human Services, implement provisions of the Patient Protection and Affordable Care Act governing dependent coverage of children. According to Temp. Reg. 54.9815-2714T, for tax years beginning after 9/22/10, a group health plan or issuer offering dependent coverage of children must make the coverage available until the attainment of age 26. For children who have not attained age 26, a plan or issuer cannot define eligibility for dependent coverage of children other than in terms of a relationship between a child and the participant. Thus, a plan or issuer cannot deny or restrict coverage for a child who has not attained age 26 based upon the child's financial dependency, residency with the participant or any other person, student status, and/or employment. The temporary regulation provides transitional relief to children whose coverage ended or was denied before the attainment of age 26 (which, under these provisions, is no longer permissible). They must be given an opportunity to enroll for a minimum 30-day period no later than the first day of the first plan year or policy year beginning on or after 9/23/10.

NOL Carryback and PAL Rules: According to IRC Sec. 469(e)(2), the passive losses of a closely-held C corporation can offset passive activity income and active business income, but cannot offset portfolio income. The taxpayer in this letter ruling was a closely-held C corporation for the first three years of its existence and earned portfolio income. Taxpayer generated a Net Operating Loss (NOL) in Year 4. Due to an ownership change in Year 4, taxpayer ceased to be closely held (i.e., was no longer owned by five or fewer individuals holding more than 50% in value either directly or indirectly). Nevertheless, IRC Sec. 469 did not prevent taxpayer from carrying back the NOL from a year when it was not a closely-held C corporation to offset portfolio income earned in years when it was closely held. Ltr. Rul. 201017007.

Small Business Healthcare Tax Credit: The Patient Protection and Affordable Care Act authorized a new tax credit (IRC Sec. 45R) to encourage small businesses employing low and moderate income workers to offer health insurance coverage. For tax years beginning in 2010, the credit generally equals 35% (25% for tax-exempt employers) of the lesser of the (1) employer's contributions during the tax year to a health arrangement to purchase qualifying health coverage, or (2) contributions the employer would have made during the tax year if each employee had enrolled in a plan with a premium equal to the average premium for the small group market in the state where the employer is offering coverage. The IRS has published the average premiums for the small group market in each state for the 2010 tax year. [**Editor's Note:** For more on the credit, see TAM-1417 in this issue.] Rev. Rul. 2010-13, 2010-21 IRB.

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Other Current Releases

Income Tax—Biological Parent as Foster Care Provider: IRC Sec. 131(a) authorizes an exclusion from gross income for amounts received by a foster care provider as qualified foster care payments. In program manager technical assistance, the IRS concluded that a biological parent who receives payments (from an unnamed payer) for the care of a disabled child cannot qualify as a *foster care provider* for Section 131 purposes. According to Black's Law Dictionary 727 (9th ed. 2009)], to *foster* is to give parental care to a child who is not one's natural or legally adopted child. More on point, in *Dorothy Bannon* [99 TC 59 (1992)], the Tax Court held that payments to the mother of an adult disabled daughter for providing in-home supportive services were taxable income. PMTA 2010-007.

Income Tax—Dependency Exemption Deduction: The Tax Court held that taxpayer could not claim dependency exemption deductions and the child tax credit for his sons from a former marriage. Under IRC Sec. 152(e)(2), taxpayer (as the noncustodial parent) could claim the dependent exemption if the custodial parent (his ex-wife) signed Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents) and taxpayer attached the form to his tax return. Although the Tax Court was "sympathetic to [taxpayer's] difficulties in acquiring a signed Form 8332, especially during those years when the children's whereabouts were unknown, the statutory language clearly controls this case Neither [his] faithful payments of child support nor [his ex-wife's] failure to comply with her divorce decree and state law is sufficient to release the deduction." Because taxpayer failed to satisfy the dependency exemption requirements under IRC Sec. 152(e)(2), he was ineligible for the child tax credit authorized by IRC Sec. 24(a). *Leslie Himes*, TC Memo 2010-97 (Tax Ct.).

Income Tax—Medical Expense Deduction for Blood Banking: According to an IRS information letter, courts have interpreted the phrase "cure, mitigation, and treatment" in IRC Sec. 213(d) as actions that address an existing or imminently probable disease, physical or mental defect, or illness. Thus, expenses for banking umbilical cord blood to treat an existing or imminently probable disease may qualify as deductible medical expenses. Conversely, banking cord blood as a precaution to treat a disease that might possibly develop in the future does not satisfy the standard that a disease must be imminently probable. [Editor's Note: The end of the letter cites proposed legislation that would allow a medical expense deduction for the costs of such blood banking services.] INFO 2010-0017.

Income Tax—Production Credits: The IRS published the inflation adjustment factors and reference prices for the 2010 renewable electricity production credit, the refined coal production credit, and the Indian coal production credit under IRC Sec. 45. These numbers apply to 2010 sales of (1) kilowatt-hours of electricity produced in the U.S. or a possession thereof from qualified energy resources, and (2) refined coal and Indian coal produced in the U.S. or a possession thereof. Notice 2010-37, 2010-18 IRB 654.

Income Tax—S Corporation Built-in Gains Tax: The maximum built-in gain an S corporation must recognize under IRC Sec. 1374(d)(1) is the excess of the aggregate FMV over the aggregate

adjusted basis of all assets on hand as of the first day the S election is effective. In this case, taxpayer sold a 25% partnership interest that it valued on the 1/1/00 S election date at \$2,600,000, the amount determined by its CPA's 2/00 valuation report. The IRS countered that the interest's value was the \$5,220,423 sales price of the interest on 11/27/00. In reaching a \$3,727,141 value [based on an equal weighting of a business enterprise analysis (\$2,718,000), a distribution yield analysis (\$3,243,000), and the sale price (\$5,220,423)], the Tax Court reduced the sales price to reflect the likelihood that the buyer viewed the partnership interest as a strategic acquisition and was willing to pay a premium to avoid an exercise of first refusal rights by the other partners. *Ringgold Telephone Company*, TC Memo 2010-103 (Tax Ct.).

IRS Offers Discount for Tax Forum Early Registration: The IRS urges tax practitioners to make their reservations soon for one of six tax forums to be held this summer. The forums last three days and offer the opportunity to receive up to 18 continuing education credits through a variety of seminars and workshops. The cost for those who preregister is \$206 per person, a savings of \$129 off the late or on-site registration price of \$335. Pre-registration ends two weeks prior to the start of each forum, as follows: Atlanta: 6/8 deadline for 6/22–6/24 forum; Chicago: 6/29 deadline for 7/13–7/15 forum; Orlando: 7/13 deadline for 7/27–7/29 forum; New York City: 7/27 deadline for 8/10–8/12 forum; Las Vegas: 8/10 deadline for 8/24–8/26 forum; and San Diego: 8/17 deadline for 8/31–9/2 forum. For more information, or to register online, visit www.irstaxforum.com. News Release IR-2010-60.

IRS Oversight Board Releases 2009 Report: On 5/12/10, the IRS Oversight Board released its 2009 report to Congress, which evaluates the IRS's performance during the past year and its ability to meet strategic goals in the future (see www.treas.gov/irsob/board-reports.shtml). While enforcement activity was generally stable compared to 2008, more audits of individuals were conducted in 2009 for taxpayers with income over \$1 million, where audits increased by 29%. Audits of corporations with assets over \$10 million increased slightly, but because more corporate tax returns were filed, the coverage rate for all corporations decreased by almost 1%. The report also focuses on the Customer Account Data Engine program, which would provide for 140 million individual account records to be stored in a modern database with the capability to update account information on a daily basis. The plan is to implement key components of this program by 2012 resulting in efficiency and taxpayer service gains.

Penalties—Accuracy-related Penalty on Underpayments: This program manager technical assistance looks at whether the accuracy-related penalty of IRC Sec. 6662 applies to a tax year when the taxpayer claims a first-time homebuyer credit (FTHBC) or earned income credit (EIC) to which he or she is not entitled. It discusses the computation of the “underpayment” for penalty purposes, and notes that the annual revenue procedure describing when proper completion of the required tax form is treated as adequate disclosure [currently Rev. Proc. 2010-15 (2010-7 IRB 404)] does not mention the FTHBC, EIC, or other tax credits that can be claimed on a Form 1040. Therefore, disclosure of these items is adequate only if the taxpayer attaches a properly completed Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement). PMTA 2010-001.

Penalties—Married Couple's Joint and Several Liability: Under IRC Sec. 6676, a 20% penalty applies to the excessive amount of a claim for credit or refund. In program manager technical assistance, the IRS concluded that married couples who file a joint claim for refund or credit have joint and several liability for any Section 6676 penalty arising from the claim. Because liability is joint and several, a spouse will not qualify for the reasonable basis exception if the other spouse does not. Whether a claim has a reasonable basis is not dependent on the subjective state of mind of the taxpayer presenting the claim or the actions of the taxpayer in determining the appropriateness of the claim. The statute requires an examination of the claim itself to determine whether it has a reasonable basis. PMTA 2010-003.

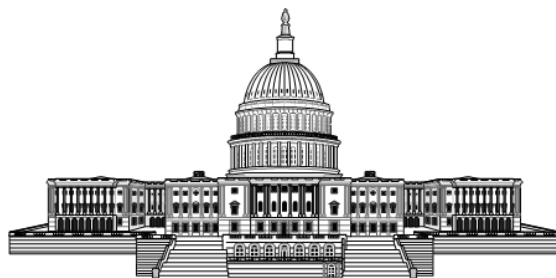
Penalties—TurboTax Problems: Taxpayers' 2004 and 2005 joint Forms 1040 were self-prepared using TurboTax preparation software. The wife reported expenses for her real estate business as well as unrelated losses on a single Schedule C. Adjustments to this schedule resulted in most of taxpayers' income tax deficiencies and the resulting Section 6662 accuracy-related penalties. At trial, the wife argued that they consistently filled out their tax returns using TurboTax and she consistently confused capital gains and losses with ordinary income and expenses. In rejecting taxpayers' misuse of TurboTax, even if unintentional or accidental, as a defense to the penalties, the Tax Court noted that “tax preparation software is only as good as the information one inputs into it.” While reliance on the advice of a tax professional can establish reasonable cause and good faith for avoiding a penalty, taxpayers did not rely on a professional preparer but prepared the returns themselves. *Aileen Yat Muk Lam*, TC Memo 2010-82 (Tax Ct.).

Procedure—Extended Limitations Period for Partnership Items: The dispute in this supplemental opinion centered on whether an overstatement of basis constitutes an omission from gross income for triggering the extended six-year limitations period under IRC Sec. 6501(e)(1)(A) (taxpayer) and IRC Sec. 6229(c)(2) (partnership). In *Bakersfield Energy Partners* [128 TC 207 (2007), *aff'd*, 103 AFTR 2d 2009-2712 (9th Cir. 2009)], the Tax Court held that a basis overstatement was not an omission from gross income for Section 6501(e)(1)(A) and 6229(c)(2) purposes. The court followed *Bakersfield Energy* when it issued its original opinion in this case on 9/1/09, but on 9/24/09, the Treasury Dept. issued temporary regulations stating that an “understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income” [Temp. Regs. 301.6501(e)-1T and 301.6229(c)(2)-1T]. Finding that the Supreme Court’s opinion in *Colony, Inc.* [1 AFTR 2d 1894 (1958)] displaced the temporary regulations, the Tax Court majority opinion invalidated the temporary regulation (with two concurring opinions reaching the same result, but on narrower grounds). *Intermountain Insurance Service of Vail LLC*, 134 TC No. 11 (Tax Ct.).

Procedure—Levy on Education Savings Accounts: According to Internal Revenue Manual 5.11.6.2 (which deals with funds in pension or retirement plans), the taxpayer “may be able to withdraw money in a lump sum from a plan. If the taxpayer has the right to do so, a levy can reach that right.” Following this same logic, a recent emailed chief counsel advice states that “as a legal matter, Coverdell ESAs and 529s are not exempt from levy. But [there] are differences between the two types of accounts, so the [revenue officer] needs to be mindful of who the taxpayer is and what property rights, if any, he has.” For example, a person setting up a Coverdell ESA lacks the right to withdraw the funds, while the same person setting up a 529 can withdraw the funds (with tax consequences). CCA 201017044.

Procedure—Levy on Partnership Draw: Taxpayer was the managing partner of a law firm organized as a partnership under New York law. Taxpayer wrote checks to himself and the other partner that were characterized as draws or advances “taken against whatever the [firm’s] profits were going to be at the end of the year.” To collect taxpayer’s unpaid taxes, the IRS served tax levies on the firm. In affirming a New York District Court’s conclusion that the firm unlawfully failed to honor the levies, the 2nd Circuit rejected the firm’s argument that the payment of partnership draws to taxpayer did not constitute “salary or wages” for Section 6331(e) purposes because (1) the time when taxpayer was required to recognize income from the draws for income tax purposes (the partnership’s year end) was irrelevant, and (2) Reg. 301.6331-1(b)(1) provides that a continuing levy “attaches to . . . advances on salary or wages made subsequent to the date of the levy.” *U.S. v. Moskowitz, Passman & Edelman*, 105 AFTR 2d 2010-2126 (2nd Cir.).

Procedure—Return Preparers’ Identification Number: The IRS’s Tax Return Preparer Review recommended, in part, that tax return preparers be required to register and obtain a Preparer Tax Identification Number (PTIN). Under recently proposed revisions to Reg. 1.6109-2 (found in REG-134235-08), preparers would be required to use a PTIN as their identifying number on tax returns or refund claims filed after 12/31/10, except as provided in any transitional period. The IRS announced that it selected Accenture National Security Services, LLC, as the vendor to establish an online registration system. While the current target date for the online system is 9/1/10, an “official system launch date will be one of the initial determinations made in the weeks ahead . . .”



National Tax Advisory®

TO: All Professional Tax Personnel
FROM: Robin Tuttle Christian, CPA

NTA-737
DATE: May 18, 2010

RE: IRS Releases Its List of 2010 Dirty Dozen Tax Scams

Background

The annual IRS list of the most notorious tax scams, the “Dirty Dozen,” has been released. (See IRS News Release IR-2010-32.) New to this year’s list is a scheme where taxpayers report nontaxable social security benefits with excessive withholding to inflate their tax refunds. “Taxpayers should be wary of anyone peddling scams that seem too good to be true,” IRS Commissioner Doug Shulman said. Tax schemes are illegal and can lead to imprisonment and fines for both scam artists and taxpayers. Taxpayers pulled into these schemes must repay unpaid taxes plus interest and penalties.

2010 Dirty Dozen

Without further ado, the following dastardly deeds make-up the IRS’s 2010 dirty dozen:

1. *Phishing.* Phishing is a tactic used by scam artists to trick unsuspecting victims into revealing personal or financial information, usually by promising a tax refund if the victim provides this information. IRS impersonation schemes can take the form of emails, tweets, or phony websites. Scammers may also use phones and faxes to reach their victims. (To protect your clients, warn them to not open any attachments or click on any of the links in suspicious emails claiming to be from the IRS. Also, the IRS requests that suspicious emails and Web addresses that do not begin with **http://www.irs.gov** be forwarded to the IRS mailbox: **phishing@irs.gov**.)
2. *Hiding Income Offshore.* Individuals continue to try to avoid paying U.S. taxes by illegally hiding income in off-shore bank and brokerage accounts or using offshore debit cards, credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities or insurance plans. The IRS, state, and U.S. possession tax agencies aggressively pursue taxpayers and promoters of these scams. Also, IRS agents continue to develop their investigations of these offshore tax avoidance transactions using information gained from over 14,700 voluntary disclosures received last year.
3. *Filing False or Misleading Forms.* This tactic is used by scam artists who file false or misleading returns to claim refunds that they are not entitled to receive. Frivolous information returns, such as Form 1099-OID (Original Issue Discount), claiming false withholding credits are used to legitimize erroneous refund claims.
4. *Reporting Nontaxable Social Security Benefits with Excessive Withholding.* New to the list this year, the IRS is finding returns where taxpayers report nontaxable social security benefits with excessive withholding. This tactic increases withholding but not taxable income, thus inflating the taxpayer’s refund. Often both the withholding amount and the reported income are incorrect. The IRS warns that this indiscretion can result in a \$5,000 penalty.



5. *Abuse of Charitable Organizations and Deductions.* The IRS continues to see misuses of tax-exempt organizations. These include arrangements to improperly shield income or assets from taxation, attempts by donors to maintain control over donated assets or income from donated property, and overvaluation of contributed property. Often, the donations are highly overvalued or the organization receiving the donation promises that the donor can purchase the items back at a later date at a price the donor sets.
6. *Return Preparer Fraud.* Dishonest preparers cause many problems for taxpayers falling victim to their schemes. Such preparers derive financial gain by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. The IRS is implementing a number of steps for future filing seasons aimed at thwarting such dishonest deeds. These include requiring all paid tax return preparers to register with the IRS and obtain a Preparer Tax Identification Number (PTIN), as well as both competency tests and ongoing continuing professional education for any paid tax return preparer who isn't an attorney, CPA, or enrolled agent.
7. *Frivolous Arguments.* Frivolous scheme promoters encourage people to make unreasonable and unfounded claims to avoid paying the taxes they owe. The IRS has a list of frivolous legal positions that taxpayers should stay away from (search for "The Truth About Frivolous Tax Arguments" on www.irs.gov.) Taxpayers who file a return or make a submission based on one of the listed positions are subject to a \$5,000 penalty.
8. *Abusive Retirement Plans.* The IRS continues to uncover abuses in retirement plan arrangements, including Roth IRAs. It is looking for transactions that taxpayers use to avoid the limits on IRA contributions (such as, shifting appreciated assets into IRAs or companies owned by their IRAs at less than fair market value), as well as transactions that are not properly reported as early distributions.
9. *Disguised Corporate Ownership.* Domestic shell corporations and other entities are formed and operated in certain states to disguise ownership of a business or financial activity. Such entities can be used to facilitate under-reporting of income, fictitious deductions, nonfiling of tax returns, participation in listed transactions, money laundering, financial crimes, and even terrorist financing. The IRS is working with state authorities to identify these entities and bring their owners into compliance.
10. *Zero Wages.* Filing a phony wage-related or income-related information return to replace a legitimate information return has been used as an illegal method to lower the amount of taxes owed. Typically, a Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 is used as a way to improperly reduce taxable income to zero. The taxpayer also may submit a statement rebutting wages and taxes reported by a payer to the IRS. The IRS warns that this indiscretion can result in a \$5,000 penalty.
11. *Misuse of Trusts.* Unscrupulous promoters have urged taxpayers to transfer assets into trusts, promising reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, some trusts don't deliver as promised. The IRS has recently seen an increase in the improper use of private annuity trusts and foreign trusts to divert income and deduct personal expenses.
12. *Fuel Tax Credit Scams.* The IRS is receiving unreasonable claims for the fuel tax credit. Some taxpayers, such as farmers who use fuel for off-road business purposes, may be eligible for the credit. But, others are claiming the credit for nontaxable uses of fuel when their occupation or income level makes the claim unreasonable. Fraud involving the credit is on the list of frivolous tax claims subject to a \$5,000 penalty.

Conclusion

Tax professionals should counsel taxpayers to steer clear of these schemes and take steps to remedy the situation for any client involved in one. Suspected tax fraud can be confidentially reported to the IRS using Form 3949-A (Information Referral) available at www.irs.gov.

Reference:

IRS News Release IR-2010-32.

Tax Action Memo®

TAM-1415
May 18, 2010

Wages Paid to Owner's Relatives Can Potentially Qualify for New Payroll Tax Breaks

<p>Type of Clients: Small businesses.</p> <p>Situation: The HIRE Act included two temporary tax breaks for wages paid to eligible new hires, which can potentially include relatives of business owners.</p> <p>Deadline: ASAP because these breaks are temporary.</p>	<p>Tax Action Required: Read this release for the scoop on how wages paid to spouses of small business owners can be eligible; in fewer cases, wages paid to other relatives may be eligible too. Consider sending the attached letter to selected clients.</p>
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Background

In this lousy economy, keeping money in the family is a good idea. Small business owners can do it by hiring family members instead of outsiders. As a bonus, two new, but temporary, tax breaks are available to owners who hire their spouses as legitimate employees. These breaks don't make the case for employing a spouse, but they are beneficial for those who were going to do so anyway. Here's the story, including when the two new breaks are available for wages paid to other newly hired members of a business owner's family.

Temporary Employer Social Security Tax Exemption for Qualified New Employees

Thanks to the Hiring Incentives to Restore Employment (HIRE) Act, wages paid by a *qualified employer* to a *qualified new employee* between 3/19/10 and 12/31/10 are exempt from the 6.2% employer portion of the social security tax that's paid in as part of the FICA tax [IRC Sec. 3111(d)]. However, there's neither an exemption for the 6.2% employee portion of the social security tax that's paid via wage withholding, nor is there any change in the 2.9% Medicare tax on wages (1.45% paid by the employer via the FICA tax plus another 1.45% taken out of the employee's hide via withholding).

The maximum amount of an employer's social security tax savings is \$6,622 for each qualified new employee (6.2% x the \$106,800 social security tax ceiling for 2010). Of course, the per-employee benefit is proportionately less if the qualified new employee's wages during the 2010 exemption period are less than the \$106,800 ceiling (which will typically be the case).

Note: According to *FAQs About Claiming the Payroll Exemption* on the IRS website, the exemption applies to wages *paid* between the magic dates of 3/19/10 and 12/31/10 as opposed to wages for *work performed* between those dates. (See IRS FAQ-PE7.)

Definition of Qualified Employer. Qualified employers include private-sector businesses, tax-exempt not-for-profit organizations, and eligible public higher-education institutions [IRC Sec. 3111(d)(2)]. In the context of this article, however, we are talking about small business employers.

Definition of Qualified New Employee. Qualified new employees are full-time or part-time workers who: (1) start work after 2/3/10 and by no later than 12/31/10 and (2) were not employed more than 40 hours during the 60-day period ending on the start date. The new worker cannot replace another worker unless that person quit voluntarily or was discharged for cause (including being discharged in a downsizing, according to updated instructions to Forms W-2 and W-3). Also, the new worker must certify to the employer with a signed affidavit that he or she was not employed more than 40 hours during the 60-day period ending on the start date. [See IRC Sec. 3111(d)(3).] The certification is accomplished by filling out new IRS Form W-11, Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit.

Related Party Rules Apply, But Wages Paid to Owners' Relatives May Still Be Eligible

The social security tax exemption is *disallowed* for new employees who are related to employers under the same related party disallowance rules that apply for purposes of the Section 51 Work Opportunity Tax Credit (WOTC). [See IRC Sec. 3111(d)(3)(D).] The WOTC related party rules are found in IRC Sec. 51(i)(1). Here's how they work.

Employer Is a Sole Proprietorship. When the employer is considered to be an individual taxpayer [meaning the business in question is a sole proprietorship or (presumably) a single-member LLC that is treated as a sole proprietorship for tax purposes], IRC Sec. 51(i)(1) defines ineligible employees by reference to the list of individuals who can be *qualifying relatives* of the taxpayer for purposes of claiming the dependent exemption deduction. Such individuals are listed in IRC Sec 152(d)(2)(A) through (H). They include the taxpayer's (employer's) child, including a stepchild, adopted child, eligible foster child, or descendant of the taxpayer's child (typically a grandchild); (2) the taxpayer's brother, stepbrother, half brother, sister, stepsister, half sister, or a descendant of one of these individuals (typically a niece or nephew); (3) the taxpayer's son-in-law, daughter-in-law, father, stepfather, father-in-law, mother, stepmother, mother-in-law, brother-in-law, sister-in-law, aunt, or uncle; and (4) anyone else (*other than a spouse*) who lives with the taxpayer.

As you can see, the taxpayer's spouse is not included on the list of individuals who can be qualifying relatives, so wages paid to the taxpayer's spouse are potentially eligible for the social security tax exemption (and for the WOTC for that matter). Therefore, when the taxpayer (employer) is an individual, wages paid to the taxpayer's spouse are eligible for the social security tax exemption if the spouse meets the definition of a qualified new employee.

Most other workers who are related to the taxpayer (including in-laws) will be on the preceding long list of ineligible employees.

Corporate Employers. When the employer is a corporation, IRC Sec. 51(i)(1) defines ineligible employees as anyone who has one of the above-listed relationships with an individual who owns [directly or indirectly under IRC Sec. 267(c)] more than 50% of the corporation's stock. However, being the spouse of a more-than-50% shareholder is not one of the prohibited relationships. Therefore, when the employer is a corporation, wages paid to a majority shareholder's spouse are eligible for the social security tax exemption if the spouse meets the definition of a qualified new employee.

Most other workers who are related to a majority shareholder (including in-laws) will be on the long list of ineligible employees. However, workers who are only related to a *minority* shareholder (taking into account both direct and indirect stock ownership) can potentially meet the definition of a qualified new employee.

Warning: The rules can get tricky in family business situations. For example, if Joe is a 55% shareholder, his newly hired spouse can meet the definition of a qualified new employee. However, if Joe's

daughter Josephine owns the other 45%, her newly-hired spouse cannot meet the definition because he is the son-in-law of Joe, who is the majority shareholder.

Partnership Employers. When the employer is a partnership (including a multimember LLC that is treated as a partnership for tax purposes), IRC Sec. 51(i)(1) defines ineligible employees as anyone who has one of the above-listed relationships with an individual who owns [directly or indirectly under IRC Sec. 267(c)] more than a 50% interest in the partnership's capital and profits. However, being the spouse of a more-than-50% partner is not one of the prohibited relationships. Therefore, when the employer is a partnership, wages paid to a majority partner's spouse are eligible for the social security tax exemption if the spouse meets the definition of a qualified new employee.

Most other workers who are related to a majority partner (including in-laws) will be on the long list of ineligible employees. However, workers who are only related to a *minority* partner (taking into account both direct and indirect ownership) can potentially meet the definition of a qualified new employee.

Warning: Once again, the rules can get tricky in family business situations. For example, if Karen is a 51% partner, her newly hired spouse can meet the definition of a qualified new employee. However if Karen's son Kerry owns the other 45%, his newly-hired spouse cannot meet the definition because she is the daughter-in-law of Karen, who is the majority partner.

Temporary Tax Credit for Retaining Qualified New Employees

Above and beyond the temporary social security tax exemption, employers can also claim a temporary new tax credit of up to \$1,000 for wages paid to each *qualified new* employee—using the same definition as for the social security tax exemption—who is retained for at least 52 consecutive weeks. In addition, wages paid during the second 26 weeks of the 52-week period must equal at least 80% of wages paid during the first 26 weeks of that period. Otherwise, the credit is off limits.

Eligible Employees. As we just explained in the context of the social security tax exemption, a business owner's spouse can meet the definition of a qualified new employee. Therefore, the new employee retention credit can potentially be claimed for wages paid to a spouse who meets that definition. Other relatives of a minority owner can also meet the definition of a qualified new employee. Therefore, the credit can potentially be claimed for wages paid to those relatives who meet the definition. To be abundantly clear, when wages paid to a business owner's newly-hired spouse or relative are eligible for the social security tax exemption, wages paid to that spouse or relative may also be eligible for the new employee retention credit because the definition of a qualified new employee is the same for both breaks.

Credit Amount. The credit equals the lesser of: (1) 6.2% of wages paid to the worker during the 52-consecutive-week period or (2) \$1,000. Therefore, to claim the maximum \$1,000 credit, the worker must be paid at least \$16,130 during the 52-week period. The credit can only be claimed for the tax year during which the 52-week requirement is first met for the worker. So, the credit is a one-time deal for each eligible worker, based on wages paid to that worker during the 52-week period that starts with his or her employment date. The credit is implemented via an increase in the employer's general business credit under IRC Sec. 38(b). (See Section 102 of the HIRE Act.)

Note: The credit provisions are found in Section 102 of the HIRE Act rather than in the Internal Revenue Code itself.

Coordination of New Breaks with Work Opportunity Tax Credit (WOTC)

When wages paid to a qualified new employee are eligible for both the temporary social security tax exemption and the WOTC, the employer can “elect out” of the social security tax exemption and instead claim the WOTC. For lower-paid workers, the WOTC will often be more lucrative. Without an election out, the WOTC cannot be claimed for wages paid during the one-year period beginning on the qualified new employee's hire date. [See IRC Secs. 3111(d)(4) and 51(c)(5).]

According to *FAQs About Claiming the Payroll Exemption* on the IRS website, the election out can be made employee-by-employee by simply not claiming the social security tax exemption for wages paid to that employee between the magic dates. (See IRS FAQ-PE8 and PE9.)

When wages paid to a qualified new employee are eligible for both the new employee retention credit and the WOTC, both breaks can be claimed for the same wages. This understanding is confirmed in *FAQs About Claiming the Payroll Exemption* on the IRS website. (See IRS FAQ-PE11.)

Remember: The WOTC can only be claimed for wages paid to newly hired members of certain targeted groups such as qualified veterans, qualified long-term family assistance recipients, qualified ex-felons, and so forth. Frankly, the odds are not so great that a business owner's spouse or relative will be a member of a targeted group. Therefore, the issue of coordination with the WOTC will be moot in many cases.

Conclusions

As we said at the beginning of this release, the two temporary HIRE Act tax breaks don't make the case for hiring a spouse, but they are helpful to small business owners who were going to do it anyway. The HIRE Act breaks may also be available for wages paid to a newly hired employee who is a nonspouse relative of a minority owner of a corporate or partnership employer. However, when the employer is treated as an individual taxpayer, most nonspouse relatives of the taxpayer (business owner) will be on the long list of ineligible employees.

Appendix 1 contains a sample letter explaining how hiring a spouse or other relative can potentially entitle the business to these new tax breaks. As a subscriber to this newsletter, you may edit and distribute the letter to clients, potential clients, and referral sources as you see fit. However, please remember that the material is copyrighted. You may not use it for any other purpose, such as posting it on a website area available to the public or sharing it with another firm or association of firms of which you're a member.

To download the letter, go to <http://ppc.thomsonreuters.com/subscriptions/tabn>. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Sample Client Letters."

References:

IRC Secs. 38(b), 51, 267(c), and 3111(d).
Section 102 of the HIRE Act.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

Appendix 1

Sample Letter on How Hiring a Business Owner's Relative Might Score Payroll Tax Breaks

Dear Client

The Hiring Incentives to Restore Employment Act (the HIRE Act) became law on March 18th. The legislation includes two temporary payroll tax breaks intended to boost hiring. An interesting point about these breaks is that they can potentially be claimed for wages paid to a business owner's newly hired spouse. They can also potentially be claimed for wages paid to other newly hired relatives of a minority business owner (a person who owns 50% or less of the employer, after considering both direct and indirect ownership).

This letter briefly summarizes how the two new breaks can apply to wages paid to spouses and other relatives of business owners.

Temporary Employer Social Security Tax Exemption for Wages Paid to Eligible New Hires

Wages paid by a private-sector business (large and small alike) to a *qualified new employee* between 3/19/10 and 12/31/10 are exempt from the 6.2% employer portion of the social security tax. The maximum amount of employer social security tax savings for a high-paid employee is \$6,622 (6.2% × \$106,800 social security tax ceiling for 2010). However, the actual savings realized will be less for lower-paid employees and for high-paid workers who are paid less than \$106,800 between 3/19/10 and year-end.

Qualified new employees are full-time or part-time workers who start work between 2/4/10 and 12/31/10 and who provide the employer with a signed IRS Form W-11, Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit, certifying that they were not employed more than 40 hours during the 60-day period ending on their start dates. However, the new worker cannot replace another worker unless that person quit voluntarily or was discharged for cause.

Employer Is a Sole Proprietor: When the employer is a sole proprietorship or a single-member LLC that is treated as a sole proprietorship for tax purposes, wages paid between the specified dates to the taxpayer's (owner's) newly-hired spouse are eligible for the temporary social security tax exemption as long as the spouse meets the preceding definition of a qualified new employee. Wages paid to other newly-hired relatives of the owner (including in-laws) will generally be ineligible.

Employer Is a Corporation: When the employer is a corporation, wages paid between the specified dates to a majority shareholder's newly-hired spouse are eligible for the temporary social security tax exemption as long as the spouse meets the definition of a qualified new employee. Wages paid to other newly-hired relatives of a majority shareholder (including in-laws) will generally be ineligible. However, wages paid to a newly-hired spouse or other relative of a minority shareholder are eligible if the new hire meets the definition of a qualified new employee and is not a relative of the majority owner.

Employer Is a Partnership: When the employer is a partnership (including a multimember LLC that is treated as a partnership for tax purposes), wages paid between the specified dates to a majority partner's newly-hired spouse are eligible for the temporary social security tax exemption as long as the spouse meets the definition of a qualified new employee. Wages paid to other newly-hired relatives of a majority partner (including in-laws) will generally be ineligible. However, wages paid to a newly-hired spouse or other relative of a minority partner are eligible if the new hire meets the definition of a qualified new employee and is not a relative of the majority partner.

Temporary Tax Credit for Retaining Eligible New Hires

Above and beyond the temporary social security tax exemption, employers can also claim a temporary new tax credit of up to \$1,000 for wages paid to each *qualified new employee* who is retained for at least 52

consecutive weeks. In addition, wages paid during the second 26 weeks of the 52-week period must equal at least 80% of wages paid during the first 26 weeks of that period. The definition of a qualified new employee is the same as for the social security tax exemption.

The credit amount equals the lesser of 6.2% of wages paid during the 52-consecutive-week period or \$1,000. To claim the maximum \$1,000 credit, the worker must be paid at least \$16,130 during the 52-week period.

Here's the important point: when a newly-hired spouse or relative of a business owner is eligible for the social security tax exemption, wages paid to that spouse or relative may also be eligible for the new employee retention credit. That's because the definition of a qualified new employee is the same for both breaks.

Contact Us for More Information

If you have questions or want more information about the temporary social security tax exemption or the temporary new employee retention credit, please contact us. The eligibility rules in family business situations are complicated, and these breaks have a relatively short fuse, so time is of the essence.

Very truly yours,

Tax Action Memo®

TAM-1416
May 18, 2010

Deciding When to Start Receiving Social Security Benefits

<p>Type of Clients: Individuals.</p> <p>Situation: The client is approaching age 62 and needs to decide when to start taking social security retirement benefits.</p> <p>Deadline: N/A.</p>	<p>Tax Action Required: Read this release so that you're ready to help clients decide when to start receiving social security retirement benefits.</p>
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Background

Workers are generally entitled to begin taking monthly social security retirement benefits once they reach age 62. However, the full benefit will be permanently reduced for each month the benefits are received before the individual reaches the full retirement age. On the other hand, benefits increase if the individual delays receiving benefits until after reaching the full benefit retirement age. Thus, a client approaching age 62 will need to decide whether to begin taking reduced social security benefits early or wait until full benefit retirement age (or later).

Note: A worker's full retirement age varies depending on the worker's birth date. The full retirement age is 66 for workers born after 1942 and before 1955, it's age 67 for those born after 1959, and it's somewhere between age 66 and age 67 for those born after 1954 and before 1960.

Practice Tip: Social security benefits are calculated by reference to the primary insurance amount (PIA), whether the worker is fully insured, and a number of other factors. Since the calculation is complicated and many of the factors change each year, the most practical way to estimate the PIA may be to have it done by the SSA. An estimate of benefits can be obtained from a local social security office or by submitting Form SSA-7004-SM (Request for Social Security Statement).

For many clients, the present value of the social security retirement benefits they would receive is similar regardless of when benefits begin, depending on their life expectancy and tax bracket. Therefore, in many cases, this decision will depend on factors other than trying to receive the greatest lifetime benefit from social security.

Practice Tip: The Social Security Administration provides a break-even age calculator at www.ssa.gov. This tool helps clients find the age at which total benefits received is equal at different starting dates.

Some clients will delay retirement and continue to work because of personal preference. Yet others will want to retire early and will need to start receiving benefits as soon as possible. Some clients choose to take early social security benefits out of necessity—they are unemployed or underemployed, or they have an immediate financial need. Those in a better financial situation often have the luxury to wait and allow their

benefits to increase, thus ensuring a more comfortable retirement. These are the clients who can best benefit from your help.

Note: While clients may have the option of retiring early and beginning to receive social security benefits immediately, the eligibility age for Medicare remains at 65. So, although they may be able to replace a sufficient amount of their earned income with social security benefits at age 62, they may not be able to adequately replace their employer-provided health insurance. While recently enacted health care legislation should help this situation, it's too early to tell exactly how much.

Factors to Consider in Taking Reduced Benefits at Age 62

Even if the retiree has sufficient funds to live on without considering social security, some practitioners advise clients to begin receiving benefits as soon as possible. For 2010, the benefits at age 62 are reduced by 25% of what they would be at age 66 (i.e., the full benefit retirement age), but the client will receive more social security checks if benefits are drawn early. In addition, drawing early social security benefits may allow the client to leave tax-deferred retirement accounts untouched and growing for longer periods.

Example: Beginning social security benefits at 62 versus the full benefit retirement age.

Curt, who was born in 1948, plans to retire on his 62nd birthday in 2010 when his PIA is \$1,000. If he begins drawing benefits at age 62, he will receive monthly social security retirement benefits of 75% of his PIA, or \$750. Thus, he will have received 48 benefit checks of \$750 each, a total of \$36,000, when he reaches age 66 (his full benefit retirement age). His benefit would be \$1,000 if he waited until age 66 to begin receiving benefits, so it would take more than 11 years before the increased \$250 per month (\$1,000 – \$750) equaled the \$36,000 he would have received between ages 62 and 66. Therefore, Curt would receive 15 years of benefits beginning at age 62 before he would receive the same amount of total benefits if payments had started at age 66, as shown as follows:

Benefits beginning at age 62 for 15 years ($\$750 \times 180$ months)	\$135,000
Benefits beginning at age 66 for 11 years, 3 months ($\$1,000 \times 135$ months)	\$135,000

Bottom Line: If the client waits until the full benefit retirement age to draw benefits (and the PIA remains the same), it will take around 11 years to reach the break-even point to make up for the years of payments that were not received. Therefore, if the client does not expect to live until age 77, more benefits will be received by taking the reduced monthly payment.

If the present value of future social security benefits is considered, it would normally be more favorable to start the benefits as soon as possible. However, if the client is using early social security benefits to replace a similar amount of earned income, the short-term position will not be improved and the long-term outlook will suffer.

Factors to Consider in Waiting until Full Benefit Retirement Age

Those who reach age 62 and desperately need retirement income may not have the option of waiting until their full benefit retirement age before they begin receiving benefits. And those with a shorter life expectancy might be wise to start receiving benefits as soon as they can because they may not receive them for very long. However, other retirees should carefully consider the long-lasting advantages of waiting until their full benefit retirement age. Factors to consider include:

- *Life Expectancy.* The client's life expectancy may be the biggest factor in deciding whether to receive social security benefits early. While tables and averages are available, a 62-year-old client should have a good handle on his or her own life expectancy. Current health and the longevity of parents should be clearly established by that age. In general, 80 years might be a good cutoff point. If the client reasonably expects to reach that age, waiting until the full benefit retirement age may be a wise choice.

- *Shortening the Retirement Period.* A significant factor in retirement planning projections is the length of the retirement period. This is determined by subtracting the age at retirement from the life expectancy. For example, if a client wants to retire at age 62 and has a life expectancy of 85, there is a 23-year retirement period to fund. By working past age 62, the client is shortening the retirement period and decreasing the resources needed to fund the retirement regardless of longevity.
- *Replacing Lower-wage Years.* As stated earlier, an individual's social security benefits are based on his or her PIA. The PIA is calculated from the individual's highest earnings during a 35-year calculation period. If a client can replace lower-wage years early in his or her career with higher-wage years after age 62, the PIA can be increased. This can lead to a dramatically higher retirement benefit when the individual retires.
- *Inflation Adjustments.* Social security benefits receive an annual inflation adjustment. By taking early benefits, the individual will be receiving a smaller annual dollar increase and will miss out on the compounding effect of that increase. For example, if an individual's PIA was \$1,000, but he or she retired early and received only \$750, each year he or she would miss out on the compounded inflation adjustment of that \$250 in lost benefits. In other words, the gap between the early retirement benefit and the amount he or she would have received by waiting will get bigger and bigger.
- *The Effect on the Spouse.* The individual's decision to start receiving social security benefits before reaching the full benefit retirement age may also affect a spouse's benefits. Unless the spouse has personal earnings record and is fully insured, he or she will be dependent on the working spouse's PIA for retirement benefits. A spouse who waits until full benefit retirement age is eligible to receive 50% of the working spouse's retirement benefit. However, a worker who retires early may have a lower PIA than by waiting until the full benefit retirement age. Therefore, the spouse's benefit would be based on that lower PIA.
- *The Earnings Test.* Clients who are considering receiving social security retirement benefits before their full benefit retirement age but who also intend to keep working need to consider the impact of the earnings test. Under this test, social security benefits are reduced \$1 for every \$2 in earnings above an exempt amount of earnings (\$14,160 for 2010) if the client has not yet reached full retirement age. Thus, clients already facing a reduced benefit amount because of their early retirement would have their benefits reduced even further by failing the earned income test.

Example 2: Effect of taxes and social security benefits reduction on excess earnings.

Charlie retired in 2009 at age 63. In 2010, he decides to work part-time and earns wages of \$15,160, \$1000 over the exempt amount. Charlie has investment income and is in the 25% marginal tax bracket. His social security benefits are subject to tax and 85% of the benefits are included in his gross income. Since Charlie is under the full benefit retirement age, his benefits are reduced \$1 for each \$2 he earns over the exempt amount. Charlie's additional spendable portion of the additional \$1,000 in income after considering taxes and the loss of social security benefits is only \$280, shown as follows:

Earnings over the exempt amount	\$ 1,000
Social security tax on \$1,000 (7.65%)	(76)
Income tax on \$1,000 (25% marginal tax bracket)	(250)
Loss of social security benefits ($\$1,000 \div 2$)	(500)
Tax savings from \$500 reduction in benefits ($\$500 \times 85\% \times 25\%$)	<u>\$ 106</u>
Additional spendable amount	<u>\$ 280</u>

Factors to Consider in Beginning Benefits after Reaching the Full Benefit Retirement Age

An individual who works past the full benefit retirement age receives larger benefits because of the delayed retirement credit. A worker born in 1943 or later receives a credit of 8% per year for each year the worker delays receiving benefits after reaching the full retirement benefit age until age 70.

Special Strategies for Increasing Retirement Benefits

Switching from One Type of Benefit to Another. A married taxpayer who has reached full benefit retirement age and wants to earn delayed retirement credits (and thus receive a larger retirement benefit) may, in the meantime, claim a spousal benefit while continuing to work. Then, when the taxpayer has earned additional delayed retirement credits, he or she can switch from spousal benefits to benefits based on his or her own (now higher) PIA. To implement this strategy, the taxpayer's spouse must already be receiving retirement benefits, for only then may spousal benefits be claimed.

Example 3: Switching from a spousal benefit after earning delayed retirement credits.

Bo and Jo have both reached full benefit retirement age. Bo wants to retire and start receiving his benefit of \$1,800 per month. Jo's benefit (based on her earnings record) is only \$800 per month. So instead, Jo receives the higher spousal benefit of half of Bo's benefit (\$900). However, if Jo chooses to continue working while receiving her spousal benefit, she will continue to earn delayed retirement credits until age 70. At that point, she would be eligible for a larger retirement benefit of at least \$1,056 based on her own earnings record (8% delayed retirement credit \times 4 years \times \$800).

Claiming Then Suspending Benefits. Occasionally, a worker may wish to delay benefits to take advantage of the delayed retirement credit, but the spouse may wish to receive his or her spousal benefit immediately. Since the spouse may only receive spousal benefits when the worker has begun drawing benefits, this creates a problem. However, a potential solution exists. The worker may file for benefits at full benefit retirement age, thus allowing the spouse to file for spousal benefits. The worker can then immediately suspend benefits to earn the delayed retirement credit, while the spouse continues to receive spousal benefit. (This strategy is allowed under the Senior Citizens' Freedom to Work Act of 2000.)

Example 4: Receiving spousal benefits while the worker earns delayed retirement credits.

Al and his wife Jo had both reached their full benefit retirement age. Al's PIA was \$2,000, but he intended to keep working and earn delayed retirement credits until age 70. Jo wanted to retire, but her PIA was only \$500. Since Al was not going to retire and receive benefits, Jo was not eligible for her \$1,000 ($\$2,000 \times 50\%$) spousal benefit based on Al's earnings. However, their planner advised Al to file for benefits so Jo could claim her higher (\$1,000 rather than \$500) spousal benefit. Then, Al immediately suspended his benefit claim and continued working. Jo was permitted to continue receiving her \$1,000 spousal benefit and Al could continue to accrue delayed retirement credits.

Variation: Assume that Jo wants to retire at age 62 instead of her full benefit retirement age (66). She files for a reduced benefit of \$375. When Al reaches his full benefit retirement age, he files for a spousal benefit of \$250 ($50\% \times \500), but continues to work and earn delayed retirement credits. At age 70, he retires and files for benefits based on his earnings history. He stops receiving his spousal benefit of \$250, but he now receives his own retirement benefit. The delayed retirement credits he earned have increased his benefit by 32% (\$2,640 instead of \$2,000).

The increase in benefits caused by the delayed retirement credit does not increase the PIA and does not affect benefits paid to family members other than the worker and, eventually, the surviving spouse. In addition, even after beginning to receive social security retirement benefits, a worker can earn a delayed retirement credit for any month that suspension of benefits is requested. This option only applies to the period beginning with the month in which the worker reaches the full benefit retirement age and ending with the month prior to reaching age 70.

Reimbursing SSA for Early Benefits. Some clients may want to consider applying for social security benefits before the full benefit retirement age with the intention of repaying the amount in full later. This strategy is best suited for clients who do not need the social security benefits to live on but can invest the full amount, or can avoid taxation of their social security benefits so as not to reduce the investable amount.

This strategy allows the client to invest the reduced early retirement social security benefits for up to four years, repay SSA the total amount of the received benefits (without penalty or interest) at full retirement age, retire at that point and receive the full (unreduced) benefit, and keep any earnings received on the investment. Form SSA-521, (Request for Withdrawal of Application), is used to implement this strategy.

One risk of this strategy is that the client may die shortly after filing Form SSA-521 and never receive much of the higher full retirement age benefit after repaying SSA thousands of dollars. However, this risk may be somewhat mitigated by the advantage of the surviving spouse receiving a higher spousal benefit. Another risk is that the client may die before filing Form SSA-521, leaving the spouse with permanently reduced benefits. This risk can be mitigated by purchasing a life insurance policy that expires at age 70.

Conclusion

Clients approaching age 62 will need to decide when to start receiving social security benefits. As described in this release, many factors will need to be considered. As their trusted advisor, you'll likely be the one they will call for help.

Subscriber Note: This *Tax Action Memo* is based on material from *PPC's Guide to Retirement Planning*. For information on this guide, visit ppc.thomsonreuters.com or call (800) 431-9025.

Tax Action Memo®

TAM-1417
May 18, 2010

Calculating the Small Employer Health Insurance Tax Credit for 2010

<p>Type of Clients: Small employers.</p> <p>Situation: The employer pays (or is considering paying) at least 50% of its employees health insurance costs.</p> <p>Deadline: ASAP—your small employer clients will be calling.</p>	<p>Tax Action Required: Read this release to get up to speed on the new small employer health insurance credit. Use the provided tables to quickly estimate the credit amount available to clients.</p>
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Background

For tax years beginning in 2010 through 2013, eligible small employers (including small tax-exempt employers) that purchase health insurance coverage for their employees may be eligible for a tax credit to help offset the cost of the insurance coverage. (See new IRC Sec. 45R.) This is one of the few provisions in the Patient Protection and Affordable Care Act (Health Care Act) that is effective in 2010. It's also one that is likely to be of keen interest to your small employer clients, especially now that the IRS has mailed millions of postcards to small businesses and tax-exempts advising them of its possible availability to save them big tax dollars.

Fortunately, the IRS has been quick to issue guidance on how this credit works, in the form of FAQ's posted on its website, and more recently in Rev. Rul. 2010-13. Here's the scoop on how to calculate a small employer's available credit for 2010.

Note: In 2014 and later, eligible small employers who purchase coverage through a state-run Insurance Exchange will be eligible for a tax credit for two years of up to 50% (35% for tax-exempt employers) of their contribution. Also, the wage limits will be indexed beginning in 2014. As 2014 is a long ways off and the state-run exchanges don't even exist yet, we won't go into those rules any further in this release.

Does the Employer Qualify for the Credit?

Only *eligible small employers* qualify for the credit. An *eligible small employer* is an employer that meets all the following requirements [IRC Sec. 45R(d)]:

1. It employs no more than 25 Full-time Equivalent (FTE) employees during its tax year. FTE employees are determined by dividing the total hours worked by all employees during the year by 2,080 (rounded down to the nearest whole number). However, the maximum hours counted for any one employee is 2,080. Also, the hours worked by seasonal workers aren't counted unless they work for the employer on more than 120 days during the tax year.

2. It pays annual FTE wages that average no more than \$50,000. This is determined by dividing the total wages the employer pays by the number of its FTE employees and then rounding that number down to the nearest \$1,000. For this purpose, wages means wages as defined for FICA purposes (without regard to the wage base limitation). (See IRS FAQ-10.) Wages paid to seasonal workers are excluded if the worker's hours are excluded in determining the number of FTE employees for item 1.
3. The employer has a qualified health insurance plan (or arrangement) that requires it to pay at least 50% of the premiums (on a uniform basis) on behalf of all of its employees who enroll in the plan.

Observation: An otherwise eligible small employer that is not currently paying any of its employee's health insurance costs that establishes a new arrangement requiring it to pay a uniform percentage of at least 50% of premiums for enrolled employees, will presumably be entitled to the credit for the payments it makes under the plan. It's not entirely clear, however, how an employer that currently has an arrangement that requires it to pay less than 50% of its employee's premiums can correct this situation so that it can qualify for the credit. Hopefully, the IRS will provide guidance on this sometime soon.

Example 1: Fast & Easy (F&E) offers a qualified health insurance plan to its employees. Under the plan, F&E pays 80% of the premiums on behalf of all employees enrolled in the plan.

F&E paid wages totaling \$450,000 to 12 employees who each worked 2,080 hours during 2010, and four employees who each worked 1,560 hours during the year. F&E has 15 FTE employees $\{[(2,080 \times 12) + (1,560 \times 4)] \div 2,080\}$. Its average annual FTE wages are \$30,000 ($\$450,000 \div 15$). Therefore, F&E qualifies for the small employer health insurance tax credit.

Variation: What if F&E is currently paying 40% (instead of 80%) of its enrolled employees' premium, but now wants to increase its pay percentage to 50% so that it can qualify for the credit? It seems logical that F&E should be able to do this as that was the intent of the legislation—to encourage small employers to provide health coverage. But, how is this accomplished? Can (or must) the change be done on a prospective basis only so that only the remaining premiums (the ones it pays 50% of) qualify for the credit, or does F&E have to (or can it) go back and pay 50% of the premiums for the entire year to qualify for the credit?

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, 5% owners of the employer [within the meaning of IRC Sec. 416(i)(1)(B)(i)], and dependents of these self-employed individuals are not treated as employees [IRC Sec. 45R(e)(1)]. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals, nor is the individual taken into account in determining the number of FTE employees or average FTE wages.

Members of a controlled group or an affiliated service group as described in IRC Sec. 414(b), (c), (m), and (o) are treated as a single employer for purposes of the credit. Thus, all employees of the group and all wages paid to employees by the group are counted in determining whether any member of the group is an eligible small employer. [See IRC Sec. 45R(e)(5).]

2010 Transitional Rule. Generally, to qualify for the credit, the employer must pay the same percentage (which has to be at least 50%) of all its employees' health insurance premiums. However, according to the IRS FAQ-22, the IRS intends to issue guidance that will provide a transition rule for 2010 only. Under this transition rule, an employer can qualify for the credit even if it pays differing percentages of different employees' premiums as long as all the payments it makes are at least 50% of each employee's premium (based on single—employee only—coverage). For example, an employer satisfies the 50% requirement with respect to the employee with family coverage if the employer pays at least 50% of the premium for single coverage for that employee even though it is less than 50% of the premium for family coverage.

Calculating the Amount of the Credit

Step One—Calculate the Maximum Credit Amount. For tax years beginning in 2010 through 2013, an eligible small employer's maximum credit equals 35% (25% for tax-exempt employers) of the lesser of the following amounts [IRC Sec. 45R(g)(2)]:

1. The amount of contributions the employer made during the tax year to its qualified health arrangement to purchase qualifying health insurance coverage for its employees. Qualifying health insurance coverage is basically health insurance purchased from an insurance company licensed under state law. Only nonelective employer contributions qualify. Basically, this means that employee elective contributions to the plan that are used by the employer to pay for the employee's coverage don't qualify for the credit. Premiums paid in 2010 before the Health Care Act was enacted can qualify for the credit. (See IRS FAQ-8.)
2. The amount of contributions that the employer would have made during the tax year to its qualified health arrangement if each employee had enrolled in coverage with a small business benchmark premium. The small business benchmark premium will be determined by the Secretary of Health and Human Services (HHS) each year on a state-by-state basis. The 2010 table can be found in Rev. Rul. 2010-13 and has been reproduced in Appendix 2 of this release.

Note: The HHS may issue additional 2010 small business benchmark premium rates for certain high cost areas within a state. However, any additional rates provided will not be less than those listed in Appendix 2. Also, if the employer pays only a portion of the employee's premium, the amount in Appendix 2 must be multiplied by the portion paid by the employer. For example, if the employer pays 80% of the employee's premium, the employer's contribution for purposes of item 2 will be 80% of the benchmark premium listed in Appendix 2. (See IRS FAQ-3.)

Step Two—Calculate the Available Credit. The maximum credit is available only to an employer with 10 or fewer FTE employees and whose employees have an average annual FTE wages of less than \$25,000. If the number of FTEs exceeds 10 or if average annual wages exceed \$25,000, the credit available to the employer equals the maximum credit amount calculated in step one reduced by the sum of the following two amounts, as applicable (but not below zero):

1. If the number of FTEs exceeds 10:

$$\text{Maximum Credit} \times \frac{\text{FTEs} - 10}{15}$$

2. If average annual wages exceed \$25,000:

$$\text{Maximum Credit} \times \frac{\text{Average Annual Wages} - \$25,000}{\$25,000}$$

Example 2: Using the same facts as in Example 1 (15 FTEs and \$30,000 average annual wages), assume that for 2010 F&E pays \$96,000 in nonelective health care premiums for its employees, which does not exceed 80% (the percentage of premiums paid by F&E) of the small business benchmark premium for F&E's state and otherwise meets the requirements for the credit.

F&E's credit is \$15,680, calculated as follows:

Maximum credit: (35% × \$96,000)	\$ 33,600
Reduction for FTEs in excess of 10: (\$33,600 × 5 ÷ 15)	(11,200)
Reduction for average annual wages in excess of \$25,000: (\$33,600 × \$5,000 ÷ \$25,000)	<u>\$ (6,720)</u>
Available credit:	<u>\$ 15,680</u>

Short-cut Credit Calculation: To help make your life a little easier, the Appendix 1 provides a table estimating the applicable reduced credit percentage available to employers with varying levels of FTEs and average annual wages. This table can be used to quickly estimate the credit available to a small employer.

Example 3: Using the facts in Example 2, the credit could be quickly estimated to be \$15,360 (16% × \$96,000). This isn't 100% accurate, but it should work for a quick and dirty estimate.

Additional Limit for Tax-exempt Employers. The credit available to tax-exempt employers cannot exceed the total amount of Federal Income Tax (FIT) and Medicare (i.e., hospital insurance) tax the employer is required to withhold from employees' wages for the year, plus the employer's share of Medicare tax on employees' wages.

Claiming the Credit

For-profit Businesses. The small employer health insurance credit will be claimed on the employer's annual income tax return. The credit is a specified general business credit. [See IRC Sec. 38(b)(36) and (c)(4)(B)(vi).] As such, it is available against AMT. Also, any unused credit can be carried back for one year (but not before 2010) and carried forward for 20 years.

Practice Tip: The employer (individual in the case of a sole proprietor) should reduce its estimated tax payments for the year to account for the availability of the credit.

The employer's income tax deduction for premiums it pays on behalf of its employees is reduced by the small employer health insurance credit. [See IRC Sec. 280C(h).]

Tax-exempt Employers. For tax-exempt organizations, instead of being a general business credit, the credit is a refundable tax credit limited to the payroll taxes (defined earlier) paid or withheld during the calendar year in which the employer's tax year begins.

Observation: As the credit offsets their payroll taxes, it would seem logical that tax-exempt employers would claim the credit on their payroll tax returns. However, the IRS has informally indicated that Form 941 (Employers Quarterly Federal Tax Return) will not be amended, but instead small tax-exempt employers will have to claim the credit on Form 990 (Return of Organization Exempt from Income)—presumably they really meant 990-T (Exempt Organization Business Income Tax Return) as Form 990 is not a tax return. In any case, this makes no sense to us—whichever way they go, they'll have to amend a form (whether it be Form 941, 990, or 990-T) or at least provide some sort of guidance. Wouldn't that be a whole lot easier to do on Form 941 where the payroll taxes are reported and paid? Whatever! We'll keep you posted as guidance comes out.

Conclusion

The small employer health insurance tax credit should be a welcome relief for small employers struggling to provide their employees with health insurance coverage. Those already paying for at least 50% of the premiums, will want to know what their tax savings will be. Those not already providing employee health insurance coverage and those providing it, but paying less than 50% of the premiums (or an nonuniform percentage of its employees' premiums), may want to reconsider this decision based on these new tax savings. In any case, you're now armed with information so that you can answer your clients' questions when they call.

References:

IRC Secs. 38(b), 45R, and 280C(h).
Rev. Rul. 2010-13, 2010-21 IRB.

Subscriber Note: This *Tax Action Memo* was written by Senior Manager, Robin Tuttle Christian, CPA. Ms. Christian is Managing Editor of this publication as well as a coauthor and contributing editor of several PPC publications.

Appendix 1

Short-cut Small Employer Insurance Credit Percentage¹

For-profit Business:

Number of employees	Average Wages					
	Up to \$25,000	\$30,000	\$35,000	\$40,000	\$45,000	\$50,000
Up to 10	35%	28%	21%	14%	7%	0%
11	33%	26%	19%	12%	5%	
12	30%	23%	16%	9%	2%	
13	28%	21%	14%	7%		
14	26%	19%	12%	5%		
15	23%	16%	9%	2%		
16	21%	14%	7%			
17	19%	12%	5%			
18	16%	9%	2%			
19	14%	7%				
20	12%	5%				
21	9%	2%				
22	7%					
23	5%					
24	2%					
25	0%					

Nonprofit Entity:

Number of employees	Average Wages					
	Up to \$25,000	\$30,000	\$35,000	\$40,000	\$45,000	\$50,000
Up to 10	25%	20%	15%	10%	5%	0%
11	23%	18%	13%	8%	3%	
12	22%	17%	12%	7%	2%	
13	20%	15%	10%	5%		
14	18%	13%	8%	3%		
15	17%	12%	7%	2%		
16	15%	10%	5%			
17	13%	8%	3%			
18	12%	7%	2%			
19	10%	5%				
20	8%	3%				
21	7%	2%				
22	5%					
23	3%					
24	2%					
25	0%					

Note:

¹ These tables are from the Congressional Research Service report *Summary of Small Business Health Insurance Tax Credit Under PPACA*, dated 4/5/2010.

Appendix 2

2010 Small Employer Benchmark Premiums

State	Employee Only Coverage	Family Coverage
Arkansas	4,329	9,677
Arizona	4,495	10,239
California	4,628	10,957
Colorado	4,972	11,437
Connecticut	5,419	13,484
District of Columbia	5,355	12,823
Delaware	5,602	12,513
Florida	5,161	12,453
Georgia	4,612	10,598
Hawaii	4,228	10,508
Iowa	4,652	10,503
Idaho	4,215	9,365
Illinois	5,198	12,309
Indiana	4,775	11,222
Kansas	4,603	11,462
Kentucky	4,287	10,434
Louisiana	4,829	11,074
Massachusetts	5,700	14,138
Maryland	4,837	11,939
Maine	5,215	11,887
Michigan	5,098	12,364
Minnesota	4,704	11,938
Missouri	4,663	10,681
Mississippi	4,533	10,501
Montana	4,772	10,212
North Carolina	4,920	11,583
North Dakota	4,469	10,506
Nebraska	4,715	11,169
New Hampshire	5,519	13,624
New Jersey	5,607	13,521
New Mexico	4,754	11,404
Nevada	4,553	10,297
New York	5,442	12,867
Ohio	4,667	11,293
Oklahoma	4,838	11,002
Oregon	4,681	10,890
Pennsylvania	5,039	12,471
Rhode Island	5,887	13,786
South Carolina	4,899	11,780
South Dakota	4,497	11,483
Tennessee	4,611	10,369
Texas	5,140	11,972
Utah	4,238	10,935
Virginia	4,890	11,338
Vermont	5,244	11,748
Washington	4,543	10,725
Wisconsin	5,222	12,819
West Virginia	4,986	11,611
Wyoming	5,266	12,163

Source: Rev. Rul. 2010-13.