tax report

SEPTEMBER 2009

Worker Classification — Making the Call

Is the person you are hiring your employee or an independent contractor? In many cases the answer is obvious, but sometimes it isn't. Worker classification continues to be a headache for businesses of all sizes — and an area of interest to the IRS.

Why Does It Matter?

The distinction is important for employment-tax reasons. With an employee, the business and the employee share the responsibility for Social Security and Medicare (FICA) taxes on the employee's earnings. The business also must pay unemployment taxes for the worker. With an independent contractor, the contractor is fully liable for his or her own self-employment taxes. FICA taxes do not apply, and unemployment taxes are not required.

Benefits are another consideration. A company's health and retirement plans must cover an employee once the employee meets plan eligibility requirements. An independent contractor typically does not receive benefits.

How To Decide

To answer the worker classification question for federal tax purposes, a company should analyze its entire relationship with the worker, focusing on the degree of direction and control the company exercises. The more control, the more likely it is that a worker is an employee. Three elements come into play:

- **Behavioral control** over what work is done and how it is done (sequence of work tasks, detailed instructions regarding how to perform the job, etc.)
- **Financial control** over the business aspects of the job (who provides tools/supplies, how the worker is paid, whether expenses are reimbursed, etc.)
- **Type of relationship** (whether it is ongoing, written contracts, provision of benefits, etc.)

Businesses that would like the IRS to determine a worker's status for purposes of federal employment taxes and income-tax withholding can file Form SS-8. The IRS advises that it could take as long as six months to get a determination.

Statute Says

Federal law specifically classifies certain workers as employees for FICA purposes, even if they are not subject to an employer's control. These include certain agent and commission drivers, a life insurance company's sales agents, home workers, and full-time traveling or city salespeople. Similarly, two categories of workers are considered statutory *non*-employees (i.e., self-employed): direct sellers and licensed real estate agents. (Requirements apply.)

A Little Relief

In some situations, the IRS may relieve a business from having to pay employment taxes for a wrongly classified worker. The business must have a reasonable basis for not treating the worker as an employee and must have been consistent in its treatment.

Upcoming Audits

The IRS is preparing to launch a new audit program focusing on federal employment-tax returns. Although all lines on the return may be scrutinized, the IRS will primarily concentrate on fringe benefits, reimbursed expenses, officer compensation, and worker classification. ■

Commuting Costs

Do you spend a bundle just getting to and from work? It would be helpful if you could deduct your expenses, but, unfortunately, the general rule is that commuting expenses are nondeductible. However, the tax law does allow deductions for the costs associated with:

- Traveling between two business locations
- Traveling between your main job and a second job
- Local trips taken for business purposes after you've arrived at work (trips to visit clients or buy supplies, for example)
- Getting from home to a *temporary* job location outside the metropolitan area where you normally live and work
- Traveling between your home office and other work locations in the same business, if your home office is your principal place of business

To qualify for a deduction, you'll need the appropriate records. Let us know if you have questions.

short takes

Buying New

Taxpayers who intend to purchase a vehicle this year for business use may save taxes if they buy a new vehicle instead of a used one. The maximum depreciation or Section 179 deduction for a new car purchased in 2009 is $10,960; it's $2,960 for a used vehicle. The maximum write-off for a new light truck or van is $11,060, compared to $3,060 for a used vehicle.

Cash for Clunkers

As an additional incentive, the federal government is providing vouchers of $3,500 or $4,500 for individuals and businesses to trade in gas-guzzling cars and trucks for new, more fuel-efficient vehicles between July 1 and November 1, 2009. The voucher does not have to be included in the vehicle purchaser's income for tax purposes. Various requirements apply.

Investing in Small Business Stock

Individuals who invest in small businesses and hold their stock for more than five years may be eligible to exclude a portion (generally 50%) of capital gain realized on the sale of their stock. The exclusion percentage is 75% for qualified stock acquired after February 17, 2009, and before January 1, 2011. Requirements apply.

Tips for Taxpayers Who Refinance

In the right situation, refinancing a home mortgage at a lower interest rate can be a smart financial move. If you refinance your mortgage this year, don't overlook the following potential tax deductions.

Points. Your lender may charge you points — prepaid interest — in connection with the refinancing. (One point equals 1% of the loan amount, two points equals 2%, etc.) The points are deductible as an itemized deduction. In general, you have to spread your deduction over the term of the new loan. But points are currently deductible to the extent you spend the proceeds from the refinancing on improvements to your principal residence.

Refinancing a mortgage for the second time opens up the opportunity to deduct the balance of the points on your first refinancing, assuming you are switching lenders. If not, you can deduct the points remaining from the first refinancing over the life of the new loan.

Mortgage insurance. Premiums paid to secure private mortgage insurance (PMI) in connection with a mortgage taken out after 2006 are deductible, once again, only if you itemize your deductions. The deduction is also available if you get mortgage insurance from the Federal Housing Administration, Rural Housing Administration, or Department of Veterans Affairs. The deduction phases out if your adjusted gross income is between $100,000 and $109,000 ($50,000 and $54,500 if you are married filing separately). Under current law, this deduction is available only through 2010. ■

Pass Those Tests

Unless a 401(k) plan has certain "safe harbor" features, it must perform nondiscrimination testing every year. The tests are meant to prevent the plan from favoring highly compensated employees.

- The actual deferral percentage (ADP) test compares the level of elective contributions made by highly compensated and nonhighly compensated employees.
- The actual contribution percentage (ACP) test looks at the level of employer matching (and certain other) contributions for the two groups.

If test results show that the highly compensated group's average contribution rates are too high relative to those of the rank and file, the plan has a limited time to fix the problem or risk disqualification. Frequently, this means distributing excess contributions to company executives, who in turn have to dig into their own pockets and pay income taxes on the distributions.

Encouraging greater plan participation and higher contribution levels can go a long way toward avoiding problems with the nondiscrimination tests.

Talk it up. Employees who decided not to join the plan when they were first given the opportunity to enroll might be receptive to joining at a later time. Similarly, employees who have been participating for a while may decide to raise their initial contribution amount if encouraged to do so. Additional meetings and personalized communications are examples of ways to stimulate increased participation.

Tout the Saver's Credit. Available only to employees with modest incomes, this federal income-tax credit essentially puts money back into the pockets of employees who contribute. The credit is available for up to $2,000 of annual contributions, and the credit rate is 50%, 20%, or 10%, depending on income. ■

How Will You Structure Your New Business?

Starting a small business can be exciting — and a little overwhelming. One decision you'll need to make before you get going is what legal form your business will take.

Sole Proprietorship

If you will be the only owner, you can operate the business as a sole proprietorship or form a limited liability company (LLC) or a corporation. A sole proprietorship is the easiest. Basically, there is no entity separate from you, although you can have a business name (often referred to as a DBA, short for "doing business as"). You can have employees, but you don't take a paycheck from the company yourself.

For federal income-tax purposes, your business income and expenses are reported on Schedule C, an attachment to your personal return. In addition to income taxes, your net earnings from the business will be subject to self-employment taxes (in lieu of the Social Security and Medicare taxes paid by employees and their employers).

Limited Liability Company

Unlike a sole proprietorship, a limited liability company (LLC) is a separate legal entity. You can form an LLC solo or the business can have co-owners (called "members"). You might prefer an LLC or a corporation over a sole proprietorship if you are concerned about protecting your personal assets in the event your business is sued. But business lenders generally require personal guarantees from a small company's owners, so you'll probably be on the hook personally for loans made to your business even if it is an LLC or a corporation. As for federal taxes, an LLC's income is taxed to the owners individually, and earnings are subject to self-employment taxes.

Corporation

A corporation is a separate legal entity that transacts business, buys equipment, borrows money, etc., in its own name. Although a corporation can be very large and have thousands of shareholders, even a small business with one owner can incorporate. Insulation from personal liability is often a key motivator for forming a corporation (but note the caution regarding personal guarantees).

A corporation files its own income-tax returns. Unless a "Subchapter S" election is made, the corporation uses a corporate tax rate schedule to figure the federal income taxes due on its taxable income. If corporate earnings are distributed as dividends, that income is taxed a second time to the shareholders, and the corporation receives no tax deduction for the dividend payments. However, as a shareholder working for the company, you generally would take a paycheck, which lets you draw out corporate earnings on a tax-deductible basis.

Making a Subchapter S election avoids the potential for double taxation. An S corporation generally does not pay federal income taxes itself. Instead, the shareholders are taxed individually on their share of the corporation's taxable income. This treatment is not available for state income-tax purposes in some states.

Partnership

By definition, a partnership is a business with more than one owner. It is similar to an LLC or an S corporation in certain respects, but it must have at least one general partner who is liable for the partnership's debts and obligations. Investors who won't play an active role in the business can receive limited partnership interests. A limited partner's liability risk is limited to the amount invested. Partnerships do not pay federal income taxes; business profits and losses are divided among the partners according to the terms of the partnership agreement and taxed to them individually. A partnership must file an informational return with the IRS annually. ■

Calendar of Filing Dates

SEPTEMBER

15 Individuals: Third installment of 2009 estimated tax due; file Form 1040-ES.

15 Corporations: Last day for filing 2008 income-tax return (Form 1120, 1120-A, 1120S) by a calendar-year corporation that obtained an automatic six-month filing extension.

15 Corporations: Due date for depositing the third installment of estimated income tax for 2009.

15 Partnerships: Last day for filing 2008 return (Form 1065) by a calendar-year partnership that obtained a five-month filing extension. Note: This is a change from prior years.

OCTOBER

15 Individuals: File 2008 federal income-tax return and pay any tax due if you obtained a six-month filing extension.

NOVEMBER

2 Employers: File Form 941, Employer's Quarterly Federal Tax Return, for the third quarter of 2009.

10 Employers: Deferred due date for Form 941, if timely deposits were made.

Donating? Keep Records

Your contributions to qualified charities are tax deductible if you itemize your deductions — assuming you have the required records. Here are some tips.

Household Items and Clothing

These must be in "good used" condition or better *unless* you are claiming a deduction of over $500 and include a qualified appraisal of the item with your return. Get a receipt from the charity showing the charity's name, the contribution date, and a description of the items you donated. If you can't get a receipt because you left items at a charity's unattended drop site, note the same information and keep it on file, along with the donated items' fair market value and how you determined the value.

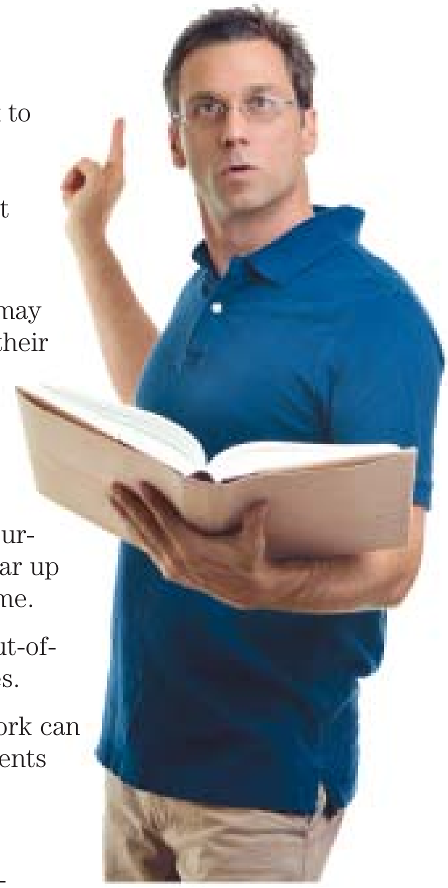
Money

Keep your canceled check or a bank, credit union, or credit card statement indicating the name of the charity, the date, and the amount paid. For payroll deductions, keep your pay stub, W-2 statement, or another employer-furnished document showing the total amount withheld for charity. You should also have a pledge card showing the charity's name.

$250 or More

You'll need an acknowledgment from the charity for each donation of $250 or more, whether the gift was money or property. ■

Quiz Time



At this time of year, school kids are heading back to the classroom in droves. In keeping with the season, spend a few minutes taking the 10-question quiz below. It will give you useful information that could save you federal income taxes this year.

(1) Working parents of children under age 13 may claim a tax _________ for a percentage of their child-care expenses.

(2) The interest on _________ activity bonds issued in 2009 and 2010 is not subject to alternative minimum tax.

(3) Although unemployment compensation insurance benefits are generally taxable, this year up to $_________ may be excluded from income.

(4) K-12 teachers may deduct up to $250 of out-of-pocket expenditures for _________ supplies.

(5) Driving a personal vehicle for charitable work can yield a tax deduction equal to _________ cents per mile.

(6) The American Opportunity Tax Credit is a credit for the payment of higher _________ expenses.

(7) Taxpayers may elect to deduct state and local _________ taxes instead of state and local income taxes as an itemized deduction.

(8) A person who is age 50 or older may contribute $_________ to an individual retirement account (IRA) for 2009 (or the amount of taxable compensation, if less).

(9) An *additional* standard deduction of up to $500 ($1,000 on a joint return) is available for the payment of state or local real _________ taxes.

(10) If an investor's capital losses exceed capital gains, the excess loss can be deducted, up to an annual limit of $_________. ■

Answers: (1) credit; (2) private; (3) 2,400; (4) classroom; (5) 14; (6) education; (7) sales; (8) 6,000; (9) estate; (10) 3,000 or $1,500 for a married-separate filer