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## THE TAX RELIEF ACT OF 2010

# MAPPING OUT STRATEGIES FOR INDIVIDUALS

The main message you heard when the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was passed in December may have been that “taxes won’t go up now after all.” But, there’s more to it than that. The act’s many provisions, in fact, map out the tax planning terrain for the near future.

### Your rates and paycheck

Indeed, individual income tax rates won’t go up this year because the Tax Relief act extends the so-called “Bush tax cuts” for two years (through Dec. 31, 2012). That’s good news because rates now ranging from 10% to 35% had been scheduled to return this year to previous levels ranging from 15% to 39.6%.

If you’re concerned about your alternative minimum tax (AMT) liability, the Tax Relief act offers relief here as well. It increases AMT exemptions that would otherwise have decreased substantially for the 2010 and 2011 tax years, lessening the odds that you’ll be subject to the tax.

What’s more, for 2011, you’ll pay less of your share (as an employee) of Social Security taxes. Rates on earnings up to the taxable wage base (\$106,800 in 2011) were dropped from 6.2% to 4.2%. That means if you earn \$100,000 in 2011, you’ll save \$2,000 in payroll taxes over what you would have paid under the previous rate.

How should all of this affect your tax planning? The extension of the lower individual tax rates

along with the payroll tax cuts should keep your tax bill at least a little lower for the next couple of years. Start thinking now of ways to put these freed-up dollars to good use, whether paying down debt or starting (or increasing) your savings.

Additionally, for 2011 you can employ the traditional tax planning strategy of deferring income to the next year and accelerating deductible expenses into the current year (unless you expect to be in a higher bracket next year or are concerned about the AMT). This will defer tax to 2012. In 2012, however, you may want to avoid such a strategy. If tax rates do go up in 2013 as scheduled, deferring income to that year could be costly.



## Don't neglect your estate plan

It's been all too easy to neglect estate planning recently because of the great uncertainty surrounding whether an estate tax would even exist for 2010. But the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 means no one should neglect his or her estate plan any longer.

The act reinstates the estate tax for 2010 at a top rate of 35% (down from 2009's 45%) and a \$5 million exemption (up from 2009's \$3.5 million), and with a generally unlimited step-up in basis. The top estate and gift tax rates and the generation-skipping transfer (GST) tax rate are set at 35% for 2011 and 2012.

Meanwhile, the estate, gift and GST tax exemptions are \$5 million for 2011 and indexed for inflation in 2012. The act also allows "portability" of the estate tax exemption between spouses for 2011 and 2012. But these provisions will sunset on Dec. 31, 2012, which would mean dramatic rate increases and exemption reductions. You'll need to consider the changing rates and exemptions in setting up and maintaining your estate plan.

If you're managing the estate of a loved one who died in 2010, note that you may either calculate estate taxes using the new 35% top rate and \$5 million exemption (with a stepped-up basis for all estate assets) or elect to apply the law as it existed before the act — that is, no estate tax but a modified carryover basis regime.

### Your investments

If you're an investor, 2010 may have had an ominous feel to it, as the 15% tax rate on long-term capital gains and qualified dividends (generally 0% for those in the 10% and 15% brackets) was set to expire at year end.

*If you were in a hurry to sell some appreciated investments to avoid paying the 20% tax rate, you've been granted a temporary reprieve.*

Again, the Tax Relief act truly brought some relieving news in that these rates have been extended through Dec. 31, 2012. Absent this extension, the capital gains rate would have gone up to 20% (10% for those in the 15% bracket) and qualified dividends would have reverted to being subject to ordinary-income rates as high as 39.6%.

In light of these developments, take another look at your portfolio. If you were in a hurry to sell off some appreciated investments to avoid paying tax at the 20% rate, you've been granted a temporary reprieve.

In fact, rather than sell the shares, you may want to gift them. If you give long-term appreciated assets to your children or other family members who are in the 10% or 15% income tax bracket (and they're not subject to the "kiddie tax"), they can take advantage of the 0% rate on some or all of the gain.

Thus, you'll minimize — and perhaps eliminate — the tax that you, as a family, will pay. This strategy may be appropriate if you initially intended to make a gift using the cash from the sale. (Keep in mind the gift tax, however. See "Don't neglect your estate plan" above.)

### Your circumstances and needs

The Tax Relief act is a provision-rich bill, and assessing its details may reveal a variety of tax-planning strategies that fit your specific

circumstances and needs. For example, many tax breaks for parents have been extended through 2012, including:

- ✓ The enhanced child credit,
- ✓ The enhanced dependent care credit,
- ✓ The enhanced adoption credit and adoption assistance exclusion, and
- ✓ The American Opportunity credit (for higher education expenses).

If you live in a state with no or low state income taxes or you're considering a major purchase, such as a car or boat, you'll want to be aware that the ability to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes has been extended through

2011 (but not for 2012). If you're considering a major purchase, you may want to make it this year to ensure you can deduct the sales tax.

The point is, any major life circumstance or change that's on the near horizon could remain a little more tax-friendly for a while longer. So it's wise to sit down and review your plans in the short term to see whether any of the extended tax breaks of this law could benefit you and whether there are any steps you should take to lock in potential savings.

### Your move

On its face, the Tax Relief act didn't change things so much as keep them the same for a little bit longer. But that doesn't mean you should do nothing. Rather, by opening this window for further tax savings under the current rates, Uncle Sam is essentially saying, "Your move." □

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# ALWAYS AN ISSUE

## IRS STILL WATCHFUL FOR MISCLASSIFIED EMPLOYEES

The conflict between the IRS and businesses regarding who is an independent contractor and who is an actual employee is nothing new and will probably always be an issue. To keep your company as far from trouble as possible, get and keep yourself up to speed on the IRS rules regarding the use and classification of independent contractors.

### Respective responsibilities

In the traditional employer-employee relationship, the employer is responsible for a number of tasks. These include:

- ✓ Withholding federal and state income taxes,
- ✓ Paying unemployment taxes (FUTA),

- ✓ Withholding the employee's share of FICA and Medicare taxes, and
- ✓ Paying both the employee and employer portions of FICA and Medicare taxes.

Independent contractors are responsible for their own taxes. In addition to making estimated tax payments for their federal and state income tax liabilities, they're subject to self-employment tax, which covers both the employer and employee shares of FICA. (They are, however, entitled to a deduction for the "employer's" portion.)

### IRS preference

Because it's easier and cheaper to collect taxes from a single employer than from multiple independent contractors, the IRS has a strong preference for employee status. If the IRS reclassifies independent contractors as employees, it can go after your company for back taxes that should have been paid, payroll and income taxes that should have been withheld, and penalties and interest.

*Even if workers you treat as independent contractors have paid their taxes, you're not necessarily safe.*

Additional penalties may apply if the IRS finds that you intentionally disregarded your tax obligations. And, of course, your state may impose penalties of its own. Finally, "responsible persons" — including certain officers, partners and managers — could be personally liable for uncollected taxes.

Even if workers you treat as independent contractors have paid their taxes, you're not necessarily safe. If the IRS finds they should have been classified as employees, it still may hit you with penalties equal to 20% of your tax liability.



### Key factors

The simplest way to avoid these consequences is to treat workers as employees unless they clearly qualify as independent contractors. The IRS typically examines and weighs 11 factors to determine whether a worker is an employee or independent contractor. These considerations indicate to the agency the degree of control exercised by the employer and the degree of independence of the worker.

For instance, the IRS looks at behavioral control such as instruction (employees usually receive detailed instructions about when, where and how to work) and training (employees often receive training on how to perform their job duties).

The type of relationship is also important. Does the individual receive benefits? Is he or she working for the business indefinitely? Are his or her services critical to the company's ongoing operations? Affirmative answers to any or all of these questions would bolster an IRS case that the person in question is an employee, not an independent contractor.

Another important issue is financial control. The IRS will look for unreimbursed business expenses, which are usually incurred by independent contractors, not employees. Independent contractors

often make significant investments in facilities and equipment as well. Employees don't.

In addition, employees are usually paid by the hour, week or some other period. But independent contractors generally receive a flat fee or submit an invoice for services. So method of payment is a key consideration.

Independent contractors will also often continue marketing themselves while working on a given project and risk suffering a profit loss on every job.

Ultimately, no one factor controls the outcome. You need to examine and weigh all the factors to determine whether a particular worker is an employee or independent contractor.

### **Not a bad idea**

Engaging independent contractors to fulfill targeted roles in specialized areas of your business isn't a bad idea. They may be less costly because you don't have to pay benefits and payroll taxes. But you must carefully evaluate how much risk there is that the IRS could reclassify them as employees. □

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## MONEYLINES: NEWS BRIEFS FOR BUSINESSES

**IRS raises mileage rates for the business use of a vehicle.** The rate for vehicles, vans, pickups and panel trucks has risen to 51 cents per mile for 2011 (up from 50 cents for 2010). The rate for medical/moving costs also has risen, going from 16.5 cents to 19 cents. The rate for charitable vehicle use remains constant at 14 cents. Bear in mind that you can't use the standard mileage rate for a vehicle you've depreciated under the Modified Accelerated Cost Recovery System (MACRS) or for which you've claimed the Section 179 expensing election.

**Top 2011 industries hold lessons for business owners.** On its website, *Inc. Magazine* has predicted the six top-performing industries of 2011. Among the winners are e-commerce and environmental consulting. Even if your company isn't involved in these sectors, there are lessons to be learned. Maintaining an effective online presence will still be important and, if you haven't started selling directly via your website, you probably should. Also, stricter environmental regulations pose a risk to businesses that don't keep up with these rules. For a complete list, go to Inc.com and search for "top performing."

**Are you ready to grow your workforce again?** A survey conducted by the National Federation of Independent Business at the end of 2010 reported that the number of businesses planning to hire more employees rose to its highest mark in more than two years. Obviously, hiring just to hire isn't a wise choice. And many small business owners are still struggling with taxes, regulatory red tape and lender financing. But this indication of potential increased hiring is at least one good sign for small business growth and may indicate that workforce expansion is something to consider again.



# NEWLYWEDS GET UP TO SPEED ON LIFE INSURANCE

**B**rent and Angela had led fairly live-for-the-moment existences before getting married, but soon after their nuptials they wisely decided to slow down and plan for the future. First up was life insurance — what type and how much. They engaged a local financial advisor to help them get up to speed.

The advisor began by noting that younger couples such as Brent and Angela usually need the most coverage because typically they have the largest financial responsibilities (raising children, paying a mortgage) and the fewest assets. Although Brent and Angela didn't have any children yet, they did have a sizable mortgage that neither could likely handle on his or her own.

## The basics of type

Like many people, Brent and Angela had heard the words "term" and "whole life" (or "permanent") used in relation to life insurance. But the particulars escaped them.

With term coverage, their advisor explained, they could choose the amount of coverage they'd want over a specified period. If the insured individual died during that period, their insurer would pay out a death benefit to his or her beneficiary. The policy wouldn't, however, build up any value other than that benefit.

A whole life policy, on the other hand, would amass a cash value along with its death benefit. This could be a helpful opportunity from a long-term investment standpoint. Plus, the couple could, if necessary, access that cash value via a policy loan. (Such a loan would reduce the death benefit and cash value.) Because of these and other benefits, the premiums would be higher than for a term policy with the same amount of coverage.



## Where to begin

Next, the advisor suggested calculating how much money their young and, for the moment, small family would need to spend annually to maintain its current standard of living. Much like a business, Brent and Angela should look at their expected cash flow.

Using conservative earnings, inflation and tax rates — and examining items such as current investments, retirement plans and any other resources — the couple could compare the amount of cash flow generated with the amount needed to cover the projected expenses.

Their advisor warned them that they might be surprised at just how much cash flow the two might need — especially if children enter the picture. She also reminded them that a policy might have to replace decades of earnings.

## A fundamental need

Brent and Angela admitted to feeling a little sheepish about not being more familiar with the ins and outs of life insurance. But, their advisor assured them, everyone should review the basics and their respective insurance requirements regularly. □



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