

The current economic downturn has forced many businesses to reduce staff and evaluate the need to retrain employees. Fortunately, the tax code permits employers to deduct the cost of educational assistance programs, and employees can exclude from taxable income up to \$5,250 of such benefits per year. This exclusion applies to assistance paid for graduate and undergraduate courses that improve or develop the individual's capabilities. The courses do not have to be job-related or part of a degree program and can qualify the employee for a new job. However, the employer may condition payment on the employee completing the course, attaining a certain grade, or satisfying a reasonable condition, such as remaining employed for one year after completing the course. This ability to encourage a desired behavior may give employers incentive to pay employee education expenses.

Nondiscrimination rules prevent employers from providing this benefit exclusively to owner-employees, their spouses, and dependents who collectively own 5% or more of the company. No more than 5% of the amounts paid by the employer can be provided for employees, their spouses, and dependents. Thus, it may be difficult for a

Deducting Educational Assistance Expenses

closely held corporation with mostly owner-employees to take advantage of this benefit.

If the program fails these requirements, payments for both highly compensated and regular employees are taxable compensation. Thus, the employer still deducts the payment, but it is taxable compensation to the employee. The only exceptions are if the payments qualify as a working condition fringe benefit (if the education is job-related) or a qualified tuition reduction or qualified scholarship.

Note, however, that unlimited job-related educational assistance is excludable from an employee's income as a working condition fringe benefit. The exclusion is available for educational instruction or training that improves or develops the employee's job-related capabilities.

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

Tax Calendar

October 15—Personal returns that received an automatic six-month extension must be filed today and any tax, interest, and penalties due must be paid.


—Electing large partnerships that received an additional six-month extension must file their Form 1065-B today.

November 2—The third quarter Form 941 (Employer's Quarterly Federal Tax Return) is due today and any undeposited tax must be deposited. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed

return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through September exceeds \$500.

November 16—If the monthly deposit rule applies, employers must deposit the tax for payments in October for social security, Medicare, withheld income tax, and nonpayroll withholding.

December 15—Calendar-year corporations must deposit the fourth installment of estimated income tax for 2009. 


Using IRA Distributions to Pay Education Costs

Receiving *penalty-free* IRA distributions before age 59½ is possible in only a few cases. One such case is for qualified higher education expenses for you or a dependent. Another way is to elect to receive substantially equal periodic



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payments for a period of time. But, if that series of payments is modified before you reach age 59½, a 10% penalty could apply.

However, the Tax Court recently ruled that an additional distribution (above the substantially equal periodic payment) is permissible if it was for qualified higher education expenses, because those expenses also qualify for the exception. The good news is that if you are already receiving periodic IRA payments prior to age 59½, this Tax Court decision indicates you should not have to worry about incurring a penalty if you need additional funds from the IRA for certain college expenses for you or your dependent. 

Recent Identity Theft Scams

The IRS frequently reminds taxpayers to beware of identity theft scams. Two of the latest phishing scams include one offering inherited funds, lottery winnings, or cash consignment and another offering a bogus tax refund. Scammers use the IRS name, logo, or website in an attempt to convince taxpayers that the scam is a genuine communication from the IRS. Scammers may also use other federal

agency names, such as the U.S. Department of the Treasury. After obtaining personal information, identity thieves use the victim's personal data to steal his or her financial accounts, run up charges on the victim's existing credit cards, apply for new loans, credit cards, services, or benefits in the victim's name, and even file fraudulent tax returns.

Please note the IRS does not discuss tax account matters by email. So, contact us if you receive an email, purported to be from the IRS, requesting personal information. 

Individuals who participate in a 401(k) plan sometimes borrow from their plan. While you may justifiably feel squeamish about taking out a 401(k) plan loan, it can actually make good sense in appropriate circumstances—assuming it is paid back on time. For instance, in today's tough economy, plan loans can be a source of much-needed cash when bank loans are unavailable or prohibitively expensive.

401(k) plan loans are generally economical and easy to obtain. In particular, a 401(k) plan participant with less-than-stellar credit or tapped out credit lines may find it much easier and cheaper to borrow from their 401(k) plan than from a commercial lender.

401(k) plan loans provide participants with access (within limits) to their 401(k) plan dollars without incurring income tax liabilities and the 10% premature withdrawal penalty tax. The 10% penalty tax generally applies to withdrawals before age 59½, however, exceptions are available. In essence, the participant (borrower) pays interest to himself or herself when taking out a plan loan.

401(k) plan loans are only permitted if the plan document allows them, and many plans do. The maximum amount that can be borrowed is generally the lesser of \$50,000 or 50% of the participant's (borrower's) vested account balance. Most 401(k) plan loans are secured exclusively by the participant's vested account balance (although other forms of security, such as a lien against the participant's home, are sometimes seen).


At least two major potential pitfalls are associated with 401(k) plan loans. First, the participant's account balance is irreversibly diminished if the loan is not paid back. Second, the federal income tax consequences are harsh for failure to pay back a plan loan according to its terms, and the loan will usually have to be repaid in full soon after the employee leaves the job for any reason. Such failure to repay the loan can result in a deemed distribution of the unpaid loan balance that triggers a federal income tax hit

Borrowing from Your 401(k) Plan

(possibly a state income tax hit, too). In addition, the dreaded 10% premature withdrawal penalty will generally apply unless the participant is age 59½ or older.

Interest paid on a loan secured by the participant's (borrower's) 401(k) plan account balance is nondeductible if any of the account balance used to secure the loan is attributable to elective deferrals (i.e., elective salary reduction contributions the employee signed up for). This is true regardless of how the loan proceeds are used and regardless of the existence of other security for the loan, such as the participant's home. Since 401(k) account balances will almost always include at least some elective deferral dollars, interest on loans from such plans will usually be nondeductible.


In most cases, borrowing from your 401(k) plan should only be done when funds are not available elsewhere. But, during this difficult economic time, it may be prudent to do so.

Please contact us if you have questions on the tax ramifications of 401(k) plan loans or other tax compliance or planning issues. 



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Generally, education qualifies if it (a) is required by an employer or the law to keep a present salary, status, or job; or (b) maintains or improves skills required for present work. However, education needed to meet minimum job requirements or that qualifies the employee for a new trade or business does not qualify as a working condition fringe benefit, but may qualify for exclusion as noted above. 

Cash for Unneeded Life Insurance Policies

Besides providing loved ones with a source of funds for income replacement in the event of an untimely death of the family's breadwinner(s), people buy life insurance for a variety of reasons. These include, but are not limited to—



1. Funding a buy/sell agreement or key person insurance for a business.
2. Satisfying a lender's requirement when a loan was made.
3. Funding anticipated estate taxes.

Whether it was one of these needs or something else, circumstances change, and sometimes people find that they no longer need, or perhaps can no longer afford, certain policies. In addition to affordability, the policy may no longer be needed if—

1. The key person in a business has retired, thus eliminating the need for the policy.

2. The business has been sold or business circumstances changed, eliminating the need for the policy.
3. Family circumstances have changed: (a) a mortgage or other loan was paid off; (b) the kids have been educated or moved away from home; (c) the policy's primary beneficiary has died; or (d) the insured went through a divorce.

If one of these describes your situation, consider whether it might be more beneficial to sell the policy before you allow a term life policy to lapse or before you turn in a whole life policy for its cash surrender value. Known in the industry as a life settlement, selling a policy can sometimes net the policyholder a sufficient sum that's far in excess of a whole life policy's cash surrender value or a term policy's unearned premium.

Although such arrangements are still fairly new, the IRS recently released guidance on the tax results of such a transaction. If you have an unneeded policy that you're thinking about getting rid of or just letting it lapse, we'd be glad to talk to you about whether it might make sense to try to sell it instead.

Please call us if you'd like to discuss this issue or any other tax compliance or planning matter.



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October 2009