

## TAX AND BUSINESS *Alert*™

May 2011

Individual taxpayers are opting to start their own businesses for myriad reasons. Regardless of why you're contemplating self-employment, you should consider several basic tax-related issues before and immediately after actually leaving your current job. Following are some tax issues to consider.

**Know the Rules for Rolling over Retirement Plan Funds.** Upon leaving your job, you generally will be entitled to immediately receive vested amounts in your qualified retirement plan accounts. Most distributions from qualified retirement programs [pension plan, 401(k) plan, etc.] can be rolled over tax-free into an IRA account. However, you must arrange for a "direct rollover," or the plan administrator is required to withhold 20% of your distribution for federal income tax. Direct rollovers involve having the funds transferred directly from your former employer's retirement plan into your designated IRA account. Failure to arrange a direct rollover means you will have to replace the 20% withheld to accomplish a totally tax-free rollover.

**Use All Your Flexible Spending Account (FSA) Funds before You Quit.** If you have an FSA (or cafeteria plan reimbursement account) for

## Tax Aspects of Becoming Self-employed

uninsured medical expenses and/or childcare expenses, make sure you incur sufficient qualifying expenses to use up the funds in your account before you leave your job. Otherwise, that money will be left behind.

**Open a Separate Business Bank Account.** Segregate your business and personal financial matters by keeping separate bank accounts. Deposit all business income into the business account and pay all business expenses out of that account. If you pay business expenses in cash or out of your personal account, reimburse yourself with checks drawn on your business account and document this with receipts. This will make your year-end recordkeeping easier. Keeping separate accounts shows you are serious about running things in a businesslike manner, and IRS examiners like to see that.



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# Repaying the First-time Homebuyer Credit

Many taxpayers were able to take advantage of the First-time Homebuyer Credit in 2008, 2009, and 2010. In some cases,




however, taxpayers will be required to repay this credit. The IRS will notify taxpayers who claimed the credit concerning their repayment requirements. IRS

letters will explain if and when repayment is required. There are different letters for different situations, including a purchase of a home in 2008, in 2009 or 2010, a sale of a main home, or a change in the use of the main home.

If you purchased your home in 2008, you will

be required to repay the credit over a period of years. The IRS will send you a notice listing the amount of credit received and the amount due as additional tax each year until the credit is repaid.


If you purchased your home in 2009 or 2010, the IRS will send you a courtesy notice each year for three years after you received the credit. This letter will let you know that if you sell your home, or no longer use it as your main home, within three years of the purchase date, you generally will have to repay the credit.

If you sell or fail to maintain the home as your main home for three years after purchase, you must notify the IRS of the disposition. The IRS matches information from a variety of sources when your home is sold, destroyed, foreclosed on, or no longer your main home, and it checks to determine if the status change has been reported. The IRS will notify you if it has not received the required information to report the sale or other disposition of your home. 

## Tax Aspects of Becoming Self-employed (Continued from page 1.)

**Keep Tax Records.** In addition to maintaining a separate business bank account, you need to keep documentation of your business income and expenses.

**Keep Good Auto Records.** Personal auto expenses used for business are deductible, but only if you document the date, number of miles, and business purpose for each business use of the car. Mileage not properly substantiated is considered personal use, and the related expenses are not deductible. You should also record the car's mileage at the beginning of the year or when you first start your business. Unless the standard mileage rate is used, receipts or invoices and cancelled checks should be retained documenting the car's purchase price, fuel costs, repairs, taxes, insurance, and other out-of-pocket costs. Auto logbooks for recording mileage and expenses are available at local discount and office product stores.

**Set up Your Own Retirement Plan.** If you work for yourself, you are on your own when it comes to retirement planning. A retirement plan set up for your benefit accomplishes two goals: it is a way to save money for your later years, and it saves taxes now. Using a defined contribution Keogh plan, you can contribute and deduct up to 25% of your net self-employment (SE) income (maybe more if you set up a defined benefit Keogh plan), but Keogh plans must be in existence before the end of this year for you to take a deduction. If it is a 401(k) plan, you may also make elective deferrals. A simplified employee pension (SEP) plan can be set up in the following year—as late as the extended due date for your return—and still provide a current-year tax deduction. SEPs are simpler and cheaper to administer, and you can contribute and deduct up to approximately 20% of your net SE income. SIMPLE retirement plans are another option available to self-employed persons. A possible disadvantage of these qualified retirement plans is that you may have to make contributions for your employees. 

A recent report indicates there were more than one million home foreclosures in 2010, and that's the good news. The bad news is it is widely anticipated that another million or more homes will be repossessed in 2011. A key question facing these former homeowners is just how does the foreclosure impact their federal taxes? Right now, you are probably thinking how in the world can taxable income and a federal tax liability result from a home foreclosure? Keep reading for the answer to this puzzling question.

Before 2007, any part of a mortgage forgiven after a foreclosure (such as when the house was sold and the bank forgave a mortgage exceeding the home's sale price) was cancellation of debt (COD) income, which is considered taxable. Fortunately, tax law changes in the 2007 Mortgage Relief Act (as extended) saved the day—at least for foreclosures occurring before 2013. The help comes in a special provision called the qualified principal residence indebtedness exclusion. Up to \$2 million of COD income can be excluded under this provision. To qualify, the COD transaction must occur before 2013; the cancelled debt must have been originally incurred to acquire, construct, or improve the taxpayer's principal residence; and the debt must be secured by that residence.

The taxpayer's basis (generally what was paid for the house, plus the cost of any improvements) in the residence is reduced, but not below zero, by the amount excluded under this exception. Thus any excluded COD will decrease any loss (or increase any gain) on the sale of the residence. However, this usually doesn't matter since the loss is not deductible, and any gain up to \$250,000 (\$500,000 if married) generally qualifies for the home-sale exclusion and isn't taxable anyway.

#### **Example: Dealing with COD income on a foreclosed house.**


Several years ago, Tim and Tina paid \$500,000 for their home. Thanks to a terrible real estate market, their home is

## **Tax Impact of a Home Foreclosure**

now worth \$350,000, but their mortgage balance is \$450,000. To make matters worse, Tim has lost his job. With no way to make their monthly payments and no hope of selling their home for enough to pay off their mortgage, Tim and Tina hand the deed to the bank and walk away from their mortgage. The bank subsequently nets \$350,000 from the sale of the home and forgives the remaining \$100,000 loan balance. As far as Tim and Tina are concerned, they've done nothing but lose their home and all the money they put into it.



For federal tax purposes, however, two things have happened—they've sold their home for a \$150,000 loss and realized COD income of \$100,000—and the two transactions do not offset each other. In fact, the loss from the sale of their residence is never deductible, whereas the COD income is fully taxable unless an exception applies. Fortunately for Tim and Tina, they can exclude the \$100,000 of COD income under the qualified principal residence indebtedness exclusion previously mentioned. This will decrease the basis in their home by \$100,000. Their loss will now be \$50,000 instead of \$150,000, but it's not deductible anyway. The bottom line is that the foreclosure has no impact on their federal income taxes.

Unfortunately, the special COD exclusion does not apply to all home loans. It doesn't work for second mortgages or home equity loans that were used for purposes other than to improve the taxpayer's principal residence, nor does it work for vacation home mortgages. It will only help those who borrowed too much to acquire, build, or improve a *principal* residence. 



# Business Charitable Contributions

Recently enacted tax legislation extended several charitable contribution provisions beneficial to businesses. The new law extends through 2011 the enhanced charitable contribution deduction for non-C corporation

businesses that donate food (it must be apparently wholesome when donated). This provision is intended for non-C corporation businesses that have

food inventories, such as restaurants. For non-C corporation taxpayers, deductions for donated food normally are limited to the taxpayer's basis in the food or FMV, whichever is lower. In contrast, the enhanced deduction equals the lesser of (1) basis plus one-half the value in excess of basis or (2) two times the basis (the same enhanced deduction rule has been available to C corporations for years).


The legislation extends through 2011 the enhanced deduction for C corporations that donate books to schools. This provision is intended for C corporations that have book inventories, such as publishers and retailers.

The new law also extends through tax years beginning in 2011 the enhanced deduction for

C corporations that donate computer equipment and technology to qualifying educational organizations and libraries.

Liberalized deduction rules for qualified conservation contributions were also extended by the legislation through tax years beginning in 2011. Qualified conservation contributions are charitable donations of real property interests, including remainder interests and easements that restrict the use of real property. For qualified C corporation farming and ranching operations, the maximum write-off for qualified conservation contributions is increased from the normal 10% to 100% of adjusted taxable income.

Finally, a favorable rule for S corporation donations of appreciated assets was extended through 2011. The new law restored the favorable shareholder basis rule for stock in S corporations that make charitable donations of appreciated assets. For such donations, each shareholder's tax basis in his or her S corporation stock is only reduced by the shareholder's pro rata percentage of the company's tax basis in the donated assets. The extended provision is taxpayer-friendly because it leaves shareholders with higher tax basis in their S corporation shares, which is almost always beneficial to these shareholders.

Please contact us to discuss appropriate methods to maximize charitable contributions for your business or any other matter impacting your personal or business taxation. 

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