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Tax and Business Alert™

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Health Savings Account (HSA) Benefits

A Health Savings Account (HSA) represents an opportunity for eligible individuals to lower their out-of-pocket health care costs and federal tax bill. Since most of us would like to take advantage of every available tax break, now might be a good time to consider an HSA, if eligible. An HSA operates somewhat like a flexible spending account (FSA) that employers offer to their eligible employees. An FSA permits eligible employees to defer a portion of their pay, on a pretax basis, which is used later to reimburse out-of-pocket medical expenses. However, unlike an FSA, whatever remains in the HSA at year-end can be carried over to the next year and beyond. In addition, there are no income phase-out rules.

Naturally, there are a few requirements for obtaining the benefits of an HSA. The most significant requirement is that an HSA is only available to an individual who carries health insurance coverage with a relatively high annual deductible. By that we mean the individual's health insurance coverage must come with at least a $1,200 (in 2011 and 2012) deductible for single coverage or $2,400 (in 2011 and 2012) for family coverage. However, for many self-employed individuals, small business owners, and employees of smaller companies, these thresholds won't be a problem. In addition, it's okay if the insurance plan doesn't impose any deductible for preventive care (such as annual checkups).

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Other requirements for setting up an HSA are that an individual can't be eligible for Medicare benefits or claimed as a dependent on another person's tax return. Individuals who meet these requirements can make tax-deductible HSA contributions of up to $3,050 in 2011 and $3,100 in 2012 for single coverage or $6,150 in 2011 and $6,250 in 2012 for family coverage. When an employer contributes to an employee's HSA, such as in the case of a closely held business, the contributions are exempt from federal income, social security, Medicare, and unemployment taxes.

An account beneficiary who is age 55 or older by the end of the tax year for which the HSA contribution is made may make a larger

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Timing Year-end Charitable Contributions

Making a charitable donation is admirable, but the tax deduction is nice, too. A charitable contribution is generally deductible in the year the property is delivered to the charity, which is when the taxpayer parts with the ability to control it. However, a charitable payment can take many forms. Whatever the form, if the deduction is substantial, the taxpayer can avoid reporting issues by inquiring about the charity's policies and procedures for recording the date of the gift prior to making the donation. This is especially important for year-end contributions or any instance in which timing is a key factor.

A payment by check is deductible in the year the check is mailed or unconditionally delivered to the charity, if it clears the bank within a reasonable time. Therefore, a check dated and mailed on December 31 is deductible in the year it is mailed. Although not specifically stated in the federal regulations, apparently a postmark showing the date the check was mailed would suffice (as it would prove the timely filing of a tax return). If a large contribution is mailed on December 31, it is advisable to use certified mail and retain the receipt to prove the mailing date.

Update on Employer-provided Cell Phones

A provision of the Small Business Jobs Act of 2010 (2010 Jobs Act) relaxed the onerous record-keeping requirements for business-provided cell phones. However, the 2010 Jobs Act did not alter the requirement that, in certain situations, personal use of an employer-provided phone would be treated as a taxable fringe benefit to the employee.

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In response to numerous questions concerning the tax treatment for the cost of employer-provided cell phones used personally, the IRS recently issued guidance on this topic. This guidance indicated that when an employer provides an employee with a cell phone primarily for business reasons, the IRS will treat the employee's use of the cell phone for reasons related to the employer's trade or business as a working condition fringe benefit. The value of this benefit is excludable from the employee's income, and the substantiation requirements that the employee would have to meet in order to deduct the cost are deemed to be satisfied. In addition, the IRS will treat the value of any personal use of a cell phone provided by the employer primarily for business purposes as a *de minimis* fringe benefit excludable from the employee's income.

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deductible contribution. Specifically, the annual contribution limit is increased by $1,000 (in 2011 and 2012).

An HSA can generally be set up at a bank, insurance company, or other institution the IRS deems suitable. The HSA must be established exclusively for the purpose of paying the account beneficiary's qualified medical expenses. These include uninsured medical costs incurred for the account beneficiary, spouse, and dependents. However, for HSA purposes, health insurance premiums don't qualify.

Voluntary Contractor Settlement Program (VCSP)

Worker classification has generated controversy between taxpayers and the IRS for decades—with businesses pushing for independent contractor status and the IRS pushing for employee status. Businesses argue for independent contractor status to reduce or eliminate the cost of fringe benefits and payroll taxes. The IRS, on the other hand, wants workers classified as employees to facilitate the collection of payroll and income taxes and monitor taxpayer income levels.

Through the years, the courts have developed the concept of common-law employees and common-law independent contractors in precedent-setting case law. Under this concept, *employees* are workers over whom the business may legally control and direct both (a) what must be done, and (b) how it must be done. *Independent contractors* are workers over whom the business may legally control and direct only what must be done. The business may not control how, when, or where the work is performed. From this case law, the IRS has identified common-law factors that it believes most clearly show the degree of control between the worker and the business, and have grouped these factors into three general categories of evidence: behavioral control, financial control, and the type of relationship between the parties. The IRS has not, however, provided a clear line between independent contractor and employee status.

Now there is some relief for a business owner who previously classified workers as independent contractors and desires to classify those workers as employees and, in addition, limit the exposure to back taxes, penalties, and interest. The IRS recently launched a program that allows the voluntary reclassification of workers as employees outside of the examination context: the Voluntary Contractor Settlement Program, or VCSP. "This settlement program provides certainty and relief to employers in an important area," said IRS Commissioner Doug Shulman. "This is part of a wider effort to help taxpayers and businesses and give them a fresh start with their tax obligations."

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To be eligible for the VCSP, a business must have consistently treated the workers in question as nonemployees and filed all required Form 1099 information returns for those workers for the previous three years. In addition, the business cannot currently be under an audit by the IRS or under an audit addressing the classification of the workers by the Department of Labor or a state government agency.

To participate in the VCSP, a business must agree to prospectively treat the class of workers as employees during future tax periods. The business must also pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates. In return for the 10% payment, the business will not be liable for any interest and penalties and will not be subject to an employment tax audit for those workers for prior years. However, a business participating in the VCSP must also agree to extend the period of limitations on assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date on which the business has agreed to begin treating those workers as employees.

If the VCSP sounds a bit complicated, it is. But this may be a way to limit a business's past and future liability for taxes, penalties, and interest.

Please contact us if you have questions concerning the VCSP or any other tax compliance or planning issues.

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Turning a Hobby into a Business

During this period of economic uncertainty, taxpayers may consider turning a hobby into a full-time business. Unfortunately, the IRS has a lot to say when it comes to the business vs. hobby decision. It's not a problem as long as the new business turns a profit. And, it may be fine as well if the business produces a loss and the taxpayer enjoys the activity; even better if the loss can offset other income. However, if the business consistently generates losses, the IRS could determine that these losses are actually nondeductible hobby losses.

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Many hobby loss issues center on the weekend farmer or rancher. However, the hobby loss rules are applicable to any type of activity in which the taxpayer might engage. In any case, to escape the hobby loss taint and avoid ending up with nondeductible losses, the activity must be conducted with the actual and honest intent of making a profit.

There are generally two ways to avoid the hobby loss rules. The first is to show a profit in at least three out of five consecutive years (two of seven years for activities involving horse racing, breeding, or showing). If the safe harbor is met, the burden of proof for lack of profit motive is shifted to the IRS. The second way is to run the venture in a manner that shows you intend to turn it into a profit-making business rather than operate it as a mere hobby. The IRS regulations themselves state that the hobby loss rules won't apply if the facts and circumstances show that you have a profit-making objective.

The best way to prove that you have a profit-making objective is to run the new venture in a businesslike manner. Specifically, the IRS and the courts will look to the following factors: how you run the activity; your expertise in the area (and your advisers' expertise); the time and effort you expend in the enterprise; whether there's an expectation that the assets used in the activity will rise in value; your success in carrying on other similar or dissimilar activities; your history of income or loss in the activity; the amount of occasional profits (if any) that are earned; your financial status; and whether the activity involves elements of personal pleasure or recreation.

In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are taken into account. No one factor is determinative. In addition, it is not intended that only the factors described above are to be considered in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa.

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