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Annual Business Tax Newsletter November 2011

New for 2011

- **W-2s & 1099s:** There will be a \$200 penalty per form for each W-2 or 1099 that is not filed timely or prepared correctly. Be sure to file 1099-Miscs by January 31, 2012 to any individual or attorney who is paid more than \$600 annually.
- **1099-Ks:** If your business entity receives income via a credit card company or a third party transactions (PayPal), you will receive a 1099-K from them in January, 2012. The IRS requires that these payments are listed separately on your business income tax returns. Therefore, the revenue received will be broken into two categories: credit card income and non-credit card income. **It is critical that you provide us the 1099-Ks.** If this is not reported correctly on your income tax return, the IRS will increase the income by the amount on the 1099-Ks and therefore increase your tax liability.
- **Payroll Taxes:** The employee's social security tax reverts back to 6.2% of their gross wages effective January 1, 2012. It had been reduced to 4.2% during the 2011 year.
- **Electronic Filing:** Income tax preparers that prepare 11 or more tax returns must file the returns electronically. Our offices will be filing all business returns (corporate & partnership returns) electronically for the 2011 tax season.

Record Retention

In general, the IRS can only go back to audit your company for the previous 3 years unless they suspect tax fraud so it is advisable to keep all business documents for a minimum of 3 years. There are exceptions to this rule: for the purchase of assets, you will need to hold the purchase invoices or receipts for the entire ownership of the asset and 3 years beyond the sale of the asset. Purchase documents are required not only for an income tax audit but also for a personal property tax audit (conducted by your local government). Payroll records should be kept for seven years to include payroll earnings reports and quarterly payroll reconciliation reports to the IRS and your state government.

Accountable Plan for Employee Expenses

Most employers cover their employee's business expenses by reimbursing them. The expenses can be a deduction for the company and non-taxable income to the employee if the reimbursements are made in accordance with a written accountable plan that requires employees to substantiate all expenses and return any advances in excess of the expenses incurred within 60 days. **If an accountable plan is not followed, the employer is responsible for adding the reimbursements to the employee's wages as compensation.** This also hurts the employer because the employer will have to match the Social Security and Medicare on the additional compensation. A generic written accountable plan has been included at the end of this newsletter that you can use for your employees. I highly recommend that you take the time to have this form completed for any employee that you provide reimbursements to – without this proper documentation, your company could be denied tax deductions which could be very expensive and detrimental to the livelihood of your business.

Automobiles - An automobile must be used more than 50% in the taxpayer's trade or business to be considered qualified business use and to be eligible for accelerated depreciation. If you purchased, sold or traded a vehicle during the year, you need to provide us with the documentation of the transaction so we can properly record it for tax purposes. Written documentation should be kept recording your business vehicle usage. Reimbursements for personal use of vehicles owned by employees or owners can be made under the standard mileage rate or actual cost method if you have an accountable plan (see above).

Mileage - The standard business mileage rate for the 2011 year has been split: 51 cents per mile from January 1st to June 30th and 55.5 cents per mile from July 1st to December 31st. All business owners with vehicles should record their odometer readings as of 12/31/11 and record business miles for the year. The IRS requires written records if either the standard mileage rate method or the actual expense method is used. If you have employees, see both 'Accountable Plan for Employee Expenses' and 'Automobiles' above.

Meals - The deduction for meals and entertainment is 50% of the expense. Occasional meals provided to your employees may be 100% deductible - if the meals are on an occasional and infrequent basis (such as a holiday party), or are provided for the employer's convenience (for emergency work or during a particularly busy time when employees are required to stay on the job during mealtimes). An accountable plan should be in place to cover meal reimbursements paid to your employees. You should choose between an actual cost reimbursement or a per-diem rate based on federal guidelines. The IRS has strict substantiation rules for meals, entertainment & mileage – see my website or call the office for further details on these rules.

Taxes & Licenses

Personal Property Taxes & Business Licenses - All businesses must file annual personal property tax returns. These are filed with the county where both your business and assets are located and in the county where you perform work and maintain assets. The due date of these returns varies from jurisdiction to jurisdiction. Charges for personal property tax are based on the year of asset purchase and should match the assets that are depreciated on the business income tax returns. All businesses should also be registered for a business license. In Prince William County, there are no taxes due for the BPOL (Business & Professional Occupational License) tax until a business has gross revenues of more than \$100,000 annually. The BPOL form is due March 1st for both Fairfax County and Prince Wm County. Please be aware that as a business owner, you are responsible for filing these annual forms. Our office can help you handle these filings at your request but will not automatically file them on your behalf.

Estimated payments - Final 2011 estimated payments for corporations are due 12/15/11. If you need us to review your corporate estimates, we need your year-to-date accounting information by the first week of December. Final estimated payments for taxpayers who are self employed are due 1/15/12. Please contact our office before the end of the year if you have concerns regarding your estimated tax payments.

Employment Related Issues

Independent Contractors – Let's get this one right....The IRS can reclassify payments to individuals that have had no payroll withholdings if they determine that the individual is an employee instead of an independent contractor. Individuals **are employees** if they are working under the company's control: working per the instructions of the company regarding where to work, how to work, and using the company's equipment. Independent contractors are paid by the job or per commission. If you are paying an individual as an independent contractor instead of an employee, be sure to have a written agreement that spells out the terms of the work along with the individual's address and social security number for reporting purposes.

Important - All independent contractors should fill out IRS form W-9 (Request for Taxpayers Identification Number & Certification) and submit it to you. If the subcontractor does not pay taxes on his or her earnings, the IRS can come back and **charge you up to 30% backup withholding taxes!!** Let us know if you need any blank Form W-9s or a generic copy of an Independent Contractor's agreement. The business owner is required to issue a 1099-Misc to any individual or attorney who is paid more than \$600 annually on a timely basis to the IRS or be subjected to penalties.

W-2s - If you mail a W-2 to an employee's last known address and it is returned, you are required to keep that W-2 on file for four years.

W-4s & I-9s - Employees should fill out new W-4s in January. Employee names and social security numbers must match their social security cards exactly. Employers will be penalized if numbers are incorrect or missing. The IRS has adopted a zero tolerance policy for incorrect filings of the W-2s.

All new employees should have filled out an I-9, which verifies the employee's citizenship. The employer penalty for not having the I-9 form on file starts at \$100.00 per employee and can go as high as \$1,000 per employee. The I-9 form must be on file by the end of the third business day after the employment date and must be retained for the longer of 3 years or 12 months after termination. I-9s can be found at www.uscis.gov/files/form/i-9.pdf.

Minimum Wage – The minimum wage is \$7.25 per hour as of 7/24/09.

Workers Compensation - Virginia law requires every employer who employs three or more full-time or part-time employees to purchase and maintain workers' compensation insurance. Employers with fewer than three employees may voluntarily comply with the Act. If you are interested in further Virginia employer obligations, visit: www.vwc.state.va.us/employers_guide.htm

Employee Benefits

Employing Your Spouse & Children - If you are operating as a sole proprietorship, it may be beneficial to employ your spouse and/or children. You do not have to withhold social security and Medicare taxes if your child is under the age of 18. Both the spouse and the children are exempt from federal and state unemployment taxes. To the extent family members earn income; they can contribute to IRA accounts on their own behalf. Even better, a retirement plan can be set up to reduce the federal tax liability of the sole proprietor and defer income of the employees (the spouse and children).

Even if you are incorporated, you may want to consider employing your children for minimal clean-up work so that they can earn at least \$5,000 per year to put into a Roth IRA. If they have no other earnings, there should be no federal or state tax liabilities; and when the money is withdrawn within the Roth account guidelines, it will be tax-free. Money that is earned in the Roth IRA will never be taxed if the guidelines are followed!!

Retirement - Retirement fund contributions are an excellent way to defer or reduce taxes. SEP (Simplified Employee Pension) plans can be set up and funded until the extension due date of the return. Example: The tax return can be prepared with a retirement contribution deduction, but the taxpayer does not have to fund the contribution until the extension due date of the return. The 401K deferral amounts for the 2012 year have increased to \$17,000 (under age 50). If 50 years or older by December 31st the maximum deferral is \$22,500.

In order to take advantage of tax breaks associated with retirement funds, the fund must comply with IRS rules. Meeting with a financial advisor may be helpful so that your specific needs may be addressed. There are **severe** penalties if you have set up a retirement plan and it is not being funded, maintained, or deducted on your income tax return properly.

Health Care Credit – This is available for those employers that employ & pay for at least 50% of the health insurance premiums for each employee. There are several qualifications that the employer must meet including employing less than 25 full time employees with an average annual wage of less than \$50,000. We will be reviewing each client for this credit.

Health Insurance for adult children - Health care insurance under a group plan must offer available coverage for an adult child until the child turns 26 years of age. Self employed individuals and more than 2% shareholders of an S Corporation may deduct health insurance premiums paid for a child under age 27 if the child does not have access to coverage elsewhere.

Additional .9% Medicare Tax – The employer will NOT be paying this tax. Effective January 1, 2013 there is an additional tax of .9% for taxpayers (other than corporations, estates, or trusts) that have total wages in excess of \$250,000 for Married Filing Jointly and \$125,000 for Married Filing Separately and \$200,000 for all others. If the employer has an employee with wages in excess of these amounts, the employer will withhold the additional .9% & submit it to the IRS but will NOT match it.

Additional 3.8% Medicare Tax - An additional 3.8% of tax will be imposed starting January 1, 2013 on net investment income for individuals, estates, and trusts. This tax will be calculated on the individual's 1040 and will be imposed on interest, dividends, annuities, royalties, and rents.

New Limits on Medical Deductions – Effective January 1, 2013, the medical deductions on the individual tax returns are only deductible if they exceed 10% of the adjusted gross income. The current law is 7.5%. Seniors (age 65 and older) will get a waiver until 2017.

Penalty Imposed on Individuals Who Fail to Maintain Health Insurance Coverage – Effective January 1, 2014, individuals will be charged a penalty on their personal income tax return for each month they do not maintain health care coverage for themselves. The fee will be an amount equal to 1/12 of the greater of a flat dollar amount or a percentage of income. The flat fee is \$95 for 2014, \$325 for 2015 and \$695 for 2016.

Other Business Income & Expenses

Financial Distress & COD – What is COD? Cancellation of Debt. Many businesses are still struggling and don't realize that they may have taxable income when unpaid debts are forgiven. Cancellation of debt or debt forgiveness creates a tax burden but there are exceptions for tax relief. The two main exceptions are bankruptcy and insolvency. Please contact us if you are going to walk away from a failing business so we can discuss your options and their potential tax consequences.

Depreciation - Section 179 allows a business to speed up the depreciation deduction and take the full purchase price of an asset, subject to limitations, in the first year that the asset is placed in service. The limit for Section 179 depreciation expense for assets placed in service during 2011 is \$500,000. See below for auto limits. **Tax Tip** - Place assets in service by 12/31/11 to take advantage of Section 179 if there is a profit in the company.

Vehicle Depreciation - Most passenger vehicles have limited depreciation for the first year they are placed into service **unless** they have a 6,000 lbs. loaded gross vehicle weight, which includes many heavy sport utility vehicles. What does this mean to the business owner who uses his or her vehicle more than 50% of the time for business? You can purchase one of these vehicles and use the Section 179 deduction maxed at \$25,000 or regular depreciation. Please note that there are some down sides to using the Sec 179 tax break.....1) The majority of the depreciation would be used up in the first year whereas it might be better tax wise to spread it out over the 5-year class life of the vehicle, 2) If the business use falls below 50% or the vehicle is disposed of, there will be a recapture of income for the amount of depreciation that was taken for years it is not in service. Please see my Web site at www.lascpa.com (go to the 'Information Center') for a detailed list of vehicles that qualify as having a gross vehicle weight of 6,000 lbs or more.

Business Gifts - The maximum deduction for a business gift is \$25.00 per gift. Any amount greater than \$25.00 for the purchase of a gift is considered to be nondeductible. Note: This IRS limit has remained the same for **48** years!

Home Office - To qualify for a home office deduction, you must exclusively use a portion of your home to carry on a trade or business. If you are unable to permanently segregate a room, you should at least use some sort of screen or divider to establish exclusive use of one section. Also bear in mind that to obtain a home office deduction under the exclusive use rules, you must use your home office computer 100% of the time for business. Even using it occasionally for personal purposes can cause your home office to be non-deductible.

Corporate Issues

Reasonable Salary – Owners and officers of corporations are considered to be employees per the IRS Code and they should not attempt to avoid paying employment taxes by taking distributions, loans, or paying personal expenses out of the corporation instead of taking a salary. They are required to take reasonable salaries based on their training, experience, duties, time, effort, dividend history, manner of payment to other key employees, and comparable services paid by other businesses to perform the same work. Distributions should never be taken in place of wages.

Leases - If a corporation rents or leases property owned by the shareholder, the lease should be in writing and the rent charged must be at fair market value.

Shareholder Loans - Closely held corporations are regularly subjected to IRS scrutiny because of loans made to stockholders. The IRS often takes the position that the loans are really disguised dividends - especially in the case of loans that remain on the books year after year. This could result in the loan being included in the recipient's income. This can be avoided by having a more formal loan agreement or promissory note in place. S Corporation shareholder loans must be put in writing with set repayment dates in order to justify basis in the company – documenting these loans ultimately could allow for the deduction of losses on the shareholder's personal income tax return. If the loan is used as a basis to deduct losses, future loan repayments may result in taxable income. Each loan should have a separate agreement. Contact us to make sure your loans are properly documented to avoid this problem.

Corporate Minutes - Keeping complete and accurate minutes of your shareholder's meetings may seem like a bothersome task. But the time spent now can save your corporation a great deal of money later on. Please take a few minutes to update your corporate books before year-end.

Privacy Statement

Federal law requires that once a year I inform you of our Privacy Policy. As you know, we collect certain personal information about you in order to prepare your tax returns. The information is either provided by you or obtained by our office with your permission. No personal information will ever be disclosed about you to anyone outside our firm except that which is already public by law or necessary to complete your work.

Should you become an inactive customer, we will continue to adhere to the policy regulations as written here. The information you give us about your personal or business records is reserved only for our employees who need to know in order to service your account. Procedural, physical, and electronic safeguards will be maintained in compliance with federal standards regarding your personal information. We are committed to retaining your confidence and want to assure you that any information you give us remains safe and confidential.

Accountable Plan

To: All Employees
From: Management
Re: Reimbursement of employee business expenses

Management has authorized the following accountable plan to reimburse employees for expenses of travel, transportation and entertainment that are ordinary and necessary.

Reimbursement will not be considered compensation to the employee if the following requirements are met:

1. The employee must substantiate the covered expenses to the employer within 60 days after it is paid or incurred, and
2. The employee returns amounts in excess of the substantiated expenses to the employer within 120 days after an expense is paid or incurred.
3. All expenses must be ONLY for business travel, lodging and meals – no personal items or personal entertainment.
4. Mileage records will be submitted by employee for reimbursement. Mileage will be reimbursed per the allowable rates established by the Internal Revenue Service:
 - a. .51 cents per mile from January 1, 2011 to June 30, 2011.
 - b. .555 cents per mile from July 1, 2011 to December 31, 2011.
 - c. .555 per mile for 2012.

If the above requirements are not met, the reimbursement will be considered compensation subject to all payroll withholding rules. Since the reimbursement is included in W-2, the employee may claim the business expense as a miscellaneous itemized deduction subject to the 2% adjusted gross income limitation.

Employee consent:

I have read the above memo and understand its implications.

Employee Signature

Date