Small Business
December 2009 – Special Issue

TAX STRATEGIES

Grow your profits—pay less tax

National Institute of Business Management

Action Line

■ **Expand your party guest list.** Are you hosting a get-together and inviting a few top-echelon employees? Invite the entire workforce instead. *Reason:* You can write off 100% of your cost instead of the usual 50% limit for entertainment deductions.

■ **Make it a tax-deductible sea cruise.** The IRS permits you to deduct up to $2,000 when attending a business convention or seminar held aboard a U.S.-flagged cruise ship. To qualify, you must establish that the cruise ship is U.S. registered and all ports of call are in the United States or its possessions. The business meeting must be the trip's primary purpose.

■ **Take the easier path to employment tax filing.** If your company expects to owe less than $1,000 in employment taxes annually, it can file Form 944, *Employer's Annual Federal Tax Return*, once a year rather than filing the quarterly Form 941.

■ **Use the new IRS web tool for retirement plans.** Uncle Sam has developed another interactive web tool for employers. Now you can determine your company's responsibilities under the Employee Retirement Income Security Act (ERISA) online. Access the ERISA Fiduciary Advisor at **www.dol.gov/elaws/ERISAFiduciary.htm**.

INSIDE

■ Just say no to family inheritance? 3
■ Lessons from the Tax Court 3
■ Set your 401(k) on 'autopilot' 4
■ Buy company assets, rent them back. . . 5
■ Grab new manufacturing deduction. . . . 6
■ 8 best tax breaks in stimulus law 7
■ Mail Call 8

Create tax breaks: Buy parents' home, rent it back to them

Say your aging parents live in a home that has appreciated in value, but they're no longer reaping any of the homeownership tax breaks during their retirement years. Sound familiar?

Good news: With one stroke of the pen, both you and your parents can win: They'd gain instant access to their home equity (without moving) and you'd pick up some generous new tax deductions.

How? Buy your parents' house, and then rent it back to them—at the going rate.

Reasons for the sale/leaseback. Under the current homeownership setup, your combined family unit is overpaying the IRS.

Your parents' mortgage is either paid off or the payments represent mostly principal at this point. Even if they still take interest deductions, your parents' tax bracket might be low in retirement, so those deductions don't provide much tax savings. In fact, many retirees take the standard deduction rather than itemizing.

Here are two good reasons for your parents to opt into this plan:

1. It puts cash in their pockets without having to refinance or dip into a home equity loan.

2. It allows them to put their money into safer investments than the real estate market.

Transferring the house. To avoid gift-tax complications, pay a fair price for the home. Support the buying price with a qualified and independent appraisal.

Continued on top of page 2

Grab 5 quick tax perks: Put spouse on payroll

Does your business need trustworthy and reliable employees? You may not have to look any further than across the dinner table.

Strategy: Hire your spouse to work as an official employee. Why put your spouse on the payroll? Because you can gain five tax benefits:

1. Build up tax-favored funds for retirement

If you meet the tax-law requirements, your company can deduct contributions made to a qualified retirement plan on your spouse's behalf. The annual limits are quite generous. If your company has a defined contribution plan, you can deduct contributions up to 25% of compensation or $49,000, whichever is less, for 2009.

With a 401(k) plan, another dollar limit applies: Your spouse can defer up to $16,500 to the plan in 2009 (plus an extra $5,500 if he or she is age 50 or older). Your company can match those contributions wholly or partially up to tax-law limits.

2. Shift taxable income away from the company

If you operate a C corporation, any compensation you pay to your spouse would have to stay with the company. Assuming your corporation is in a higher tax bracket than your personal tax bracket, you'll save tax overall if your spouse draws a salary. But don't look for any income-shifting tax benefit—possibly a drawback—if your

Continued on bottom of page 2

Parents' home (Cont. from page 1)

Then, both sides should enter into a lease at a fair rental value.

One benefit: Courts have said that landlords can reduce their fair-market rent by 20% when renting to relatives. That lower rent reflects the savings in maintenance and management costs. (*L.A. Bindseil,* TC Memo 1983-411)

But don't set the rent too low; the IRS might say the rental home is really for your personal use. In that case, your deductions might be limited to mortgage interest and property tax, the same as if you owned a vacation home.

Taking deductions. Once you own your parents' house, you're entitled to reap the tax benefits of owning rental property.

That includes taking write-offs for operating expenses, such as utilities, maintenance, insurance, repairs and supplies.

You also can claim depreciation deductions for the home, but you can't depreciate the cost of the property apportioned to land.

So, obtain an appraisal allocating the price paid between the depreciable structure and the nondepreciable land.

You can use these deductions to offset the rental income received from your parents. Any allowable tax loss will phase out for people with adjusted gross incomes between $100,000 and $150,000. You can take any suspended losses when you sell the house.

Bonus benefit: Once you own the house, you may be able to write off occasional travel expenses you incur when visiting the house (your rental investment).

Endgame: Eventually, your parents won't be able to live in the house. Then, you can sell it, rent it to another tenant or move in. If you move in and make it your principal residence for at least two years, you can sell it and shelter another $250,000 or $500,000 worth of capital gains: a true tax bonanza!

Grab 5 tax perks (Cont. from page 1)

company falls in a lower tax bracket than your personal bracket.

Note: S corporation owners and sole proprietors don't pay corporate income tax. You report business income on your personal return whether or not you pay your spouse a salary. So this could be a wash.

3. Get more tax mileage from business trips

Generally, you can't deduct the travel expenses attributable to your spouse if he or she accompanies you on a business excursion. However, if your spouse is a bona fide company employee and goes for a valid business reason, you may deduct his or her travel costs, including air fare, lodging and 50% of the meal expenses. The benefit also is tax-free to your spouse.

4. Cure health insurance coverage ills

If you're already paying more to cover your spouse under your company health insurance plan, hiring him or her shifts the expense to your company. Typically, your company can deduct your spouse's full health insurance cost. Even self-employeds can write off 100% of the cost under a so-called Section 105 medical-reimbursement plan.

5. Join the employer-paid life insurance group

Your spouse is entitled to the same group-term life insurance coverage as your other employees.

Key point: The first $50,000 of employer-paid, group-term coverage is tax-free to an employee.

However, one catch for S corp owners: Generally, you can't deduct fringe benefits, such as group-term life insurance, for any employee who owns 2% or more of the company. By extension, that rule also applies to an employee-spouse.

Follow the tax prescription to the letter

For years, self-employed taxpayers operated at a tax disadvantage: They could not deduct the full cost of family health insurance premiums. But they could circumvent that tax rule with a "back door" approach: By hiring a spouse as a bona fide employee, the spouse would be eligible to receive tax-deductible coverage.

Best of all, tax-advantaged coverage could be extended to other family members—including the business owner—if certain requirements were met.

Recent case: Mr. Albers, an unincorporated farmer, established a written agreement for his spouse to provide services to the business as a bona fide employee. Mr. Albers claimed that he, as the employer, paid out medical reimbursements under the arrangement as purported compensation to his wife.

The Tax Court concluded that the farmer paid the medical expenses directly himself. They were not paid to his spouse to reimburse her. Therefore, they did not qualify as deductible business expenses. (*Albers,* TC Memo 2007-144)

Tip: Taking the back-door route no longer is necessary for self-employeds. But the case points out the need to observe all the law's intricacies if you want to set up a Section 105 medical-expense reimbursement plan.

Say no to a family inheritance? Well, maybe

Sometimes it makes sense to look a gift horse in the mouth. Suppose you expect a whopping inheritance from an elderly parent, and you plan to pass on Mom's or Dad's assets to your children because you don't need the money.

Strategy: Turn down the inheritance. You can use a "qualified disclaimer" to keep your mitts off the money. Have an attorney provide the necessary paperwork.

If your parents' assets bypass you on their way to your kids, the family can cut its overall estate-tax bill. Similarly, a disclaimer may save tens of thousands of dollars in estate taxes when a spouse passes away (*see box, right*).

Let's take a closer look: A qualified disclaimer is a written, irrevocable decision by the estate's beneficiary to refuse all or part of a bequest. The beneficiary must make the disclaimer within nine months of the decedent's death and before the property has been received. The main point here is avoiding an extra estate-tax bill. Under the current estate-tax rules, a person who died in 2008 could have passed up to $2 million estate-tax-free to nonspouse beneficiaries. The estate-tax exemption increases to $3.5 million in 2009. *Even better:* The federal estate tax is scheduled to go away completely in 2010.

However, unless Congress amends the law, the estate tax will be revived in 2011 with only a $1 million tax-exemption shelter. So you still must plan carefully to avoid dire estate-tax consequences.

Estate-tax dilemma: When you receive an inheritance from a parent, any amount above the estate-tax exclusion is subject to estate tax when you die. Thus, the same assets could be taxed twice, once in your parents' estate and again in your estate.

A qualified disclaimer avoids that harsh result. Federal estate tax is due only once when the assets pass to your children. If your parents' estate is worth less than $3.5 million, no estate tax is due, even if those assets could be worth considerably more upon your death.

Note: Certain transfers that "skip" a generation —such as direct bequests from a grandparent to a grandchild—are subject to a special generation-skipping tax (GST).

Tip: The GST exemption, which mirrors the regular estate-tax exemption, is $3.5 million for decedents dying in 2009.

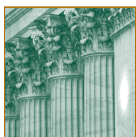
Example: Avoid 'marital problems'

Say a husband and wife own $4.5 million in assets. They have two adult children. Assume the husband dies in 2009 and leaves his entire estate to his wife. The unlimited marital deduction covers the entire amount, so the wife won't owe any federal estate tax.

But suppose the wife dies shortly thereafter in 2009. If so, $1 million of the wife's assets will be exposed to estate tax after using the federal tax exemption. The estate-tax bill comes to a whopping $450,000.

Alternatively, the wife can disclaim part of the bequest. *Example:* If she bypasses $1 million in assets, that amount can be passed to her two children without any estate-tax consequences. The transfer is completely sheltered from estate tax by the exemption for the husband's estate.

Bottom line: No federal estate tax when the husband dies, and none when the wife dies either.



Lessons from the Tax Court

■ **Add tax insult to injury.** A recent decision by the Court of Appeals for the District of Columbia finally ended one of the most topsy-turvy cases in recent years. The court rejected a request to review the reversal of a tax-free award for nonphysical damages. This tax treatment is only available for damages resulting from physical injuries.

The case: A taxpayer filed a complaint against her employer for unlawful discrimination in 1994. The administrative law judge awarded her $45,000 for past and future emotional distress and $25,000 for injury to her professional reputation. She reported the entire award as taxable income.

Subsequently, the taxpayer filed for a refund, which the IRS denied. She sued in federal district court, claiming that the award did not represent taxable income within its constitutional meaning. A trial court rejected her claim, but the D.C. Circuit Court surprisingly sided with the taxpayer. After the IRS petitioned for a rehearing, the Court of Appeals, on its own motion, vacated its judgment and reheard the case earlier this year. Then the three-judge panel reversed the original decision. *Reason:* The panel said that imposing tax on compensatory damages for emotional distress and injury to professional reputation was not unconstitutional.

The taxpayer requested that the full court rehear the panel's decision. The court denied the request. It noted that no member of the court had requested a vote on the petition. *(Murphy, CA-DC, No. 05-5139, 9/14/07)*

Bottom line: Awards for nonphysical injuries, such as emotional distress, will continue to be taxable. You can choose to fight this issue in a different jurisdiction, but you'll face an uphill battle.

Set your 401(k) on 'autopilot' to stockpile more for retirement

You can't deny that a 401(k) plan is an excellent deal. You defer part of your salary to an account where it can grow tax-deferred. Usually, your company will match part or all of your deferral.

But, if you're one of the company's top wage earners, you must contend with annual limits on contribution amounts. Even worse, contributions for highly compensated employees (HCEs) may be reduced under strict nondiscrimination rules if enough lower-compensated employees don't join in the plan.

Online resource

For more details on auto enrollment plans, go to **www.dol.gov/ebsa**.

Strategy: Turn your 401(k) into an auto-enrollment plan. Amend the existing plan document so that employees are enrolled automatically, unless they opt out. Otherwise, a "default contribution" is made on their behalf.

By adding this feature, it's likely that a higher percentage of non-HCEs will participate in the plan. So you should be able to stockpile even more money for retirement.

Is it legal? Absolutely. The Pension Protection Act of 2006 (PPA) encourages auto-enrollment plans, effective beginning in 2008 (*see box, below*).

Here's the whole story: The dollar limit on deferrals to a 401(k) for 2009 is $16,500. Plus, you can defer an extra $5,500 if you're age 50 or older. *Icing on the cake:* Within limits, the employer can provide matching contributions (e.g., 50 cents on the dollar) that also grow tax-deferred.

To qualify for those tax benefits, the plan must satisfy tough testing requirements to ensure that it doesn't discriminate in favor of HCEs.

For starters, the plan must meet participation and vesting rules that apply to all tax-qualified plans. In addition, a 401(k) plan must pass both an actual deferral percentage (ADP) test for pre-tax contributions and an actual contribution percentage (ACP) test for matching contributions.

If the 401(k) plan fails on either count, the employer has to make corrective distributions to HCEs or kick in extra contributions for non-HCEs. *Safe-harbor rule:* The employer can satisfy the rules if it provides minimum contributions of at least 3% of compensation to the lower-paid group.

If some of your employees don't participate in the plan, it could rain on your parade, one way or another.

The auto-enrollment feature generally eliminates the doubt. More employees are inclined to go along with the program if they must take action to decide against it. With the auto-enrollment feature, the plan should be able to easily pass both of the tough nondiscrimination tests.

Prior to the PPA, the IRS gave its blessing to auto-enrollment, provided that employees were properly notified and could revoke the automatic deferral at a later date. Proposed regulations issued in 2006 spelled out the rules for establishing investment defaults.

Tip: An auto-enrollment plan can help lower-paid employees save for retirement when they otherwise would not have done so. So everyone benefits under this type of setup.

New opportunities for auto-enrollment plans

The Pension Protection Act of 2006 (PPA) liberalizes the rules for 401(k) plans that are treated as "automatic contribution arrangements." Some of the key changes:

- Previously, employers were concerned about potential violations of state wage-and-hour laws. The PPA pre-empts state laws that could interfere with the operation of an auto-enrollment plan.
- PPA relieves plan fiduciaries of their fiduciary responsibilities for investing employee contributions in a qualified default alternative when the employee fails to make an investment election.
- The act extends the time period for making corrective distributions for failed ADP/ACP testing from 2½ months after the close of the plan year to six months after the end of the plan year.
- Under the PPA, a qualified automatic contribution arrangement provides a safe harbor from ADP/ACP testing if it meets certain technical requirements (e.g., an automatic deferral for eligible employees must equal at least 3% of compensation for the 2009 plan year, but not more than 10%, increasing by 1% per year for three years).
- In determining "eligible employees" for plan purposes, plans with existing auto-enrollment features can exclude eligible employees who already participate in the plan or have elected not to participate.
- Employer contributions to the plan are vested after two years of service.
- The regular restrictions on 401(k) plan withdrawals apply to auto-enrollment plans.

Tip: Take steps now to implement changes.

The PPA rules went into effect for plan years beginning in 2008.

To slash taxes, buy assets and lease them back to your company

It's bad enough when you have to pay tax once to the IRS. But C corporation owners are hit with a double tax whammy: first, when the corporation pays tax and, second, when Uncle Sam taxes them personally on dividends paid out by the company.

Strategy: Buy property and assets personally and lease them back to your company.

That way, the company pays you deductible lease payments instead of nondeductible dividends, and you can offset the income with depreciation or amortization deductions.

That technique works particularly well with real estate and other assets that are likely to appreciate in value.

In fact, if your company already owns a business building, you can buy it from your company now and then lease it right back.

Example: sale-leaseback deal. Suppose your company bought its building years ago and has since depreciated it down to zero. You estimate that the building and adjacent land are currently worth $1.5 million. Your company needs a quick cash infusion for proposed expansion, but money is tight.

Solution: Buy the building from your company for $1.5 million—using mostly cash you've borrowed—and lease it back. Then you begin depreciating the building all over again, using a 39-year write-off period. Your company pays the going rate for rentals in your area, but the rental income is offset by the depreciation and other related expenses.

Your company now has the cash it needs for expansion and can deduct rental payments for a building that had previously been fully depreciated.

This strategy works especially well with real estate and other assets that are likely to appreciate in value.

In comparison, your company receives no tax deduction for money paid to you as dividends. The downside is that the company must pay tax on the gain.

Fly under IRS radar. This technique can be perfectly legal, but the IRS often casts a skeptical eye on such deals.

To make sure your deal is legit and satisfies IRS standards, meet these five requirements:

1. The property's useful life must exceed the lease term.

2. Any lease renewal is set at a market value.

3. The buyer reasonably expects to profit from the deal.

4. The property is sold at a fair price, and the buyer assumes the risk of losing money.

5. A valid nontax business reason exists for the rental (e.g., leasing assets instead of owning them can release working capital).

Property value declining but assessment still sky high? How to fight it

In many U.S. cities, houses bought years ago quickly doubled in value. But now values are declining, yet your "paper windfall" still shows a high property tax bill.

Our advice: Appeal it if you think you have grounds.

As much as 60% of U.S. property is overassessed, according to the National Taxpayers Union.

Five tips:

1. Don't delay. In some areas, you have only 30 days to appeal.

2. Check proportions. Examine the notice to see whether it overstates your home's dimensions. Mistakes occur frequently. Some assessors don't even come on site; they simply compare comps in your neighborhood.

3. Compare your assessment to a half-dozen similar homes (in size, age and location) at the assessor's office or a home-search site.

4. Battle the bureaucracy. If your assessment seems high, arrange a meeting at your assessor's office.

Bring all evidence: photos, data on comps, etc. You may get a tax reduction based on obvious facts. If it doesn't work, you can still file a formal appeal.

5. Consider a consultant. If you don't have time to fight city hall, property tax consultants or attorneys can do the legwork. Fees are charged by contingency, a flat fee or by the hour.

Nonmanufacturers: Cash in on 'manufacturing' write-off

Don't be deceived by the nickname of an important tax deduction recently made available to U.S. businesses.

The "manufacturing deduction" doesn't favor only industrial giants. Many small businesses can squeeze through the loopholes opened up by this law.

Even better, recent IRS regulations show that many businesses that aren't considered traditional manufacturers will qualify under the law's definition of a "domestic manufacturer," including some construction, engineering, film-production and computer software firms.

Advice: Tailor your business operation to qualify. Nontraditional manufacturers fit snugly under the technical qualifications, and small businesses can use safe-harbor rules to cut down on the paperwork.

Tax break favors smaller firms

Congress threw businesses this tax-break bone in 2005 to compensate for a repealed export subsidy. It isn't limited to C corporations; just about any business entity can claim the manufacturing deduction, including S corporations, partnerships, sole proprietors and even estates and trusts.

Qualified businesses can take a "domestic-production activities deduction" for gross receipts derived from the sale, lease or rental of tangible personal property (e.g., clothing, goods, food and computer software).

How much is it worth? Potentially, a lot. For 2007 through 2009, qualifying businesses can deduct 6% of their qualifying income from domestic-production activities. The deduction percentage is scheduled to increase to 9% in 2010.

For example, if your company is taxed at the top 35% corporate rate, the deduction will eventually translate in 2010 into a 3.15% cut in your tax rate (9% deduction times 35% tax rate). **Note:** The annual deduction is limited to 50% of the W-2 wages for qualified domestic production activities paid during the year.

Must be made in the USA. Production activities must be performed in whole or in "significant" part in the United States.

As long as your labor and overhead costs for the manufacture, production growth and extraction of the property equal at least 20% of the total cost for the property, it will be treated as being manufactured in "significant" part.

3 ways to expand your write-off

If you think you may qualify, talk to your tax advisor. For example, if you were eligible in 2008, you may amend your 2008 return to grab the deduction. Here are three ways to secure and expand your tax savings:

1. Review pricing policies. It may be possible to boost the deduction by adjusting your pricing method. For instance, if you currently charge separately for a product and its warranty, you might bundle them together to increase its gross receipts.

2. Cut back on outsourcing. Since the deduction is limited to 50% of the W-2 wages paid out, you may want to reduce your reliance on independent contractors, if that makes sense.

3. Increase U.S. production. You can claim the deduction only if at least 20% of your labor and overhead costs are incurred domestically. Companies near that threshold may want to increase production activities at home.

☑ **Yes, I want to start my subscription to *Small Business Tax Strategies* for only $97!**

Name________________

Company________________

Address________________

City, State, ZIP________________

Phone________ E-mail________________

Payment Method:

❒ Credit card ❒ Visa/MC ❒ AMEX ❒ Discover

Fax this form to (703) 905-8040

Card #________________ Exp. date________

Signature________________

❒ Check/money order *Mail to:* Small Business Tax Strategies, *P.O. Box 9070, McLean, VA 22102-0070*

❒ Bill me

Contact our Customer Service Center at (800) 543-2055, M-F, 9 a.m.-5 p.m. ET, or e-mail us at customer@NIBM.net.

SB6642

S T A F F

Publisher: Phillip Ash, CPA

Associate Publisher: A. Paul Ash, CPA

Editor: Ken Berry, SBTSeditor@NIBM.net

Senior Editor: Carolyn Frazier, (703) 905-4575, cfrazier@NIBM.net

Contributing Advisor: Bill Bischoff, CPA

Copy Editor: Cal Butera

Production Editor: Nancy Asman

Customer Service: (800) 543-2055, customer@NIBM.net

Small Business Tax Strategies (ISSN 1935-1992) is published monthly by the National Institute of Business Management LLC, 7600A Leesburg Pike, West Building, Suite 300, Falls Church, VA 22043-2004, (800) 543-2055, **www.SmallBizTax.net**. Annual subscription price: $192.

© 2009, National Institute of Business Management. All rights reserved. Duplication in any form, including photocopying or electronic reproduction, without permission is strictly prohibited.

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering financial or legal service.

Get your piece of the pie: 8 best tax breaks in the stimulus law

Are you collecting your maximum tax breaks from the massive economic stimulus law passed earlier this year?

The IRS just issued a fact sheet touting the tax perks available to small business owners under the new American Recovery and Reinvestment Act of 2009. *(IRS FS-2009-11)*

Here are eight key provisions:

1. Bonus depreciation. The new law extends the special depreciation deduction that was available in 2008 to acquisitions of qualified new (not used) assets in 2009. This provision enables a business to deduct 50% of the cost of an asset in the year it is placed in service. The extension applies to qualifying assets placed in service in 2009 (2010 for property with a cost recovery period of 10 years or longer and certain transportation property).

2. Acceleration of business credits. Corporations that acquire eligible business property are granted an extra year to accelerate certain tax credits in lieu of claiming bonus depreciation. The extension applies to eligible business property placed in service in 2009 (2010 for property with a cost recovery period of 10 years or longer and certain transportation property).

3. Section 179 expensing. A small business can elect to expense up to $250,000 of the cost of qualified assets placed in service in its tax year that begins in 2009. Without the new law, the limit would have dropped to $133,000. The existing $25,000 limit still applies to sport utility vehicles (SUVs).

Note: The $250,000 allowance for 2009 is reduced if the cost of all Section 179 property placed in service during the year exceeds $800,000.

4. Net operating losses (NOLs). If a small business had expenses exceeding its income for its taxable year beginning or ending in 2008, it can elect to carry the loss back for up to five years instead of the usual two years. For small businesses that were profitable in the past but lost money in 2008, that could mean a special tax refund. To be eligible, the business must have an average of no more than $15 million in gross receipts over a three-year period.

Note: This option is available only for a limited time. For example, a corporation operating on a calendar-year basis must file an NOL carryback claim by Sept. 15, 2009. For eligible individuals, the deadline is Oct. 15, 2009.

5. Estimated tax payments: For 2009, eligible individuals can make quarterly estimated tax payments equal to 90% of their 2008 tax liability under a modified safe-harbor method. Previously, this safe harbor had to be based on 100% of your 2008 liability (or 110% if your 2008 AGI exceeded $150,000).

You may qualify if you received more than half of your gross income from your small business in 2008 and meet certain other requirements. See IRS Pub. 505, *Tax Withholding and Estimated Tax*, at **www.irs.gov/pub/irs-pdf/p505.pdf**.

6. Discharge of business debt. The new law allows certain businesses that repurchase specific types of debt in 2009 and 2010 to pay taxes on cancellation of debt income over a five-year period, beginning with the 2014 tax year.

The IRS is touting the tax perks.

7. Qualified small business stock. Now there's an added incentive to invest in small businesses. The exclusion for qualified small business stock (QSBS) is increased from 50% (60% for enterprise zone QSBS) to 75% for any gain from the sale or exchange of QSBS issued after Feb. 17, 2009, and before Jan. 1, 2011. The stock must be held for more than five years. This provision is not available to C corporation investors.

8. S corp built-in gains tax. For tax years beginning in either 2009 or 2010, the new law eliminates the corporate level tax on built-in gains of an S corporation that converted from C corp status at least seven tax years before the current tax year.

The IRS also refers to COBRA subsidies in the new fact sheet. Under the new law, employees involuntarily terminated after Aug. 31, 2008, and before Jan. 1, 2010, may be able to continue health insurance coverage for a nine-month period by paying only 35% of the premiums. Employers must pay the remaining 65%.

Tip: The employer's costs can be recovered through a payroll tax credit or reduced withholding.

Online resource

To read the entire IRS fact sheet, *Business Provisions of the American Recovery and Reinvestment Act of 2009*, go to **www.irs.gov/newsroom** and click on "2009 Fact Sheets" in the left column.

Mail Call

Deductions OK for 'homemade' mortgage

Q We gave our daughter and her husband money to buy a house, and they're paying us back, with some interest. Basically, it's just like a mortgage. Can they deduct the interest payments? R.R.S., Omaha, Neb.

A Yes, as long as you both meet certain requirements. Most important, for the loan to be deductible as qualified mortgage interest, it must be secured by the home. If you haven't done so already, run the loan agreement by an attorney. *One downside:* If your daughter deducts the mortgage interest, you must report the interest as taxable income.

Home office deductions: Stand on firm ground

Q In a previous issue, you stated that you could deduct home office expenses based on the number of rooms in the home. Do you have any authority for this statement? J.R.M., Largo, Fla.

A Yes. Typically, home office deductions are based on the percentage of business use (square footage of the business portion of the home divided by the total square footage). But the IRS says in Publication 587, *Business Use of Home*, a taxpayer *can* base the percentage on the number of rooms if the rooms are about the same size. For instance, say you use one room of an eight-room house for business. The room is 300 square feet out of a total of 3,000 square feet. In this case, the "rooms method" (12.5%) yields a bigger deduction than the square-footage method (10%).

Tip: Access Publication 587 at **www.irs.gov/pub/irs-pdf/p587.pdf**.

Tap unique tax break on company stock

Q When my friend retired several years ago, she didn't roll over her company stock into an IRA. (She had bought some of the stock and her employer gave her some.) If she sells the stock, will it be taxed as capital gain? F.G., King of Prussia, Pa.

A Partially. Assuming your friend holds the company stock in a qualified retirement plan, she's eligible for a unique tax break: If a retirement plan distribution is paid in company stock, the retiree is taxed at ordinary income rates on the stock's original cost. Any appreciation is untaxed. When she sells it, the difference between the sales price and the original cost is taxed as capital gain.

Deduct education costs for child/employee

Q My kids work for my business and also attend college. I found a course on family business at a different college that I'd like them to take. If I pay for the course, can I deduct the cost? A.C., Oxnard, Calif.

A Based on this information, the costs would be deductible if they clearly improve the skills necessary for your children's current jobs or if you simply treat the company-paid costs as additional compensation paid to your kids. If you personally pay the tuition as a parent, you can't take the deduction. That's why it's best to have the company pay the course expenses.

Dividing the spoils of a spousal IRA

Q I retired in 2006, but my wife is still working. I'm now 66, and my wife is 62. We both have IRAs and we file a joint tax return. Can we both still contribute to our IRAs this year? A.K., Margate, N.J.

A Yes. Since you qualify for a "spousal IRA" and you're both over age 50, you have until April 15, 2010, to jointly contribute up to $12,000 to your IRAs for the 2009 tax year (assuming either of you earned at least that much in compensation during the year). That maximum $12,000 contribution can be divided among your IRAs in any manner in which you see fit as long as no more than $6,000 is allocated to either account. You have until your tax return due date to make the annual contribution. **Tip:** To delay mandatory distributions from the IRA, allocate more of the contribution to the younger spouse.

Submit Mail Call questions to: SBTSeditor@NIBM.net.

The Tax Ticker

Beware of phony e-mail from 'IRS.' We've said it before; we'll say it again: Never send personal financial data in response to unsolicited e-mail. The IRS says scam artists are sending e-mails to random people, telling them they're due a refund or under investigation. The message directs people to a fake IRS web site that asks for personal data. In reality, the IRS won't contact you via e-mail.

Need an old tax return fast? Contact your tax advisor. A new IRS service lets tax practitioners receive transcripts of clients' tax returns electronically in minutes. Taxpayers can still receive a free paper transcript of their returns within seven to 10 days by calling the IRS at (800) 829-1040.

Know the difference between gifts and compensation. If you give a favorite employee a big check at Christmas, you might consider it a gift, but the IRS will likely consider it income. That could be true even if the employee and owner were family. In one case, the IRS said payments to an owner's daughter (who was an employee) were for past services, not a gift. Talk with your tax pro if you face a similar dilemma.

SBTS-SIS-020