



## TAX ALERT

FEBRUARY 16, 2009

### CONGRESS REACHES AGREEMENT ON STIMULUS ACT

Tax provisions make up approximately 35% of the American Recovery and Reinvestment Act of 2009. The important provisions are as follows:

#### Tax Incentives for Businesses

- Extended bonus depreciation and increased expensing for investments in equipment and certain improvements in 2009.
- Longer loss carryback for small businesses (average gross receipts of \$15 million or less during the last two years and the current year).
- A cut in the taxable gains for investors in certain small businesses who hold stock for more than five years.
- Delaying the tax on businesses that have acquired their own debt under certain circumstances.
- Incentives to create new jobs with tax credits for hiring recently discharged unemployed veterans and youth that have been out of work and out of school for the six months prior to hire.

#### Tax Relief for Individuals and Families

- A Making Work Pay credit, consisting of a refundable tax credit of up to \$400 per worker (\$800 per couple filing jointly), phasing out completely at \$190,000 for couples filing jointly and \$95,000 for single filers.

- Expansion of the child tax credit (allowing families to begin qualifying for the child tax credit with every dollar earned over \$3,000).
- Eased Earned Income Tax Credit rules (tax relief to families with three or more children and increased marriage penalty relief).
- A new, partially refundable \$2,500 higher education tax credit.
- A one-year AMT patch.
- An enhanced credit for first-time home purchases with the removal of the repayment requirement, if the home is held for more than three years. This credit phases out completely – \$150,000 joint return, \$75,000 single.
- One-time payment of \$250 to Social Security recipients.
- A tax deduction for state and local sales tax paid on the purchase of new cars, including light trucks and SUVs – total phase out \$250,000 - \$260,000 AGI for joint returns and \$125,000 - \$135,000 single.
- Temporary suspension of tax on the first \$2,400 of unemployment benefits.
- A 65% subsidy for COBRA premiums for up to nine months.

#### Energy Incentives

- \$20 billion in tax incentives for renewable energy and energy efficiency over the next 10 years.
- Three-year extension of the production tax credit (PTC) for electricity derived from wind (through 2012) and for electricity derived from biomass, geothermal, hydropower, landfill gas, waste-to-energy, and marine facilities (through 2013).

- Grants of up to 30% of the cost of building a new renewable energy facility to address current renewable energy credit market concerns.
- Extension through 2010 and expansion of tax credits for home energy efficiency for purchases such as new furnaces, energy-efficient windows and doors, or insulation.
- A tax credit of up to \$7,500 for families that purchase plug-in hybrid vehicles.
- Clean renewable energy bonds for state and local governments.
- A new manufacturing investment tax credit for investment in advanced energy facilities, such as facilities that manufacture components for the production of renewable energy, advanced battery technology, and other innovative next-generation green technologies.

#### **Tax Incentives for State and Local Economic Development**

- Changes to enhance the marketability for state and local government bonds, which will reduce the costs they incur in financing state and local infrastructure projects.
- A new bond-financing program for school construction, rehabilitation, and repair.

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### **ESTATE PLANNING IN TROUBLED TIMES**

The Silver Lining in this bleak market is that this is an unusually good time to do estate planning. The stock and real estate market has started the ball rolling by substantially reducing everyone's estate.

Consider gifting early this year before asset values increase. Remember – this year the annual exclusion has increased to \$13,000 per recipient. Also, if married, the husband and wife can each give up to \$13,000 per recipient (or one can gift up to \$26,000 per recipient if the other does not gift anything).

Gifted assets retain their basis (or the market value at the date of the gift, whichever is lower) while inherited assets get a stepped-up basis

equal to the date of death value or the value six months after the date of death. Therefore, ignoring other factors, it is best to gift assets having a high basis to minimize the heirs' capital gains tax if and when they sell the assets. If the value of your stock is less than its cost, sell it so you can use the capital loss to reduce your income tax and gift the cash proceeds.

In addition to the annual exclusion, individuals can give up to \$1,000,000 (couples can give \$2,000,000) free of gift tax. This can be a powerful transfer tool in today's depressed markets.

If you have several stocks that are substantially depressed, consider transferring them to a grantor retained annuity trust (GRAT). The term of the trust is short, usually five years or less, because if the grantor dies during the term of the trust, the assets revert to his estate. In other words he loses the tax advantage of reducing his estate. However, he won't be any worse off than if he didn't establish the GRAT. The grantor gets an annuity equal to the statutory rate – presently an all time low of 2% – plus the principal. The beneficiary gets all of the appreciation in excess of 2% per year. If you feel that the stock market will recover over the next three to five years, you will benefit substantially by using a GRAT.

Another effective technique, again considering the 2% statutory rate in effect this month, is the charitable lead trust. This concept requires an intention to benefit charity as well as to pass assets to heirs at a reduced tax. It involves creating a trust for a term of years, transferring assets to the trust, and requiring the trust to make contributions each year to designated charities. The assets can pass to your heirs at a low gift tax rate at the termination of the trust.

Estate tax changes appear inevitable. This year the estate tax exemption has risen to \$3.5 million and the maximum estate tax rate is 45%. In 2010, the estate tax is scheduled to disappear entirely. In 2011, it is scheduled to reappear with a \$1 million exemption and a maximum estate tax rate of 55%.

While Congress has been trying unsuccessfully to arrive at a long-term solution, the Republicans and Democrats were unable to reach an agreement. President Obama has stated that he is opposed to the outright repeal scheduled to take place in 2010 and the higher tax scheduled to take place in 2011. Instead he favors extending the 2009 exemption (\$3.5 million) and the 2009 maximum tax rate (45%).

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## **CONGRESS DECLARES TRUCE ON MANDATORY 401(k) / IRA DISTRIBUTIONS**

The new law, which became effective for 2009, suspends required distributions this year. This gives time for nest eggs to recover if you can afford to reduce or eliminate your IRA or 401(k) distribution. This moratorium extends to all individuals, age 70-1/2 or older, owning IRA's and all other defined contribution plans including 401(k)'s.

Note that participants are still permitted to donate to charity up to \$100,000 per year from their IRA's income tax free.

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## **NANNY TAX**

The earliest and most memorable nanny tax case occurred when President Clinton nominated Zoe Baird in 1993 to serve as the Nation's first female Attorney General. It was discovered during the nomination process that Ms. Baird and her husband hired two undocumented aliens to serve as their chauffeur and nanny and they failed to pay payroll tax. The uproar caused her to request that her nomination be withdrawn.

This issue has arisen subsequently, most recently when Nancy Killefer withdrew after being named by President Obama to the new post of Chief Performance Officer. It would be a mistake to conclude that one's exposure for failure to pay the nanny tax – payroll tax including Social Security tax on household employees – occurs only if the taxpayer is nominated for a high government office.

Sometimes exposure occurs when the household employee is terminated, applies for unemployment compensation and learns that she isn't covered. Exposure may occur when the household employee retires and attempts to collect Social Security only to learn that she isn't covered because the employer never remitted Social Security tax. If payroll tax returns are not filed, the statute of limitations never begins to run – therefore the IRS can go back many years. The penalties and interest can far exceed the amount of the unpaid payroll tax.

The problem is complicated by the fact that the household employee may insist on not being covered. Many nannies are undocumented immigrants who can't work legally. Others insist on being paid in cash because they never have paid income tax and they want to remain outside the system. Often the employer has to choose between hiring or retaining a nanny who doesn't want to comply with the law or to obey the law. Finally, the taxpayer is often intimidated by the filing requirements. The filing requirements are often more overwhelming than paying the tax.

Following is a listing of important definitions and the filing requirements:

- Household employees include, but are not limited to: nannies, babysitters, cleaning people, chauffeurs, housekeepers, private nurses, yard workers, etc.
- Nanny Tax includes Social Security tax, Medicare tax, federal unemployment tax, and state unemployment tax. Each state has different rules; we will be focusing on Illinois in this Tax Alert.

- **Filing Requirements**

Federal (for Social Security or Medicare) – you must pay at least one household employee at least \$1,700 during 2009.

Federal or Illinois Unemployment Tax – you must pay at least one household employee at least \$1,000 per quarter in 2009.

NOTE: If you withhold any federal or Illinois income tax, you must report the wages regardless of the dollar amount.

- Application Forms to Complete

Employer

Federal –

Form SS-4 – Application for a Federal Employer Identification Number

Illinois –

Form UI-1 DOM – Application for State Unemployment Tax.

Form UI-51 – Election for annual filing of Illinois unemployment tax and income tax withholding.

Form REG-1 – Business Registration Application. This form is only necessary if the employee elects to have Illinois income tax withheld.

The employer must contact the Illinois Department of Employment Security (IDES) within 20 days of a new employee's start date, giving the IDES the employee's Social Security number, address and start date.

Employee

Form I-9 – Information and Proof of Residency (Revised 02/02/2009)

Form I-9 requests information and proof of residency. This form must be completed by your employee.

Form W-4 (Federal) and IL-W-4 (Illinois)

Forms W-4 and IL-W-4 request the employee's Social Security number, address, and number of withholding allowances to compute income tax withholding, if any.

The employee completes these forms only if she wants to have federal or state income tax withheld

- Paying Taxes

Federal – The federal taxes for a household employee are only reported once a year on the employer's personal income tax return, Form 1040, Schedule H. These federal taxes include **Social Security tax** (6.2% of wages; the 2009 maximum wages are \$106,800), **Medicare tax** (1.45% of wages), **federal income tax withheld** (if the employee elects to have it withheld, not required for household employees), and **federal unemployment tax** (0.8% of wages as long as all state unemployment taxes have been paid; maximum wages of \$7,000). In addition, the employer is required to match the amount of Social Security tax and Medicare tax withheld from the employee.

There are also forms required for the employee and for the state.

## CONCLUSION

These rules can be complicated and appear overwhelming. Attempting to ignore the law can be quite costly. As your tax preparer and business consultant, we can help you sort through the various regulations and guide you toward responsible household employer reporting. If you prefer to file the returns yourself, we will help you.

**IRS Circular 230 Notice:** Any tax advice contained herein is not intended to be used and cannot be used by the recipient for the purpose of avoiding penalties that may be imposed by law.