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Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*SM

IRS Offers a Deal to Companies Claiming Contractors

February 2012



Many companies make payments to independent contractors. The IRS, however, prefers to see workers classified as employees. Over the years, such disputes have triggered tax audits and court cases. Recently, the IRS has offered amnesty to companies with questionable claims of hiring contractors.

The issues

When companies pay employees, income taxes are withheld from each paycheck. In addition, employers pay certain payroll taxes, such as contributions to Medicare and Social Security, on behalf of employees. As a result, the IRS receives a steady stream of revenues from employers with employees.

Employers treat independent contractors differently. Generally, companies pay contractors for the work they do, and they do not withhold taxes. Then, it's up to the contractors to pay the taxes they owe, including self-employment taxes for Medicare and Social Security. Because taxes are not withheld upfront, the IRS may find it challenging to collect all the taxes legitimately owed by independent contractors. In addition, contractors can take business deductions against their income more easily than employees can, so federal revenues may be reduced.

The potential for losing significant amounts of revenues due to worker misclassification has led to frequent IRS audits of employers to determine whether they are properly classifying their workers. In many cases, the IRS has ruled that independent contractors are really employees, so their employers owe taxes, interest, and penalties on the payments they have made to the contractors. Along with the IRS, the federal Department of Labor (DOL) and many state agencies are stepping up audit activity, looking to see which companies are improperly classifying employees as

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In 2012, Social Security taxes are collected on earnings up to \$110,100. That cap started at \$3,000 in 1937 and didn't top \$10,000 until 1973.

independent contractors. In some cases, government agencies are assessing penalties.

The offer

The IRS has announced a voluntary classification settlement program for this issue. To settle the matter, companies will pay a certain amount. The calculation is fairly complicated, but it usually turns out that companies will pay about 1% of the wages paid to each worker covered by the settlement in the past year. If a worker was paid \$50,000, for instance, the company's obligation under this program might be about \$500.

In order for companies to settle in this manner, they must meet certain conditions:

- They must have consistently treated workers as nonemployees.
- They must have filed all required Form 1099s for those workers in the past three years, reporting taxable earned income.
- They must not currently be undergoing an IRS audit, or undergoing an audit on this issue by any federal or state agencies.

In addition, a taxpayer who was previously audited by the IRS or DOL concerning the classification of the workers will only be eligible if

the taxpayer has complied with the results of that audit.

Assuming companies qualify, make the required payments, and agree to treat the covered workers as employees in the future, they will owe no interest or penalties related to this issue. In addition, the IRS will not initiate payroll tax audits for any prior years on workers covered by this settlement. Companies agreeing to these terms also agree to extend the statute of limitations on payroll tax issues for an additional three years; this portion of the agreement will cover the three calendar years after the settlement.

Business owners considering this settlement should realize this is not an all-or-nothing proposal. An employer may reclassify certain classes of workers as employees while continuing to treat other classes as contractors.

Example: Company ABC has treated all of its telephone salespeople and its software designers as independent contractors. It decides to reclassify its software designers as employees, under the IRS settlement program, but continues to treat its telephone salespeople as independent contractors. Going forward, ABC

agrees to treat all of its software designers as employees.

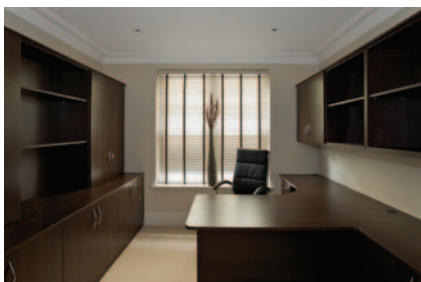
Making the decision

According to the courts that have ruled on this issue, the difference between an employee and an independent contractor is a matter of control. The more that a company can tell a worker what to do and how to do it, the more likely that worker deserves to be classified as an employee.

Therefore, business owners who hire contractors and grant them a great deal of leeway in the way they operate may have a solid case for classifying them as independent contractors. On the other hand, companies that exercise control over workers now classified as contractors may decide to take the IRS offer and pay the relatively modest amount to avoid future challenges.

There may be other issues facing companies that agree to this settlement, such as employee benefits and state and local taxes. Business owners who wish to participate in this program must apply on Form 8952 at least 60 days from the date the company wants to begin treating its workers as employees. ■

Home Office Deductions Demand Exclusivity



In order to take deductions for an office in your home, you must meet several requirements. For instance, you must use the space “regularly and exclusively” for business. A recent

decision by the U.S. Tax Court indicates that exceptions won't be tolerated.

In this case, an accountant used one bedroom in his home as an office. He built a bathroom across the hall from this bedroom for clients to use. On his tax return for the year in question, he took over \$9,000 in deductions for his home office, which the IRS denied.

The accountant brought the case to the Tax Court, which took a close look at the deduction. The

accountant testified that he used the bedroom, the bathroom, and the hallway in between exclusively for business. He also said, however, that his children and some personal guests (that is, nonclients) occasionally used the bathroom. Because the hallway and bathroom were not used exclusively for business purposes, the Tax Court limited the home office deduction to the bedroom used as an office.

According to the opinion in the case, the total area of the accountant's

residence, including a garage and a guest house, was 2,677.34 square feet. The bedroom used as an office had 226.3 square feet. Dividing 2,677.34 by 226.3, the court determined that 8.45% of the accountant's residence was his home office, so he could deduct 8.45% of his allowable expenses.

Home sweet home

As this case indicates, if you use part of your home as an office and wish to take tax deductions, you should refrain from any personal use there. Don't let your kids use your office computer to update their Facebook pages, for instance.

Still, this decision illustrates the potential advantages of claiming a

home office. Despite the IRS denial, the Tax Court upheld an 8.45% deduction of "allowable" expenses. That could mean deducting 8.45% of everything this taxpayer spent on utilities and home insurance, for example, in addition to depreciation deductions for 8.45% of the residence.

In order to qualify for these deductions, several paths can be taken. You can claim the deductions if you meet with clients regularly in your home office, if you work from a separate structure such as a detached garage, or if the home office is your principal place of business. Often, taxpayers who claim home office deductions assert that the office is their principal place of business—it's

where the most critical activities of a business take place, or it's the only fixed location for conducting substantial business activities. Regardless of which path you take, you must use the space regularly and exclusively for business in order to take proportionate deductions.

As a bonus tax benefit, if you have a home office that is your principal place of business, you won't have commuting trips. That is, every trip you make from your home to see a customer, prospect, supplier, and so on, is considered a business trip, so your expenses are deductible. In some cases, the transportation deductions may be larger than your other home office deductions. ■

Making Sense of Mutual Fund Taxation

When you gather up all the paperwork for filing your 2011 tax return, you may notice some surprising information from your mutual funds. Last year was marked by volatility in the financial markets, with losses as well as gains. Yet you may owe tax on capital gains from your mutual funds, no matter how well or how poorly they performed.

Indeed, investors may not be aware of how mutual funds are taxed. If you know the rules, you might be able to improve your after-tax results.

Passing through

Under the tax code, mutual funds can avoid paying income tax by distributing all of their income and capital gains to shareholders each year, so that's a common practice. Some of the tax results are straightforward. The interest income that a bond fund receives can be distributed to shareholders who will owe income tax on ordinary income if the fund holds taxable bonds. A stock fund can distribute the dividend

income it receives from the stocks in its portfolio; shareholders who receive those dividends generally owe tax at the special low rate now in effect for qualified dividends.

In addition, many mutual funds buy and sell securities throughout the year as they change their holdings. If a fund winds up with net gains at the end of its tax year, those gains will be passed through to shareholders. Net gains may be short-term, long-term, or a combination. In many down years for stocks or bonds, investors wind up owing tax on capital gains distributions.

Example 1: Mutual Fund XYZ invests in large-company stocks. During its current tax year, economic news is dreadful, and many investors flee the stock market. Some of those investors redeem their shares of XYZ, which must sell some assets to raise cash in order to meet the redemptions. Once all of the selling has been done for the year, XYZ discovers that it has more gains from selling stocks than it has losses from

other stock sales, thus, winding up with net capital gains.

Suppose that XYZ has 1 million shares outstanding. In its current tax year, it winds up with \$3 million of net long-term capital gains (on stocks held for more than one year) and \$2 million of net short-term capital gains. Therefore, XYZ has \$5 million of gains to distribute to shareholders: \$5 per share. XYZ distributes those gains to shareholders, reporting \$3 per share of long-term gains and \$2 per share of short-term gains, which pass through as ordinary income. So, for this example, the fund would make those capital gains distributions even though the fund has posted a 10% loss for the year.

Tales of taxation

These distributions may affect different investors in different ways.

Example 2: Anne Young holds 100 shares of XYZ in her traditional IRA. She receives the \$500 distribution (\$5 per share) within her IRA and reinvests the

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money in accordance with her asset allocation. Anne owes no tax because she holds the shares in her IRA. When she takes the money out, Anne will owe tax at her ordinary income tax rate.

Example 3: Brandon Wells holds 100 shares of XYZ in his taxable account. He collects the \$500 and pays the required income tax. Brandon owes 15% on \$300 worth of long-term gains but owes tax at his ordinary 28% rate on \$200 in short-term gains. After paying \$101 in tax (\$45 plus \$56) Brandon has \$399 left to reinvest.

Example 4: Claire Vincent holds 100 shares of XYZ in her taxable account. She has chosen to reinvest all her distributions. If XYZ then trades at \$50 per share, Claire acquires 10 additional shares of XYZ with her \$500 distribution.

Even though she has not received any money, Claire still owes tax on a \$500 capital gains distribution. Assuming that Claire also is in a 28% ordinary income tax bracket, she will owe the same \$101 in tax as Brandon does, but with no cash from XYZ from which to make the payment.

Savvy strategies

Once you know these tax rules, you may be able to adapt your mutual fund investment strategies. Before you buy a fund, examine its history of capital gains distributions. A fund that historically has made large distributions in relation to its trading price might be a fund that trades heavily and realizes capital gains regularly. You may decide to hold such a fund in your IRA, where taxes are deferred.

Did You Know?

Average total charges at private nonprofit colleges are \$38,589 in the 2011–2012 academic year, up 4.4% from a year ago. Those charges are for tuition, fees, room, and board. Total charges for in-state students at four-year public colleges rose 6.0%, on average, but they still are relatively modest, at \$17,131.

Source: collegeboard.org

For your taxable account, consider funds that have been tax efficient over the years, making relatively small capital gains distributions. Some funds are “tax managed,” meaning that they try to minimize taxes to shareholders by taking losses as well as gains when they sell securities. ■

TAX CALENDAR

FEBRUARY 2012

February 15

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

February 16

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2011, but did not give you a new Form W-4 to continue the exemption for 2012.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2011. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is April 2.

February 29

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2011. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is April 2.

MARCH 2012

March 15

Corporations. File a 2011 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2011 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2012. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2013.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.