Burke, Montague & Associates L.L.C.

Certified Public Accountants, Advisors & Auditors

Members - Partners: Charles R. Burke, CPA Jodi K. Gill, CPA Raymond J. Raymond, CPA Kathleen C. Wilson, CPA

Professionals: Randall Hill, CPA Diane Thiele, CPA Sheila Hessler, BS Richard Schiltz, CPA

Consultant: Robert J. Montague, CPA

253 West Broadway, Bradley, Illinois 60915 Phone 815.933.5641 Fax 815.939.0016
33 North Main, Manteno, Illinois 60950 Phone 815.468.8802 Fax 815.468.8805

Toll Free 800.272.8753 • www.mybmacpa.com

Client Information Bulletin

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Avoiding Taxes on Independent Contractors

Meet requirements for "Section 530" relief

During this current economic slowdown, your company may decide to outsource certain projects that have traditionally been performed by in-house workers. Consider all the implications.

Case in point: Because your company is using independent contractors as opposed to employees, it is not responsible for payroll taxes and income tax withholding on the amounts paid to these workers. Similarly, you do not have to cover independent contractors under your qualified retirement plan and health insurance program.

However, the difference between independent contractors and employees is not always clear-cut. The IRS often investigates these determinations. If it reclassifies some of the workers as employees, which is a common practice, your company could be hit with hefty payments for back taxes, plus penalties and interest.

Saving grace: Fortunately, you may be able to rely on "Section 530" relief in a pinch. This special tax rule, legislated into law in Section 530 of the 1978 Revenue Act, enables you to claim independent contractor status for workers if certain requirements are met. Specifically, your company is exempt from employment tax liability under Section 530 if you satisfy these rules:

♦ The company has not treated the worker as an employee for any period of time and does not treat workers in similar positions as employees.

♦ All federal returns required to be filed by the company (including information returns) consistently treat the worker as an independent contractor.

♦ The company has a reasonable basis for not treating the worker as an employee.

How do you show a "reasonable basis" for treating a worker as an independent contractor? Any one of the following four methods may suffice.

1. The classification is a long-standing practice of a significant segment of your industry or profession. For this purpose, "long-standing" can mean less than 10 years, while a "significant segment" may be less than 25%.

2. The classification has survived an IRS audit. If your business was audited after 1996 regarding the employment tax treatment of workers and the classification was allowed to stand, you qualify under this exception. For audits started prior to 1997, it does not matter if the audit involved any worker classification issues; there is no problem as long as the treatment of the workers has not changed.

3. You can provide adequate precedent. If there is an authoritative

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court decision or IRS ruling that supports your position, you may meet the reasonableness test.

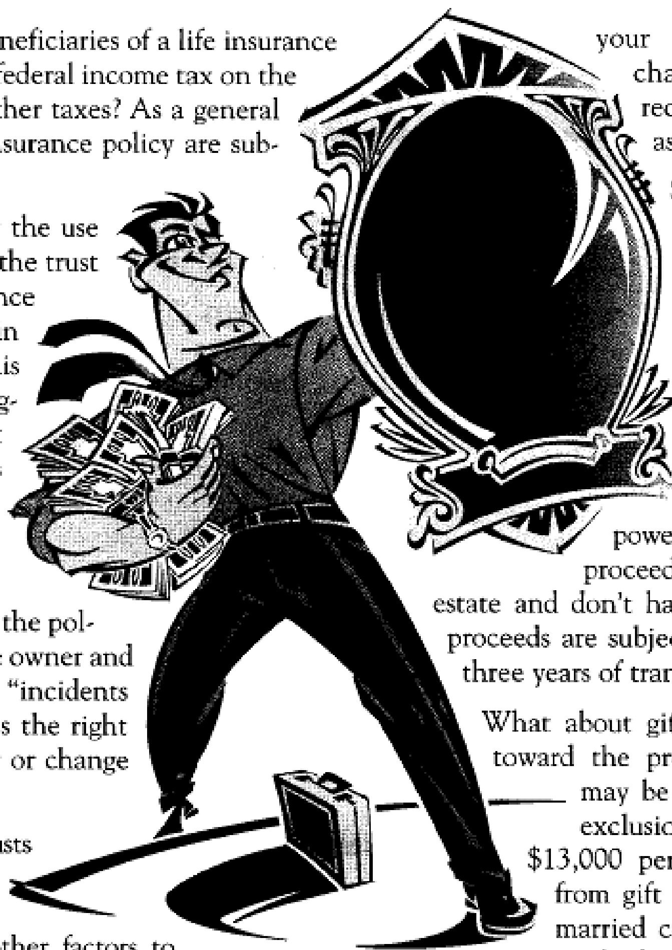
4. You can show that your determination for independent contractor status is based on the sound reasoning of a paid tax professional.

Note that you cannot qualify for Section 530 relief for a prior tax year if you failed to issue Form 1099s for independent contractors in that particular year. This is a critical aspect for avoiding tax liability. ***The lesson is clear:*** *Coordinate these activities with your tax advisers.*

Preserving Tax Shelter for Life Insurance

Use a trust to shield proceeds from estate tax

It's well known that the beneficiaries of a life insurance policy do not have to pay federal income tax on the proceeds. But what about other taxes? As a general rule, payouts under a life insurance policy are subject to federal estate tax.



Possible solution: Consider the use of a "life insurance trust." If the trust is set up properly, the insurance proceeds are not included in your taxable estate. So this amount can pass to the designated beneficiaries without any estate-tax erosion. That's true even if you give the trust the funds to pay the policy premiums each year.

This tax break is available if the policy is not issued to you as the owner and you do not retain any other "incidents of ownership." This includes the right to borrow against the policy or change the designated beneficiaries.

Caution: Life insurance trusts are not for everyone. Besides the aforementioned restrictions, there are costs and other factors to consider. Whether or not you should use a trust depends upon your particular situation. For example, to achieve the desired tax results, the trust must be irrevocable. If your family's financial condition changes significantly, you cannot recover the policy or other trust assets.

Suppose that your spouse is well provided for and your adult children, whose judgment is sound, are the intended beneficiaries of your insurance policy. You could give cash to your children, and they could take out a policy on your life naming themselves as beneficiaries. If you have an existing policy, you can transfer it and all powers over it to them. **Result:** The proceeds are not included in your taxable estate and don't have to pass through probate (but proceeds are subject to estate tax if you die within three years of transferring the policy).

What about gift tax on the cash gifts that go toward the premium payments? The transfers may be sheltered by the annual gift-tax exclusion. For 2009, transfers of up to $13,000 per year per recipient are exempt from gift tax ($26,000 for joint gifts by a married couple). To take advantage of the annual gift-tax exclusion for a transfer to a trust, the children must have a limited right to withdraw the funds from the trust. With a straight cash gift to your children, there are no such problems.

Other estate-planning techniques may be more suitable for your situation. So when is creating a life insurance trust the "right thing" for someone to do? It may be particularly appropriate when insurance needs are high (e.g., a business interest makes up a large part of an estate) or additional assets are needed to provide support for a surviving spouse and minor children.

This is just a brief overview. Consult with an experienced estate planner regarding your personal situation.

Give Us A Call!

Do you have any questions or comments about ***Client Information Bulletin*** *or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.*

How to Encourage More Bright Ideas

Give creative employees a chance to shine

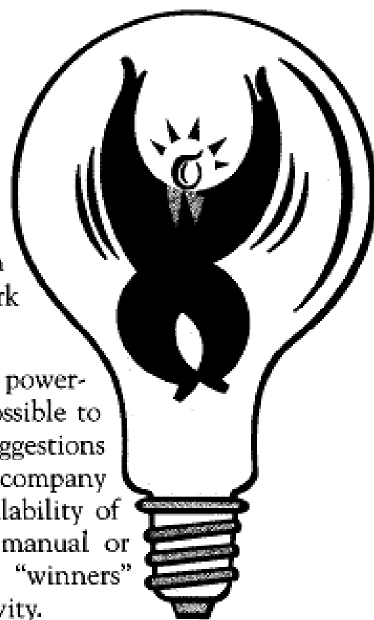
Creative employees can revive a struggling business operation or inject it with a new sense of purpose and energy. But you may not be giving these employees opportunity to present their thoughts to the higher ups. It's the responsibility of your company's managers to "bring out the best" in your workforce, without causing any major disruptions.

Of course, each situation is different and should be handled differently. But here are several practical suggestions to consider.

♦ **Acknowledge creativity.** If employees come up with bright ideas that will build sales or cut costs, let everyone else at the company know about it. You might put their names up on the bulletin board or in the company newsletter, or select them to represent the company at industry meetings.

In contrast, dismissing ideas from workers out-of-hand is a surefire way to discourage creativity. **Even worse:** Don't "steal" ideas from workers without providing them with the proper recognition.

♦ **Reward creativity.** Workers should know that coming up with a creative idea will pay off for them personally.



Rewards can, of course, come in all shapes and sizes. They can be as simple as giving an employee an extra day off or a bigger work area.

A monetary bonus is also a powerful incentive. It may be possible to tie bonus payments to suggestions that end up saving the company money. Advertise the availability of bonuses in the company manual or newsletter. Announce the "winners" to further encourage creativity.

♦ **Stimulate creativity.** It helps to supply some sort of outlet for creative ideas and suggestions (and even for simply blowing off steam). The tried-and-true suggestion box may be the simplest way to get the ball rolling.

Another possibility is to hold casual get-togethers where employees can speak freely about how company products are manufactured, shipped, advertised and sold. You might hold these on a regular basis (e.g., the first Friday afternoon of every month). Invite the entire workforce to participate.

♦ **Train employees to be creative.** It's a simple but unfortunate fact of life: Many employees simply don't have the self-confidence to step forward with good ideas. They think that they have nothing to offer your firm other than the mechanical performance of the job they have been hired to do.

Frequently, educating workers is the best way to overcome this misconception and turn employees into a source of creativity. Some companies have hired professionals who specialize in this kind of creativity training, while others have been able to develop their own training programs from the ground up.

On the downside, creative employees can also be rebellious and difficult to manage. Such employees may be a double-edged sword because they might create as many problems—or even more—than they solve. Try to harness the energy to produce favorable results.

***Lights out**: It is important to maximize the benefits these employees can bring to the table while minimizing the potential distractions. These activities can help spur your company forward in 2009.*

Should You Skip Bonus Depreciation?

If your business placed qualified assets in service in 2008, it can claim a 50% "bonus depreciation" tax break for the assets. But there is a potential drawback for some business operations.

Reason: A business may not derive tax benefits if it shows a loss for the year. This is a common occurrence in the current economic environment.

Instead, a business may elect to forego bonus depreciation on its tax return. With this approach, the business can treat unused alternative minimum tax and research credits as being refundable, freeing up cash.

Caution: The rules in this area are extremely complex. It is recommended that you seek professional guidance for your company's situation.

IRS Boosts Retirement Plan Limits for 2009

Higher figures reflect higher inflation rate

The IRS recently issued its annual cost-of-living adjustments for certain retirement plan thresholds. Due to low inflation rates during the middle of this decade, the increases have been relatively modest or nonexistent the last few years. However, the new indexed figures for 2009 reflect a few significant jumps as inflation crept higher last year.

Below is a summary of the key retirement plan limits for the past two years.

Note: The dollar limit for catch-up contributions to a SIMPLE (Savings Investment Match Plan for Employees) plan remains unchanged at $2,500. We will feature contribution limits for traditional and Roth IRAs in an upcoming issue.

	Limit for 2008	Limit for 2009
Maximum annual dollar benefit for a defined benefit plan	$185,000	$195,000
Maximum dollar limit on additions to a defined contribution plan	$46,000	$49,000
Maximum amount of compensation taken into account for qualified retirement plans	$230,000	$245,000
Dollar limit for definition of "key employee" in top-heavy retirement plan	$150,000	$160,000
Dollar limit for definition of "highly compensated employee" in qualified plan	$105,000	$110,000
Dollar limit for elective deferrals to a 401(k) plan	$15,500	$16,500
Dollar limit for contributions to a SIMPLE plan	$10,500	$11,500
Dollar limit for elective deferrals to deferred compensation plans of state and local governments and tax-exempt organizations	$15,500	$16,500
Dollar limit for catch-up contributions to a SIMPLE plan	$2,500	$2,500
Dollar limit for catch-up contributions to a 401(k), 403(b), 457 or SEP (Simplified Employee Pension) plan	$5,000	$5,500

Facts and Figures

Timely points of particular interest

➡**Checking on Rebates**—The economic stimulus checks handed out in 2008 were based on data from 2007 tax returns. But some taxpayers were shortchanged because they lost their jobs last year or their income in 2008 declined for other reasons. In that case, a rebate credit may be available when an individual's 2008 federal tax return is filed. Check with a tax professional if you are unsure of your status.

➡**Gift-tax Exclusion**—The IRS recently announced that the annual gift-tax exclusion has increased from $12,000 per recipient for 2008 to $13,000 per recipient for 2009. A married couple can jointly give gifts of up to $26,000 exempt from gift tax this year. For example, by giving the maximum gifts to ten family members for five consecutive years, you can reduce your taxable estate by $1.3 million.

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