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## **Dear Client:**

The tax laws enacted in the last couple of years contain important income tax and information reporting provisions that are effective for the first time in 2011. To inform you of what's new in the tax rules, here's a summary of the key tax changes for 2011, broken down into three categories: Personal Income Taxes, Retirement Plan Changes, and Tax Changes for Businesses and Investors. If you'd like to discuss how these changes affect your personal, business or investment situation, please give us a call.

### **Personal Income Taxes**

***Payroll tax holiday in place.*** Employees will pay only 4.2% (instead of the usual 6.2%) OASDI (Social Security) tax on compensation received during 2011 up to \$106,800 (the wage base for 2011). Similarly, for tax years beginning in 2011, self-employed persons will pay only 10.4% Social Security self-employment taxes on self-employment income up to \$106,800. In either case, the maximum savings for 2011 will be \$2,136 (2% of \$106,800) per taxpayer. If both spouses earn at least as much as the wage base, the maximum savings will be \$4,272.

***Stricter rules apply to energy saving home improvements.*** You can claim a tax credit for energy saving home improvements you make this year, but stricter rules apply for 2011 than for 2010. You can only claim a 10% credit for qualified energy property placed in service in 2011 up to a \$500 lifetime limit (with no more than \$200 from windows and skylights). What's more, the credit you claim for any year can't exceed \$500 less the total of the credits you claimed for all earlier tax years ending after Dec. 31, 2005. The amount you claim for windows and skylights in a year can't exceed \$200 less the total of the credits you claimed for these items in all earlier tax years ending after Dec. 31, 2005. The credit is equal to the sum of: (1) 10% of the amount you pay or incur for qualified energy efficient improvements (such as insulation, exterior windows or doors that meet certain energy efficient standards) installed during the year, and (2) the amount of the residential energy property expenses you paid or incurred during the year.

The credit for residential energy property expenses can't exceed: (A) \$50 for an advanced main circulating fan; (B) \$150 for any qualified natural gas, propane, or hot water boiler; and (C) \$300 for any item of energy efficient property (advanced types of energy saving equipment, such as electric heat pumps, meeting specific energy efficient standards).

***Partial annuitization of annuity contracts.*** When you receive non-retirement-plan annuity payments from an annuity contract, part of each payment is a tax-free recovery of your basis (cost of the annuity contract for tax purposes), and part is a

taxable distribution of earnings. For amounts received in tax years beginning after Dec. 31, 2010, taxpayers may partially annuitize such an annuity (or endowment, or life insurance) contract. If you receive an annuity for a period of 10 years or more, or over one or more lives, under any portion of an annuity, endowment, or life insurance contract, then that portion is treated as a separate contract for annuity taxation purposes. The net effect is that the annuitized portion is treated as a separate contract, and each annuity payment from that portion is partially a tax-free recovery of basis and partially a taxable distribution of earnings. Absent this rule, the payments might have been treated as coming out of income before recovery of any basis. The portion of the contract that is not annuitized is also treated as a separate contract and will continue to earn income on a tax-deferred basis.

***Restricted definition of medicine for health plan reimbursements.*** Beginning this year, the cost of over-the-counter medicines can't be reimbursed with excludible income through a health flexible spending arrangement (FSA), health reimbursement account (HRA), health savings account (HSA), or Archer MSA (medical savings account), unless the medicine is prescribed by a doctor or is insulin. This new rule applies to amounts paid after 2010. However, it does not apply to amounts paid in 2011 for medicines or drugs bought before Jan. 1, 2011. Also, for distributions after 2010, the additional tax on distributions from an HSA that are not used for qualified medical expenses increases from 10% to 20% of the disbursed amount, and the additional tax on distributions from an Archer MSA that are not used for qualified medical expenses increases from 15% to 20% of the disbursed amount.

### **Retirement Plan Changes**

***Small employers may establish "simple cafeteria plans."*** For years beginning after Dec. 31, 2010, small employers (those having an average of 100 or fewer employees on business days during either of the two preceding years) may provide employees with a "simple cafeteria plan." An employer that uses this type of plan gets a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for certain types of qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program.

***Election to treat January 2011 charitable distributions as made in 2010.*** If you are age 70 1/2 or older, you can make tax-free distributions to a charity from an Individual Retirement Account (IRA) of up to \$100,000. This applies for charitable IRA transfers made in tax years beginning before Jan. 1, 2012. In addition, if you make such a distribution in January of 2011, you can treat it for income tax purposes as if it were made on Dec. 31, 2010. Thus, a qualified charitable distribution made in January of 2011 may be treated as made in your 2010 tax year and count against the \$100,000 exclusion for 2010. It is also may be used to satisfy your IRA required minimum distribution for 2010.

### **Tax Changes for Businesses and Investors**

***Electronic filing rules now in place.*** Beginning Jan. 1, 2011, employers must use electronic funds transfer (EFT) to make all federal tax deposits (such as deposits of employment tax, excise tax, and corporate income tax). Forms 8109 and 8109-B, Federal Tax Deposit Coupon, cannot be used after Dec. 31, 2010.

**Up-to-\$1,000 credit for "retained workers" in 2011.** Employers may claim a "retention credit" for retaining qualifying new employees (certain formerly unemployed workers meeting specific requirements). The amount of the credit is the lesser of \$1,000 or 6.2% of wages you pay to the retained qualified employee during a 52 consecutive week period. The qualified employee's wages for such employment during the last 26 weeks must equal at least 80% of wages for the first 26 weeks. The credit may be claimed for a retained worker for the first tax year ending after Mar. 18, 2010, for which the retained worker satisfies the 52 consecutive week requirement. However, the credit applies only for qualifying employees hired after Feb. 3, 2010, and before Jan. 1, 2011.

**New basis and character reporting rules.** Generally effective on Jan. 1, 2011, every broker required to file an information return reporting the gross proceeds of a "covered security" such as corporate stock must include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to the security is short-term or long-term. The reporting is generally done on Form 1099-B, "Proceeds from Broker and Barter Exchange Transactions." A covered security includes all stock acquired beginning in 2011, except stock in certain regulated investment companies (i.e., mutual funds) and stock acquired in connection with a dividend reinvestment plan (both of which are covered securities if acquired beginning in 2012).

**Corporate actions that affect stock basis must be reported.** Effective Jan. 1, 2011, issuers of "specified securities" must file a return describing any organizational action (e.g., stock split, merger, or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by IRS. The issuer's return (and information to nominees or certificate holders) must be filed within 45 days after the date of the organizational action or, if earlier, by January 15th of the year following the calendar year during which the action occurred. Nominees or certificate holders must (unless the IRS waives this requirement) be given a written statement showing (1) the name, address, and telephone number of the information contact of the person required to file the return, (2) the information required to be included on the return for the security, and (3) any other information required by the IRS. In general, a specified security is any share of stock in an entity organized as, or treated for federal tax purposes as, a foreign or domestic corporation.

**Reporting requirement for payment card and third-party payment transactions.** After 2010, banks generally must file an information return with the IRS reporting the gross amount of credit and debit card payments a merchant receives during the year, along with the merchant's name, address, and TIN. Similar reporting is also required for third party network transactions (e.g., those facilitating online sales).

**Information reporting for real estate.** For payments made after Dec. 31, 2010, for information reporting purposes, a person receiving rental income from real estate is treated as engaged in the trade or business of renting property. As a result, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of \$600 or more during the tax year to a service provider (such as a plumber, painter, or accountant) in the course

of earning rental income must provide an information return (typically Form 1099-MISC) to the IRS and to the service provider.

The rental property expense payment reporting requirement doesn't apply to: (1) an individual who receives rental income of not more than a minimal amount (to be determined by the IRS); (2) any individual (including one who is an active member of the uniformed services or an employee of the intelligence community) if substantially all of his or her rental income is derived from renting the individual's principal residence (main home) on a temporary basis; or (3) any other individual for whom the information reporting requirement would cause hardship (to be defined by the IRS).

**Sincerely,**

Bagby, Johnson & Associates, AC