POINTERS

New Laws Enacted In 2010.

The Patient Protection And Affordable Care Act that was signed into law on March 23, 2010, is both complex and far reaching. Of immediate interest to the small business owner are the following:

Self-insured health reimbursement arrangements. These arrangements must comply with many of the requirements of the new law, but grandfathered plans are exempt from some additional requirements that apply to new and non-grandfathered plans. See chart on page 247 and **Q 320-321**, *Tax Facts on Insurance & Employee Benefits (2011)*.

Insured health reimbursement arrangements. These arrangements can no longer benefit only a select class of employees (but those in existence on March 23, 2010 are grandfathered). See the chart on page 247.

Tax credit for health insurance costs. Generally, beginning in 2010 businesses with 24 or fewer employees, whose average compensation is less than $50,000, may receive a 35 percent income tax credit for the cost of qualifying health insurance costs in 2010 through 2013, provided they pay 50 percent of the cost of health care coverage. The credit is increased to 50 percent of qualifying expenses for any two consecutive years beginning in 2014 (resulting in a maximum of six years that an employer can take advantage of the credit). See **Q 313-316**, *Tax Facts on Insurance & Employee Benefits (2011)*.

SIMPLE Cafeteria Plans. Beginning in 2011, SIMPLE cafeteria plans may be established by employers who employed an average of 100 or fewer employees for either of the prior two years (the concept is similar to the SIMPLE 401(k) and SIMPLE-IRA). See the discussion on page 523.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided tax cuts and tax extenders for everyone. Some that should not be overlooked include:

Educational Benefits. Among the many educational tax benefits that were extended through December 31, 2012 are: The American Opportunity Tax Credit (including enhanced income limitations); the $5,250 education assistance exclusion; the enhancements to the $2,500 above-the-line student loan interest deduction (including a modified AGI phase-out range); the $2,000 maximum contribution to Coverdell Education Savings Accounts (including elementary school expenses as qualified expenses); and the $2,000/$4,000 higher education interest deduction. See pages 361-363.

IRA Charitable Rollover. The IRA charitable rollover was restored for 2010 and may be used for all of 2012. The IRA owner must be age 70½ or older, the amount cannot exceed $100,000

total in one year, and the rollover must be a trustee-to-charity transfer. Transfers qualify as required minimum distributions.

Time Can Work For You . . . And Against You.

Dollars can grow, but they need time. Some people have more time, and some people have less time. If you are just starting out, time is your friend; the stock market will go up, maybe not today, tomorrow, next week, next month, or even next year, but it will go up. If you are about to retire, time is *not* your friend, particularly if you did not take advantage of time when it was your friend. By allowing before-tax dollars to grow tax-deferred, tax-favored retirement plans offer a very effective way of using time to secure your retirement years. The materials on pages 258-261, 315-320, 560 and 561, will help you better understand and explain concepts involving the time value of money.

Providing For Retirement.

Retirement income planning. Retirees are living longer, healthier, and more active lives (see table, Healthy Life Expectancy, page 557). No longer is it adequate to merely help clients save for retirement. Your soon-to-retire clients must have a plan that will provide an inflation-adjusted stream of income that will not be outlived (pages 501-502). In this regard, see the Longevity In Retirement table on pages 558-559. This table can be used to estimate the odds of living to a specific retirement age. For example, a 65-year-old male has a 55.6 percent chance of living to age 80, and a 34.6 percent chance of living to age 85; but only a 15.5 percent chance of living to age 90. Given those odds, a healthy 65-year-old male should be very concerned about having sufficient retirement funds for at least the next 20 years (age 85), if not the next 25 years (age 90).

Self-Employed Individuals. A variety of retirement plans are available for the self-employed. The discussion on page 521 generally lists them in the order of amount of maximum annual contribution, costs to set up, complexity, and difficulty of administration.

Minimum distribution rules. With qualified retirement plans, there are strict rules regarding when, how much, and for how long money can be put away (pages 262-277, 303-309, 427, 433-434, and 524-525). The minimum distribution rules allow your clients to significantly defer income taxes with post-retirement and post-death distribution planning, particularly with regards to IRAs (pages 433-434 and 551). Under rollover rules, your clients have a great deal of flexibility to transfer, or consolidate, their retirement funds between IRAs, 403(b) plans, 457 plans, and qualified plans including 401(k) plans.

Will The Plan Fit?

Employers and employees come in many shapes and forms. Before proceeding with recommendations as to a specific benefit plan, it is essential to ascertain whether your client is

doing business as a C corporation, S corporation, partnership, limited liability company, or sole proprietor (pages 286-294, 412, 445, 465-467, 471, 483, and 510-512). In general, the S corporation, partnership, and sole proprietorship provide limited opportunities for creative employee benefit plans for the owner/employee (pages 176-178).

In contrast, C corporations are taxable entities, separate and apart from their stockholders. They offer attractive opportunities for using tax-advantaged employee benefits for employee/stockholders. For example, a deferred compensation plan can be used in the medium to large sized corporation to reward key executives who are stockholders in the corporation (page 235). However, deferred compensation is not appropriate if your client is a sole proprietor. The threshold question is simple: are your client and his business separate taxable entities? If they are, then your client is able to use a "business check" for funding employee benefits, and can take advantage of any tax leverage provided by the difference between employer and employee income tax brackets (pages 200-201 and 398).

You should refer to the following footnotes for guidance regarding the appropriateness of specific employee benefits: group insurance (footnote 1, page 205); executive equity (footnote 2, page 213); split-dollar insurance (footnote 2, page 221); deferred compensation (footnotes 1 and 7, page 237); disability income plan (footnote 1, page 245); and health reimbursement arrangements (footnote 1, page 249).

With Whom Are You Working?

It is also important to consider *whom* you are working with and what their objectives are. Is your client the owner of a small closely-held business who wants to fund his corporate buy/sell agreement with split-dollar life insurance, or is your client the chief financial officer of a larger corporation charged with the responsibility of assembling a selective supplemental retirement plan for a group of key executives? Is the benefit for a "pure" employee (i.e., a nonowner)? Is the nonowner/employee related to your client? Is it expected that the nonowner/employee will eventually become an owner? Answers to these questions will help you design an employee benefit plan that is responsive to your client's objectives. A relevant and responsive plan improves your credibility with your client, and is far more likely to be accepted and implemented.

Disability, Long-Term Care, And IRAs.

As with retirement planning concepts, disability income, long-term care, and IRAs are included in this employee benefits section. However, these important needs may well be provided for outside the context of an employer-employee relationship. For example, some of your clients will establish IRAs that have nothing to do with their employer, while other clients may participate in Simple IRAs established by their employer (pages 427 and 524). Likewise, many clients acquire individual disability income contracts outside of a formal disability income plan; while other clients are covered by plans with varying degrees of employer participation (pages 238-241, 242-248, 323, and 387).

TAXATION OF EMPLOYEE BENEFITS

Employee benefits, once considered an "addition" to wages, have now become an integral part of virtually all compensation packages. Because the rapid increase in their variety and value has made it difficult to evaluate them, this overview is designed to review some of their tax advantages and disadvantages.[1]

Characterization of a benefit as either bad, better, or best, can be made according to its effect upon the income taxes of the employer and the employee. For example, assume that in 2011 we have an employer in a 34 percent marginal tax bracket and an employee in a 25 percent tax bracket.

BAD. A bad employee benefit is one that is *nondeductible* to the employer yet *taxable* to the employee, such as one that results in unreasonable compensation or is treated as a dividend. Because it is nondeductible, on each $1.00 of income the employer must pay 34 cents in taxes. Since the remaining 66 cents is taxable to the employee, 17 cents of employee taxes will further reduce the original $1.00 to only 49 cents. That's bad!

BETTER. A better employee benefit is one that is *deductible* to the employer, although still *taxable* to the employee. Since there are no employer taxes, the full $1.00 is taxable income to the employee. Now 25 cents goes to pay employee taxes, and the remaining 75 cents actually benefits the employee. That's better!

Better benefits include salary allotment plans, executive equity plans, split-dollar insurance, survivor income plans, disability income plans, and deferred compensation.

BEST. The best employee benefit is one that is *deductible* to the employer and either *nontaxable* or *tax deferred* to the employee. Now the entire $1.00 benefits the employee, without any current reduction for either employer or employee taxes. That's the best!

"Best" benefits include group term insurance, medical expense reimbursement plans, SIMPLE IRAs, and qualified retirement plans, including 401(k) plans.[2]

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[1] The checklist on pages 286-294 describes many employee benefits and the income tax effect on employees.

[2] Specific benefits may not be available to all employees and employers. Although SIMPLE IRAs and qualified retirement plans, including 401(k) plans, are listed among the "best," it must be recognized that the employee pays taxes when retirement income is actually received. Tax-free group term insurance is limited to $50,000 of coverage. The term "leveraged benefit" can be used to describe some of the best employee benefits, as discussed further on page 437.