HIGHLIGHTS OF THE NEW 1996 TAX RULES AFFECTING SMALL BUSINESSES

In the waning days of its last session before the 1996 elections (and in marked contrast to 1995 gridlock), Congress passed a spate of legislation affecting small and home-based businesses. The new legislation mostly takes effect starting January 1, 1997. Below are some of the highlights.

Increased Deduction For Self-Employed Health Insurance Premiums

For 1996, the Internal Revenue Code permits self-employed business owners to deduct 30 percent of their cost of health insurance premiums. Starting in 1997, the deduction will increase to 40 percent. Between 1997 and 2006, the deduction will gradually rise to 80 percent. This is an improvement over past years, when the deduction was only 25 percent (or zero in those years when Congress let it lapse). However, this still does not match the 100 percent deduction available to "C corporations" (including those with only one shareholder).

Liberalized S Corporation Rules

Starting in 1997, the maximum number of S corporation shareholders increases from 35 to 75. Estate planning will also be a bit easier for S corporation owners. They will be able to leave S corporation stock in a trust that can distribute income to more than one person at time. Previously, only one person at a time could receive the income.

Exclusion Extended For Employer-Funded Tuition

Until 1995, employees could receive up to $5,250 per year in tuition from their employers for non-job-related education, and they were not required to pay income taxes on that tuition. This exclusion, which expired in 1995, is now being retroactively reinstated. Of course, Congress does not like to keep things simple. The exclusion will once again expire for courses beginning after May 31, 1997. For graduate-level courses, the exclusion is reinstated only for courses that began before June 30, 1996. But employees will still not be taxed on employer-funded tuition for courses, including graduate-level courses, that are job related and do not qualify an employee for a different line of work.

SIMPLE Retirement Plans

Speaking of simple, the new legislation creates a new "simplified" retirement plan for small business that is actually known by the acronym SIMPLE (Savings Incentive Match Plan for Employees). The old familiar SARSEPs (simplified employee pension plans) that are used by many small businesses will be eliminated (but existing plans are grandfathered).

SIMPLE plans will be available to employers (including self-employed business owners) with 100 or fewer employees. SIMPLE plans will not be subject to the complex nondiscrimination rules that now apply to most existing retirement plans. The employer has two choices: He or she can match, dollar-for-dollar, contributions to the SIMPLE plan that employees make voluntarily (up to 3 percent); or, the employer can contribute 2 percent whether or not the employee also makes a contribution.

Employees' voluntary contributions will be capped at $6,000 per year. The employer's contributions will be fully vested. This means that after an employer makes a contribution, the employee will own that contribution regardless of how long the employee thereafter remains employed. However, like IRAs, early withdrawals from the SIMPLE plan will be subject to a penalty on the amount withdrawn.

Increased IRA Contributions

Perhaps in an effort to simultaneously encourage savings and one-income families, starting in 1997, married couples who file joint income tax returns will be able to contribute up to $2,000 each to an IRA, regardless of the income of each spouse. Previously, each spouse could not contribute more to an IRA than they each earned during the year. For example, in 1996, if one spouse earns $1,000, that spouse cannot contribute more than $1,000 to an IRA, regardless of the income of the other spouse.

Medical Savings Accounts

The move toward health care reform and universal coverage continues with the enactment of Medical Savings Accounts (MSAs). Starting in 1997, individuals employed by small employers (including self-employed business owners) who are covered by a high deductible plan will be able to make tax-deductible contributions to special accounts designed to pay medical bills. Like IRAs, earnings on amounts in the accounts will not be taxed. Congress hopes that MSAs will give small business owners an incentive to provide their employees with health insurance.

For purposes of MSAs, a small employer is a business employing 50 or fewer employees. A high deductible plan is a health insurance plan with an annual deductible between $1,500 to $2,250 for an individual or between $3,000 and $4,500 for a family. The maximum out-of-pocket expenses (known as co-insurance or co-payments) must not exceed $3,000 for an individual or $5,500 for a family.

The maximum annual contribution to MSAs will be limited to 65 percent of the annual deductible for an individual or 75 percent for family coverage. Distributions from MSAs to pay medical expenses will be tax-free. Distributions that are not for medical expenses will be subject to a 15 percent penalty, unless made after 65 or upon the death or disability of the MSA owner.

Changes to Group Health Insurance

Most group health plans will be barred from excluding coverage for an illness if an employee received treatment for it more than 6 months before enrolling in the plan. Even when coverage may be excluded (i.e., the employee received treatment within 6 months before enrolling), the exclusion generally cannot last more than 12 months. Most group plans will also be portable. This means that the group insurer will have to offer the same or comparable coverage to terminated employees.

Conclusion

The new rules offer many tax-saving opportunities for small business owners, including self-employed owners. To take full advantage of the benefits, you should consult with an attorney or an accountant.