

CPA Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisorsm

Lower Taxes May Mean More Jobs



In some ways, the title of the Small Business Jobs Act of 2010 says it all. This new federal law aims to create jobs within the United States, with small companies acting as engines of growth. Among the multiple provisions of this act, several provide tax benefits for small businesses. The authors of the new law hope that lower taxes will make many small companies more profitable and thus more likely to add employees.

Equipment deductions

One provision of the new law expands Section 179 of the tax code, which allows small companies to buy business equipment and take a first-year tax deduction. Ordinarily, companies must depreciate the equipment they buy, thus spreading deductions over several years.

From 2008 through 2010, Congress passed a series of laws setting the maximum first-year "expensing" election at \$250,000. Once annual equipment purchases topped \$800,000, companies would lose the tax benefits of expensing, dollar for dollar. In the Small Business Jobs Act of 2010, the \$250,000 expensing cap for 2010 was increased from \$250,000 to \$500,000, and the higher limit was set for 2011 as well. (Up to \$250,000 of the \$500,000 cap can be deducted for leasehold improvements, such as renovating a store or a restaurant.) For each of those two years, the phaseout threshold is now \$2 million.

Example 1: ABC Corp. spends \$450,000 on business equipment in 2011. It can immediately deduct \$450,000, which is under the \$500,000 cap.

Example 2: DEF Corp. spends \$1.1 million on business equipment in 2011. It can immediately deduct \$500,000, the amount of the cap. The other \$600,000 of equipment purchases will be depreciated under standard IRS rules.

Example 3: GHI Corp. spends \$2.2 million on business equipment in 2011. The company's expenditures are \$200,000 over the \$2 million phaseout threshold so its expensing election is reduced by \$200,000, from \$500,000 to \$300,000. The company can depreciate the other \$1.9 million of equipment purchases under standard IRS rules.

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CPA

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Build America Bonds

Since their creation in 2009, taxable Build America Bonds have constituted over 20% of all municipal bonds issued.

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Required Income

- ❖ A “taxable income limitation” test exists that applies to the deduction under Section 179 of the tax code. The amount of the Section 179 expense deduction, the first-year deduction for business equipment, can't exceed the purchaser's business income.
- ❖ For example, suppose PQR Corp. buys \$100,000 worth of equipment in 2011. The company is entitled a \$100,000 deduction this year, but only if it has at least \$100,000 of income.
- ❖ With C corporations, the corporation usually buys its own equipment. If the corporation “zeroes out” its income via salary and bonus payments to executives, there won't be enough income to cover the Section 179 election.
- ❖ To use the Section 179 deduction, a company can pay less compensation to its executives and keep enough taxable income to be offset by the expensing deduction. In the case of PQR Corp., the company might pay a smaller bonus to its CEO and retain \$100,000 of profits, which can be offset by the Section 179 deduction.

With the new law in place, if a company spends \$2.5 million or more on equipment this year, no expensing will be permitted. As you can see, the increased deduction and phaseout levels greatly expand the number of companies that might save tax by deducting equipment expenses right away.

The Section 179 tax deduction is limited to the buyer's taxable business income that year. If a company spends \$100,000 on equipment in 2011, for example, it must have at least \$100,000 of taxable income this year to take a full deduction.

Startup deductions

The new law also increases startup deductions allowed under Section 195 of the tax code. For 2010 and 2011, the ceiling is raised from \$5,000 to \$10,000, and the phaseout threshold rises from \$50,000 to \$60,000. With this arrangement, new companies can deduct the lesser of (1) the amount of the startup expenses or (2) \$10,000, reduced by the amount by which the startup expenditures exceed \$60,000.

Example 4: JKL Corp. has startup expenses of \$10,000 in 2011. The company can deduct all \$10,000 of its outlays.

Example 5: MNO Corp. has startup expenses of \$63,000 in 2011. The company is \$3,000 over the \$60,000 threshold so it can deduct \$7,000 of its outlays: \$10,000 minus the excess \$3,000.

You incur startup costs when you're investigating or creating a new business but have not actually begun operations. (Money spent to buy capital equipment doesn't qualify.) Those costs might include market surveys, advertisements, travel to line up suppliers, consulting fees, and wages paid prior to opening the doors of a new business. Such

outlays may be deductible in the year that you begin operations, under Section 195. Costs you can't deduct right away can be amortized over 180 months, beginning in the month operations begin.

Example 6: MNO Corp. takes a \$7,000 deduction for startup costs, out of \$63,000, as previously explained. The remaining \$56,000 may be amortized over 180 months, providing MNO with a deduction of \$311 a month for those 180 months.

Built-in gains

Standard C corporations face many tax hurdles. They could owe corporate income taxes on profits, for example. The IRS might determine that a business owner's compensation is unreasonable and deny a deduction to a C corporation.

To avoid such tax traps, small companies may elect to be S corporations rather than C corporations. To qualify for this election, S corporations must meet certain criteria: they can have no more than 100 shareholders and only one class of stock, for example. After an S corporation election, business owners report company profits on their personal tax returns and the company owes no corporate tax.

Some C corporations elect S corporation status while holding appreciated assets. In the past, a 10-year rule had been in effect—if holdover assets with built-in gain were sold within 10 years of a switch to S corporation status, the company would owe tax on the built-in gain at the highest corporate tax rate, which is now 35%. The American Recovery and Reinvestment Act of 2009 shortened that 10-year holding period to seven years for 2009 and 2010. The new Small Business Jobs Act further reduces the holding period to five years for dispositions of assets with built-in gain in 2011.

With this new provision, companies that have made the C-to-S switch won't owe corporate income tax in 2011 on the built-in gain of appreciated assets sold after five years from the conversion. The reduced tax bite may help small businesses sell off unneeded assets and raise capital.

Self-employment health insurance

For several years, self-employed individuals have been able to deduct 100% of the cost of health insurance for themselves and family members. However, that deduction does not reduce the amount of self-employment income subject to self-employment (Medicare and Social Security) tax. Under the new law, self-employed individuals can deduct health insurance premiums when calculating earned income subject to self-employment tax for tax years beginning in calendar year 2010.

Example 7: Joan Barnes is a self-employed Web designer. In 2009, she reported earned income of \$90,000. Joan paid \$8,000 in health insurance premiums in 2009, which she deducted from her gross income; nevertheless, she paid Social Security and Medicare tax on \$90,000 of earnings.

Assume that Joan had the same earned income and health insurance premiums in 2010. Again, she will deduct that \$8,000 deduction from her gross income on her tax return. For 2010, though, she will owe Medicare and Social Security tax only on \$82,000 of earned income: \$90,000 of earnings minus \$8,000 in health insurance costs.

Cell phones

The tax code considers certain types of assets to be "listed property." The list includes items such as cars, motorcycles, cameras, and computers—in essence, assets that a business might provide to employees but that also can provide a nonbusiness personal benefit. Employees with listed property must keep records to show business use versus personal use. There may be limits on depreciation deductions and employees might have to report some taxable income from personal use of listed property. Your depreciation and related deductions are limited if listed property is not used more than 50% for business.

When cell phones were introduced, they were relatively expensive; employer-provided cell phones were often a perk to selected

employees. Therefore, cell phones were classed as listed property. Now, of course, cell phones are priced for a mass market and may be a workplace necessity. Therefore, the new law removes cell phones and similar devices from the category of listed property, effective in 2010. If an employer-provided cell phone is used primarily for business, employees won't have to report any taxable income for personal use.

Fed funding

Under the new law, the Small Business Administration (SBA) will create an online lending platform that lists all lenders offering SBA-guaranteed loans. This platform will display the interest rates each lender charges for SBA loans so that small business borrowers can compare rates.

Among other features of the Small Business Jobs Act are increased funding and lower fees for some SBA loans. The SBA also will conduct a three-year pilot program that offers grants to states with plans to increase small business exports. Beyond the SBA, federal contracting requirements are being amended to encourage bids from small companies and federal agencies have been told to solicit bids from small businesses. ■

More Flexibility in Retirement Planning

Some provisions of the Small Business Jobs Act of 2010 are not restricted to small companies or to job creation. Instead, they provide more choices for retirees and preretirees.

An annuity alternative

The new law gives individuals the option of annuitizing a portion of an annuity, an endowment, or a life insurance policy. That is, you can partially convert one of these financial instruments to a stream of income while the remainder is left

alone. The annuity period must last for 10 years or more, or for the lives of one or more individuals.

Example 1: Carol Thomas, age 70, has invested \$100,000 in a deferred annuity. This is a type of investment contract that permits investment income to grow tax free until money is withdrawn. Carol's deferred annuity is now worth \$200,000.

Starting in 2011, Carol can annuitize part of her deferred annuity. She decides to use

\$100,000 for an annuity that will pay her a fixed amount as long as she lives. The other \$100,000 remains in her deferred annuity, where Carol hopes for more growth. At the time Carol makes this decision, her deferred annuity contract consisted of one-half taxable earnings (\$100,000) and one-half aftertax dollars she invested. Therefore, half of her cash flow would be tax free until Carol receives a full return of half of her investment: \$50,000.

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Roth IRAs Versus DRACs

- ❖ You are now able to convert a distribution from an employer plan to a designated Roth account (DRAC). You also can convert a distribution to a Roth IRA or roll your employer plan balance to a traditional IRA.
- ❖ After a Roth IRA conversion, you can recharacterize (reverse) all or part of the conversion back to a traditional IRA until October 15 of the following year.
- ❖ When you rollover an employer plan to a DRAC, you cannot recharacterize the transaction.
- ❖ Therefore, many people will be better off with a Roth IRA than with a DRAC.
- ❖ DRACs may offer some advantages over Roth IRAs, though. Employer plans often have more creditor protection than Roth IRAs and more desirable investment opportunities may exist.

Roth rollovers

The Small Business Jobs Act also allows rollovers from elective deferral plans to Roth-designated accounts.

- Elective deferral plans are employer sponsored retirement plans that allow employees to defer some compensation and the tax on that compensation. They include 401(k), 403(b), and 457(b) plans.
- Designated Roth accounts (DRACs) are employer sponsored plans with many of the same features as Roth IRAs. They are funded with aftertax contributions. After age 59½, and after five years, all DRAC withdrawals are tax free.

To execute a rollover, your company plan must offer DRACs to employees who participate in the retirement plan. Also, you must be entitled to take distributions from your employer's plan, which typically means that you are at least age 59½ or have left the company, although some plans permit younger employees to take "in service" distributions.



If you qualify, you can execute a rollover immediately. Of course, you'll owe income tax when you convert pretax money to an aftertax DRAC.

Example 2: Lynn Parker, age 60, works for ABC Corp., where she has \$80,000 in her 401(k), all from pretax contributions. Her plan permits Lynn to take distributions from her 401(k). In 2011, Lynn rolls over \$80,000 to a DRAC offered by ABC Corp. She will have to report \$80,000 of taxable income from the rollover. Beginning January 1, 2016, Lynn can take as little or as much from her DRAC, tax free. ■

Choices for Holding Investment Property

Now that prices are off sharply from their peak levels of a few years ago, you may want to invest in real estate. If so, you are looking for a promising property at the right price. Assuming you find such an opportunity, you'll have to make still another crucial decision: how to hold your property.

Outright ownership

The simplest option is to hold the property in your own name. You'll have absolute control and flexibility. You can make the decisions on capital improvements, tenant

selection, and so on; you can sell the property or refinance it.

You'll face some disadvantages with this form of ownership, however. Depending on the amount of capital you're willing to invest, you might be limited in what you can buy. You'll also have to be sure that you're adequately insured against any liability resulting from someone being injured on your property.

Joint ownership

Married couples especially might want to hold investment property

as joint tenants with the right of survivorship. That way, when one owner dies, the surviving owner inherits automatically. The real estate won't go through probate, which can be expensive and time consuming.

The downside? When property is held as joint tenants with right of survivorship, no other heirs can inherit it. If you have remarried and hold property in this manner with your spouse, for example, you can't leave all or part of this investment to children from a previous marriage.

General partnerships

As another approach to real estate investing, you might pool your capital with others to form a general partnership.

Example 1: Tom Adams, Richard Baker, and Harriet Carter form a partnership to buy investment property. When they find something for sale that they all like, each will contribute one-third of the capital.

With this method, the partners will have access to more expensive real estate (compared to what they could have bought as individuals), and they will have extra hands to help oversee their investment. Any investment losses can be passed through to each partner.

Suppose that the partnership of Tom, Richard, and Harriet buys an office building. In 2011, the property posts a \$30,000 loss for tax purposes. As per their partnership agreement, each of the co owners will report a \$10,000 loss on his or her tax return for the year. That loss may be deducted now or in the future, depending on the taxpayer's adjusted gross income and the partner's adjusted basis in the venture.

As with anything, general partnerships are not without drawbacks. Conflicts may arise if the individual owners disagree among themselves on issues relating to the real estate. Also, each partner is personally liable for debts the partnership incurs. Even with insurance, the investors' personal assets might be at risk.

Limited partnerships

Some limitations to the general partnership might be more appealing. A *limited partnership* is a specialized form of partnership, with two types of partners.

Limited partners are usually investors with no say in the management of partnership assets. They are liable only for the capital they contribute and any notes they sign. Often, any real estate losses are allocated largely to the limited partners for tax purposes.

One or more general partners runs the business. In a real estate limited partnership, the general partner is responsible for managing the property or delegating that responsibility. The general partner bears liability for all of the partnership's obligations.

Limited liability companies

A limited liability company (LLC) might offer the best features of all the other structures. As an LLC investor (or member), you'll benefit from partnership taxation. That is, any losses from the real estate are passed through to each member's tax return. In addition, LLC members enjoy the same type of limited liability that corporate shareholders have, so their other personal assets are not at risk.

In these litigious times, you should not downplay the threat of personal liability from real estate investments. By recognizing the danger, you may be able to limit your exposure.

Example 2: Jane Clark invests in several rental properties. She has no coowners. To minimize her paperwork, Jane could create a single-member (one owner) LLC to hold all those properties. Instead, Jane creates a separate single-member LLC for each property. Therefore, if a tenant is severely injured at one of Jane's properties and sues for damages, the risk can be confined to that one property rather than affect all of the investment real estate Jane owns. ■

Trusted Advice

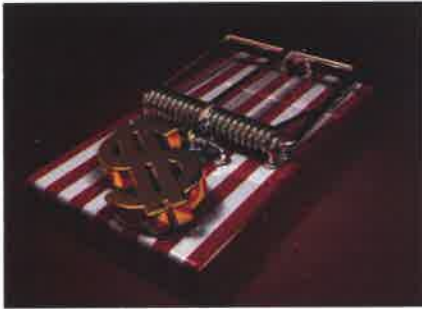
Passive Losses

- ❖ Under the tax code, a loss from investment real estate is usually a *passive loss*.
- ❖ Passive losses generally can only be deducted against passive income, perhaps from another real estate investment.
- ❖ Even without passive income, you might be able to deduct some passive losses. Typically, investors with adjusted gross income (AGI) of \$100,000 or less can deduct up to \$25,000 worth of passive losses from rental real estate activities per year.
- ❖ For every \$2 that AGI increases over \$100,000, your allowable passive loss deduction shrinks by \$1. At \$110,000 of AGI, for example, you can deduct up to \$20,000 of passive losses: the \$25,000 maximum loss minus the \$5,000 that results from the income-based phase-out.
- ❖ No deduction is permitted if your AGI reaches or exceeds \$150,000.
- ❖ Passive losses you can't deduct right away (suspended losses) can be carried forward and deducted if you have passive income in future periods or if you dispose of your entire interest in the property.

You and Your Company Can Avoid the Disguised Dividend Tax Trap

If you are the owner or part owner of a C corporation, you might think that your compensation plan is relatively straightforward. You pay yourself a salary to cover your living expenses during the year. At year end, if your company has made money, you pay yourself a bonus. Your company deducts the salary and bonus so it winds up with little or no net income and pays little or no corporate income tax.

In such a scenario, you might be in for a shock. The IRS could say that your compensation is unreasonable. Part of your compensation may be recast as a dividend, subject to both corporate and personal income taxes.



Example: Grace Moran owns 100% of ABC, a C corporation. She pays herself a salary of \$10,000 a month, or \$120,000 a year. In 2011, Grace pays herself a \$300,000 bonus. ABC reports no taxable income for 2011, and Grace pays personal income tax on her total income of \$420,000.

The IRS examines ABC's corporate return and decides that Grace's \$120,000 salary is reasonable compensation for her efforts. The other \$300,000 is classified as a dividend, bringing ABC's corporate income up to \$300,000 for the

year. Counting state and federal taxes, ABC owes about \$100,000 in corporate income tax. Grace, meanwhile, also has to pay personal income tax on both the \$300,000 dividend and her \$120,000 salary.

Sidestepping the snare

With careful planning, your C corporation can avoid this tax trap.

Possible strategies include

- **creating a formal compensation plan.** Your corporate minutes can explain the plan and report its adoption. Such a plan might call for owner-executives to receive a salary plus a bonus that's determined by financial goals, such as revenues, profits, and market share. If you worked for years with little compensation, helping your company to grow, your minutes might state that some of your compensation is a makeup for prior sacrifice.
- **using external comparisons.** Your compensation plan might refer to an industry study indicating that executives at other companies in your field are paid amounts comparable to those you are likely to receive. You might get such data from an industry association.
- **paying some corporate income tax.** In the previous example, Grace could pay herself a \$200,000 or \$250,000 bonus, rather than a \$300,000 bonus. That would leave some money in the company subject to corporate income tax. On the first \$75,000 of corporate income, your company will pay only 15% or 25% in federal corporate income tax.

- **paying some dividends.** Taking some profits as double-taxed dividends can indicate you are not "zeroing out" corporate income to avoid tax.
- **making an S corporation election.** Your company must meet several criteria (for example, it can have only one class of stock). But, if your company meets these criteria and makes the election, it will be an S corporation and, therefore, will not be subject to corporate income tax. ■

Trusted Advice

Bonuses That Look Like Dividends

- ❖ A closely held C corporation should avoid pro rata bonuses that look like dividends.
- ❖ Suppose Ann Walker owns 70% of XYZ Corporation, and Brad Taylor owns 30%. XYZ has net income of \$250,000 in 2011.
- ❖ The coowners decide to leave \$50,000 in the company. Of the remaining \$200,000, XYZ pays a \$140,000 (70%) bonus to Ann and a \$60,000 (30%) bonus to Brad.
- ❖ The IRS could say that these "bonuses" look like a division of corporate profits. The bonuses might be recast as dividends, subject to both personal and corporate income tax.
- ❖ C corporations should adopt a performance-based plan for distributing executive bonuses.