YEAR-END INCOME TAX PLANNING FOR CORPORATE AND NON-CORPORATE BUSINESSES

INTRODUCTION

Over the past twelve months we have witnessed legislative tax changes at an unprecedented pace. Now that it's time for year-end planning, we must navigate through a host of new tax changes that will have a major impact on tax planning for corporations and other businesses. Responding to a fragile economy, Congress has enacted no less than six separate tax bills, culminating with the "Emergency Economic Stabilization Act of 2008" signed by President Bush on October 3, 2008. Collectively, these six Tax Acts not only extended a variety of popular business tax breaks that had expired in 2007, but created a long list of new business tax relief provisions. **Planning Alert!** Several of the most important changes involve *short-term* economic stimulus provisions that are generally available **only in 2008**. These "2008 only" changes include: an increase in the §179 deduction, a 50% bonus depreciation deduction, a substantial increase in the first-year depreciation for passenger automobiles used for business, and the ability of corporations to swap the 50% bonus depreciation for "refundable" AMT and Research & Experimentation (R&E) credits. As 2008 is rapidly coming to a close, time to take advantage of these tax breaks is growing short!

We are sending you this letter to bring you up-to-date on these and other *new* tax planning opportunities for corporate and non-corporate businesses. We also want to remind you of the *traditional* year-end tax planning strategies that **1)** help ensure your business income is taxed at the lowest possible rate, and **2)** will postpone taxes by deferring taxable income and accelerating deductions. To help you locate items of interest, we have divided the planning ideas into the following categories:

- Recent Tax Legislation
- Traditional Planning for C Corporations
- Traditional Planning for S Corporations
- Traditional General Business Planning

Caution! This letter contains planning ideas. However, you cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the alternative minimum tax) with and without the strategy. In addition, this letter contains ideas for Federal income tax planning only. However, you should also consider any state income tax consequences of a particular planning strategy. We recommend that **you call our firm before implementing any tax planning technique** discussed in this letter, or if you need more information.

RECENT LEGISLATION

As you read the following highlights of recent tax legislation, please keep in mind that several of the most important economic stimulus tax breaks are available **only in 2008**, other long-term changes are **first effective in 2008**, while some changes are not effective until later. So, please pay careful attention to the **effective date** and **sunset date** (if applicable) of each new provision which we **highlight prominently** in each segment.

Expired Tax Breaks Extended. A long list of popular tax breaks for business taxpayers was originally scheduled to expire at the end of 2007. The Emergency Stabilization Act of 2008 (*2008 Stabilization Act*) extended the expiration dates for many of these provisions, as follows**:**

- ***Selected* Expiring Tax Provisions Extended Through The End Of 2009: 1)** 15-Year (instead of 39-Year) Depreciation Recovery Period for "Qualified Leasehold Improvements;" **2)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Restaurant Improvements;" **3)** Various Tax Incentives for Investing in the District of Columbia; **4)** Favorable S Corporation Charitable Contribution Provisions; **5)** Enhanced Charitable Contribution Rules for Qualifying Business Entities Contributing Computer Equipment, and Book and Food Inventory; **6)** Extension of Increased Rehabilitation Credit for Structures in the Gulf Opportunity Zone; and **7)** Research And Experimentation (R&E) Credit. **Planning Alert!** *Qualified leasehold* and *qualified restaurant* improvements to an existing building [i.e., **items 1)** and **2),** above] may also qualify for the temporary 50% bonus depreciation deduction (discussed below), provided the improvements are **acquired and placed in service during 2008. Tax Tip.** If your business is making improvements to an existing leased commercial building or a restaurant building, obtaining a "certificate of occupancy" for the **building by December 31, 2008** should satisfy the "placed in service" rule. Please call us if you need a rundown on the types of capital expenditures that will be considered "qualified leasehold" or "qualified restaurant" improvements to an existing building.

Increased 179 Deduction For Tax Years Beginning In 2008. For tax years beginning in 2007, your business could have deducted (under §179) up to $125,000 of the cost of qualifying depreciable business property (e.g., machinery and equipment). Also, for 2007, this deduction phased out dollar-for-dollar for the cost of §179 property exceeding $500,000. **Effective for tax years beginning in 2008**, the *2008 Economic Stimulus Tax Act* increased the maximum §179 deduction to $250,000. In addition, the $250,000 deduction is reduced by the amount by which the cost of qualifying §179 property placed-in-service during the 2008 tax year exceeds $800,000. **Planning Alert!** This increased §179 limit is available only for one year (i.e., **for tax years *beginning in* 2008).** Thus, if your business is a *calendar-year* taxpayer, the increased §179 deduction is available only if the qualified property is "placed-in-service" **by December 31, 2008.** For calendar-year taxpayers to be safe, your qualified property should be set up and tested **before 2009.**

The 50% Bonus Depreciation Is Back (For 2008 Only). The original bonus depreciation deduction was first allowed following the terrorist attacks of 2001 and generally sunset after 2004. The *2008 Economic Stimulus Tax Act* reinstated the 50% bonus depreciation deduction for **new** "qualifying property" **acquired and placed-in-service during calendar year 2008. Caution!** Property acquired pursuant to a binding contract entered into before 2008 does not qualify. **Tax Tip!** IRS says that an option to acquire property is not a binding contract. **Planning Alert!** Remember, whether your business uses a fiscal or calendar tax year, the 50% bonus depreciation is allowed only if "qualified property" is "acquired" and "placed-in-service" **during calendar year 2008**. To meet the placed-in-service requirement, property must be ready and available for use during 2008. Also, the §179 deduction (discussed above) must be taken before the 50% depreciation, and there is no AMT impact with respect to 50% bonus depreciation property unless the taxpayer elects not to take the 50% bonus depreciation. **Qualifying Property.** Generally, the 50% deduction applies only to new property that has a depreciable life for tax purposes of 20 years or less (e.g., machinery and equipment; furniture and fixtures; cars and light general purpose trucks; sidewalks, roads, landscaping, **depreciable computer software).** Also, **certain leasehold improvements** to commercial buildings and qualifying improvements to **certain restaurant buildings** may qualify for the 50% deduction. **Planning Alert!** These are only *examples* of qualifying property. If you have a question

about property that we have not mentioned, call us and we'll help you determine if it qualifies. **Tax Tip.** Make sure you properly classify "land improvements" as "15-year property" (and not as part of the building) since land improvements qualify for the 50% bonus depreciation, and buildings generally do not. Furthermore, property within a new building that is not a structural component of the building (e.g., pursuant to a *cost segregation study*) may be treated as "tangible personal property." If you can effectively segregate these costs, you may qualify for three favorable depreciation benefits: **1)** §179 treatment, **2)** the 50% bonus depreciation deduction, **and 3)** more rapid regular depreciation write-offs.

Bonus Depreciation For Passenger Automobiles. The maximum annual depreciation deduction (including the §179 deduction) for most *passenger automobiles* used in a business is capped at certain dollar amounts. For example, for 2008, the maximum first year depreciation on a business automobile is generally capped at $2,960 ($3,160 for trucks and vans not weighing over 6,000 lbs). Under the *2008 Economic Stimulus Act*, for passenger autos otherwise qualifying for 50% bonus depreciation, the first year depreciation cap is increased from $2,960 to $10,960 (for trucks and vans not weighing over 6,000 lbs, the increase is from $3,160 to $11,160).

Trucks And SUVs Over 6,000 Lbs. SUVs with loaded vehicle weights over 6,000 lbs are exempt from the passenger auto annual depreciation caps discussed above. However, these "heavy" SUVs are required to limit the §179 deduction to $25,000 (instead of $250,000 for 2008). For example, for a new "over-6,000 lbs" SUV used entirely for business that is **placed-in-service by a calendar-year taxpayer in 2008: 1)** up to $25,000 of the cost can be deducted immediately under §179, **2)** 50% of the remaining balance can be claimed as bonus depreciation, and **3)** 20% of what's left can generally be taken as regular depreciation for the first year. Thus, for a $50,000 new heavy SUV placed-in-service this year, $40,000 could be written off in 2008 (assuming 100% business use). Pickup trucks with loaded vehicle weights over 6,000 lbs are exempt from the $25,000 limit under §179 (imposed on SUVs) if the truck bed is at least six feet long. **Planning Alert!** It has been widely reported that the $25,000 deduction for SUVs over 6,000 lbs may be on the chopping block as Congress searches for ways to increase tax revenues. Therefore, 2008 may be the last year to take advantage of this tax break.

Certain Farming Business Equipment "Temporarily" Treated As 5-Year Property. The *2008 Stabilization Act* generally allows a 5-year recovery period (instead of the previous 7-year period) for any machinery or equipment (**other than** grain bins, cotton ginning assets, fences, or other land improvements) which: **1)** is used in a farming business, **2)** the *original use* of which commences with the taxpayer **after 2008**, and **3)** is *placed in service* **before 2010.** You are generally considered in the "farming business" if your business involves the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.

Small Firms Get New Credit Up To $4,000 For Make-Up Wages To Called-Up Reservists. When a reservist is called to active duty, some employers voluntarily pay the difference between the reservist's regular pay and his or her military pay. Recent tax legislation creates a new tax credit for an eligible small business employer who makes *qualified* differential wage payments **after June 17, 2008 and before 2010** to employees who are on active military duty. The credit is equal to 20% of the eligible differential wage payments for each "qualified employee." To qualify for the credit, your business generally must employ an average of fewer than 50 workers a year. The maximum amount of differential wage payments to any one employee qualifying for the credit may not exceed $20,000 for a tax year. Thus, the maximum credit for a single employee is $4,000 ($20,000×20%).

TRADITIONAL PLANNING FOR C CORPORATIONS

Should Shareholder/Employee Take A Year-End Bonus Or Dividend? Since your corporation can generally deduct a bonus, and cannot deduct a dividend, the answer to this question is based largely on the tax brackets of both the corporation and the shareholder. If your corporation would receive little or no tax benefit from a bonus deduction (e.g., it is incurring current losses and/or has net operating losses), then a dividend taxed at a maximum rate of 15% will generally save taxes. On the other hand, if your corporation is currently in the top tax bracket, and the shareholder can shelter a bonus with other losses, then a bonus would likely save taxes. **Planning Alert!** If your corporation pays compensation to a

shareholder/employee that is considered unreasonably high, the IRS will likely attempt to re-classify the payment as a dividend payment. **Tax Tip.** If you are wrestling with this issue, please contact us and we will help you tailor a compensation plan that will maximize the tax savings to you and your corporation. **Planning Alert!** Paying dividends to shareholders of Personal Service Regular "C" Corporations (in lieu of compensation) will generally not save you taxes. Personal Service Corporations generally are required to pay a flat 35% corporate tax rate (as discussed below).

Year-End Planning For Personal Service Corporations. If you own a "C" corporation that is a personal service corporation (PSC), all income retained in that corporation is taxed at a flat rate of 35%. Your C corporation is a PSC if its business is primarily in the areas of health, law, accounting, engineering, actuarial sciences, performing arts, or consulting. Furthermore, in order to be classified as a PSC, substantially all of your corporation's stock must be held by employees who are performing those services. **Tax Tip.** Generally, it is preferable from a tax standpoint to leave as little taxable income in a PSC as possible. This may be accomplished by paying reasonable salaries and compensation to the stockholders/employees **by year-end.**

Pay Sufficient Estimated Tax. If your C corporation had less than $1 million of taxable income for each of the past three tax years, it will be classified as a "small corporation" and may base its quarterly estimated tax payment on 100% of its "prior" year tax liability. If the corporation is not a "small corporation," it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its "current" year tax liability, or 100% of its annualized tax liability. **Planning Alert!** If your "small corporation" had no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the "current" year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty. **Tax Tip.** If your "small corporation" anticipates showing a small tax loss in 2008, you may want to accelerate income (or defer expenses) in order to generate a **small income tax liability in 2008.** This will preserve the corporation's ability to use the "100% of last year's tax" safe harbor for 2009 estimates. If the corporation expects taxable income of more than $1 million for the first time in 2008, you should consider **deferring income into 2009** or **accelerating deductions into 2008** to ensure that your corporation's 2008 taxable income does not exceed $1 million, so that it maintains its "small corporation" status for 2009.

Document Uncollectible Debts. If you have previously loaned money to your corporation and the corporation cannot repay the loan, you may be entitled to a bad debt deduction. To take that deduction in 2008, you must establish that you began efforts to collect the debt **well before December 31, 2008,** in order to establish the debt's worthlessness in 2008. **Tax Tip.** Generally, a shareholder's bad debt from the corporation is treated as a short-term capital loss (i.e., deductible up to the shareholder's capital gains plus $3,000). However, if you can establish that the primary purpose for loaning the funds to your corporation was to preserve your employment by the corporation, you may be entitled to a deductible "business bad debt" and avoid the limitations on capital losses. The IRS typically requires significant evidence showing you made the loan to preserve your job. **Planning Alert!** If your loan to your corporation is treated as a business bad debt, it will constitute a "miscellaneous itemized deduction" which is subject to the 2% reduction rule, and is not deductible at all for alternative minimum tax purposes.

TRADITIONAL PLANNING FOR S CORPORATIONS

Check Your Stock And Debt Basis Before Year End. If your S corporation is anticipating a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless you have adequate "basis" in your S corporation. You will have basis to the extent of the amounts paid for your stock (adjusted for net pass-through items and distributions) plus any amounts you have personally loaned to your S corporation. If you do not have sufficient stock basis for the pass-through loss, a mere guarantee of a third-party loan made to your S corporation will not give you basis for loss pass-through purposes. **Tax Tip.** It may be possible to restructure an outside loan to your corporation in a way that will give you adequate basis. However, this restructuring must occur **before the end of the tax year**. **Planning Alert!** The rules for restructuring loans to an S corporation are complicated. **Please do not attempt to restructure your loans without contacting us first.** Also, if you finance losses of an S corporation with loans from other entities controlled by you, or if you borrow from another shareholder, the

IRS may take the position that these loans do not give you basis. It is best not to finance S operations with funds borrowed directly from related corporations or from other shareholders.

Be Careful With Payments On Shareholder Loans. If your S corporation makes a principal payment on a shareholder loan where the loan's basis has been reduced by previous pass-through losses, the shareholder will recognize gain. If the loan is an "open account" (i.e., not evidenced by a written promissory note), the gain will be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note, the gain on the payback may qualify for favorable long-term capital gains treatment. **Tax Tip.** It may save you taxes in the long run if you postpone principal payments on the depleted-basis loan until the loan's basis has been restored by subsequent S corporation pass-through income. **Planning Alert!** These rules are quite technical. Please call us before your S corporation makes principal payments on shareholder loans and we will advise you on which payoff strategy is best for you.

Salaries For S Corporation Stockholders/Employees. The combined employer and employee FICA tax rate is 15.3% of your wages up to $102,000 for 2008. For 2008, the combined rate drops to 2.9% for wages in excess of $102,000. **Tax Tip.** If you are a stockholder/employee of an S corporation, you may wish to take no more than a "reasonable salary" from your corporation to minimize your FICA tax. Other income that passes through to you or is distributed to you as a distribution on your stock is not subject to FICA tax. **Planning Alert!** Determining "reasonable salaries" for S corporation stockholders/employees is a hot audit issue and the IRS has taken many taxpayers to court and won! The IRS has been successful where S corporation owners pay themselves no salary even though they provided significant services to the corporation. In these cases, the courts generally held that all amounts paid out to the S corporation owners were actually wages subject to FICA and Medicare taxation. **Caution!** Minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages."

TRADITIONAL GENERAL BUSINESS PLANNING

Self-Employed Business Income. If you are self-employed and use the cash method of accounting, consider delaying year-end billings to defer income until 2009. **Planning Alert!** If you have already received the check in 2008, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

Year-End Accruals To Employees. Generally, if an accrual-basis business accrues year-end compensation to its rank-in-file (unrelated) employees, the accrual must be paid no later than the 15th day of the third month after year-end to be deductible for the year of the accrual. Otherwise, the accrual is not deductible until paid. **Planning Alert!** These rules also apply to accrued vacation pay, and to accruals for services provided by independent contractors (e.g., accountants, attorneys, etc.).

Accruals To "Related Parties." Don't forget, year-end accruals to certain cash-basis recipients must satisfy the following rules in order for an accrual-basis business to deduct the accruals. These rules apply to fiscal year as well as calendar year-end businesses:

- **Regular C Corporations.** If your regular C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning more than 50% (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income. **Tax Tip.** If the corporation's tax rate for 2008 is significantly greater than the stockholder's individual rate for 2008, the accrued amount should be paid by the **end of 2008.**

- **S Corporations And Personal Service Corporations.** If your S corporation or personal service C corporation accrues an expense to any shareholder (regardless of the amount of stock owned), the accrual is not deductible until the day it is includable in the shareholder's income.

- **Partnerships, LLCs, LLPs.** If your business is taxed as a partnership, its accrual of an expense to **any owner** will not be deductible until the day it is includable in the owner's income.

- **Other Related Entities.** Generally, an expense accrued by one related partnership or corporation to another **cash-basis** related partnership or corporation is not deductible until the day it is includable in the cash-basis entity's income.

Establishing A New Retirement Plan For 2008. Calendar-year taxpayers wishing to establish a qualified retirement plan for 2008 (e.g. profit-sharing, 401(k), or defined benefit plan) *generally* must adopt the plan **no later than December 31, 2008**. However, an SEP may be established by the due date of the tax return (including extensions), and a **SIMPLE plan** must be established **no later than October 1, 2008.**

FICA Withholding On Deferred Compensation. If your business sponsors a nonqualified deferred compensation plan, you may have certain FICA tax withholding and reporting responsibilities. IRS regulations provide that FICA taxes are due on most deferred compensation in the year the compensation is **earned, rather than the year it is paid.** The IRS says that your business can pay its portion of the FICA tax (and can withhold the executive's portion) with the final payroll of the year. The specifics of these regulations are too lengthy to address in detail in this letter. Please call us if you have questions.

Personal Use Of Company Cars. If your company provides employees with company-owned cars, the company is required to include the value of the personal use of the car in the employees' W-2 income. However, this is not required if the employee reimburses the company for the personal use. **Planning Alert!** If your company does not report the employee's personal use as W-2 income and the employee does not reimburse the company for the personal use, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion. **Tax Tip.** If the employee chooses to reimburse the company for personal use of the car, the obligation for reimbursement should be established **on or before December 31st** so the employee will not have income in one year and a deduction in the next. This can be accomplished by establishing a published policy for reimbursement of personal use. Furthermore, your company should obtain signed statements from employees documenting their business and personal mileage for the company car.

Mileage Reimbursement Rates. This summer, IRS had some good news for businesses and individuals struggling with record-high gasoline prices. The IRS raised the "business standard mileage" reimbursement rate from **50.5 cents-per-mile to 58.5 cents-per-mile**. Taxpayers may use the higher rate for business use of an automobile for the **period July 1, 2008 through December 31, 2008.** Business travel before July 1 must be computed using the old rate of 50.5 cents-per-mile.

Be Careful Before You Trade In A Business Vehicle. If you are considering a trade of your business auto for another business auto, please call us first. **Tax Tip.** If the tax basis of the old vehicle is significantly greater than the fair market value at the date of the trade (due to annual depreciation limits), a sale of the old auto (and a purchase of the new one) could produce a deductible tax loss that will be deferred if you trade. However, the sales tax implications of a sale, rather than a trade, must also be considered.

Expanded "Kiddie Tax" Encourages Hiring Children By Family Businesses! Previously, children under age 18 were taxed on their unearned income (e.g., interest, dividends, and capital gains) at their parents' marginal tax rate if the unearned income exceeded a *threshold amount*. This rule is commonly referred to as the "kiddie tax." **Starting in 2008**, the *kiddie tax* is expanded and becomes more complicated. Under the new rules, a child who *is not filing a joint return with a spouse* will have his or her "unearned income" in excess of the *threshold amount* ($1,800 for 2008), taxed at the *parents' tax rate* if: **1)**The child either *has not attained age 18* by the *close of the tax year*; **OR 2)** The child *is age 18* by the *close of the tax year* AND the child's earned income does not exceed one-half the child's support; **OR 3)**The child is *age 19 through 23* by the *close of the tax year* AND the child is a full-time student AND the child's earned income does not exceed one-half the child's support. **Tax Tip.** Since a child's *earned income* is not taxed at the parents' rate, the expanded kiddie tax further encourages you to employ your child in your business and pay your child *reasonable* compensation. Your child's W-2 earnings won't be

subject to the kiddie tax and will generate a deduction for the family business. Also, to the extent of your child's unused standard deduction, the earnings will not be taxed for Federal income tax purposes. If a child is under age 18 and working for a parent's sole proprietorship or partnership where the only partners are the parents, the child's wages will also be exempt from FICA tax. **Planning Alert!** If you employ your children in your family business, be sure to **1)** carefully document that the wages are reasonable, **2)** pay the wages as part of the regular payroll, **3)** make sure the payroll checks are timely cashed and placed in the child's account, and **4)** comply with all laws relating to the employment of children.

FINAL COMMENTS

Please call us if you are interested in a tax topic that we did not address in this letter. Tax law constantly changes due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes and we will be glad to discuss any current tax developments and planning ideas with you. **We urge you to call us before implementing any planning ideas addressed in this letter, or if you need more information.**

Note: The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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