

BUSINESS LAW NOTES

Special End of Year Tax Issue



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Business Strategies for 2011 Year-End Tax Planning

By F. Stephen Glass

Old Father Time has just a few weeks left for you to make strategic tax changes for your 2011 tax return. Just a little bit of planning now can often go a long way on April 15. You might consider some of the following ideas for possible year-end tax strategies:

- **Accelerate deductions and defer income.** Why pay tax now when you can pay tomorrow? Deferring tax is a cornerstone of tax planning. Generally this means you want to accelerate deductions into the current year and defer income into next year. There are many items of income and expenses you may be able to control; business owners and self-employed taxpayers often have the best opportunities to execute this strategy by deferring income into 2012.
- **S Corporation Built-In Gains Tax:** An S corporation generally is not subject to tax; instead, it passes through its income or loss items to its shareholders, who are taxed on their pro-rata shares of the S corporation's income. However, if a business that was formed as a C corporation elects to become an S corporation, the S corporation is taxed at the highest corporate rate on all gains that were built in at the time of the election if the gains are recognized during a special holding period. While for tax years beginning in 2009 and 2010, the special holding period was shortened from 10 years to seven years, it is shortened even more for tax years beginning in 2011, to five years.
- **Maximize "above-the-line" deductions.** Above-the-line deductions are adjustments that are certain expenses which directly reduce your total income. You do not need to itemize your deductions in order to claim these expenses. Instead, adjustments are considered "above-the-line" tax deductions. You claim these deductions directly on Form 1040 page one. Adjustments include traditional IRA deduction, student loan interest, moving expenses, health insurance expenses and SEP IRA contributions for self-employed persons, and alimony paid. A complete list of adjustments to income can be found on the IRS website: www.irs.gov. Adjustments reduce your total income to arrive at your Adjusted Gross Income (AGI).
- **Consider charitable contributions carefully.** Think about giving appreciated property to charity so you can deduct the full value without paying capital gains taxes. But don't donate depreciated property. A company can generally deduct donations of property equal to its basis in the property.
- **Hire "target" workers.** The Work Opportunity Tax Credit (WOTC) is a Federal tax credit incentive to private-sector businesses for hiring individuals from nine target groups who have consistently faced significant barriers to employment. To be eligible under the WOTC program, a new hire must have begun to work for an employer **after** December 31, 2006 **and before January 1, 2012**. For an employee to be certified as an eligible group member, the new hire must belong to one nine WOTC target groups. For more information, see <http://www.doleta.gov/business/incentives/opptax/eligible.cfm>.



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- **100% Exclusion of Gain Attributable to Certain Small Business Stock:** The incentive for individuals to acquire qualified small business (QBS) stock is higher before the end of 2011. An individual ordinarily may exclude 50% of the gain from qualified small business stock that is held for at least five years (subject to a cap). "Qualified small business stock" is stock of a corporation the assets of which do not exceed \$50 million when the stock is issued. The 50% exclusion of gain was increased to 75% for qualified small business stock acquired after February 17, 2009, and before September 28, 2010. The 2010 Small Business Jobs Act excluded 100% of the gain for qualified small business stock acquired or issued after September 27, 2010, and the 2010 Tax Relief Act extended the 100% exclusion to qualified small business stock acquired before January 1, 2012. In addition, the alternative minimum tax preference item attributable to the sale is eliminated. **Action opportunity: Organize or convert into a QSB!!!**
- **Qualified Dividends:** Qualified dividends received in 2011 are subject to rates similar to the capital gains rates. Therefore, qualified dividends are taxed at a maximum rate of 15%. Qualified dividends are typically dividends from domestic and certain foreign corporations. Note that the reduced dividend rates apply through 2012.
- **Differential Wage Pay Credit:** The 2010 Tax Relief Act revived the differential pay credit (which had expired at the end of 2009) and extended the availability of the credit to amounts paid on or before December 31, 2011. Therefore, if an employer meets certain qualification requirements, it can take a credit against its 2011 income tax liability in an amount equal to 20% of the sum of the "differential wage payments," up to \$20,000, that the employer makes to an employee in active duty in the military.
- **Credit for Employee Health Insurance Expenses of Small Employers:** Eligible small employers are allowed a credit for certain expenditures to provide health insurance coverage for their employees. Generally, employers with 10 or fewer full-time equivalent employees (FTEs) and an average annual per-employee wage of \$25,000 or less are eligible for the full credit. The credit amount begins to phase out for employers with either 11 FTEs or an average annual per-employee wage of more than \$25,000. The credit is phased out completely for employers with 25 or more FTEs or an average annual per-employee wage of \$50,000 or more. The credit amount is 35% of certain contributions made to purchase health insurance.
- **Self-Employed Health Insurance Premiums:** Self-employed individuals are allowed to claim 100% of the amount paid during the taxable year for insurance that constitutes medical care for themselves, their spouses, and their dependents as an above-the-line deduction, without regard to the 7.5%-of-AGI floor.
- **Increase Business Expenses.** Purchase items your business will require in the immediate future to maximize deductions for this year. If you can see a need for goods and services in the first quarter of the new year, buy them now, if cash flow permits. Consider the following items for expenses:

Office Supplies: Stock up on fax paper, printer cartridges, stationary, and other office items.

Pay Bills Early: Pay your bills before 2012 in areas such as; cell services, subscriptions, rent, insurance, and utilities [including legal fees for business expenses]!!!

Equipment Purchases. Section 179 expensing allows businesses to deduct the full purchase price of certain equipment and software. Under the 2010 Small Business Jobs Act, for tax years beginning in 2010 and 2011, you may be able to expense up to \$500,000 in eligible purchases as long as the equipment is placed into service during the eligible tax years. Qualifying property includes machines purchased for business use, business vehicles with a gross vehicle weight exceeding 6,000 lbs. (SUVs and many trucks are subject to a \$25,000 limitation), computers, off-the-shelf computer software, office furniture and equipment, and certain qualified leasehold improvement, restaurant and retail improvement real property. Note that you may be eligible for Section 179 expensing whether you lease, finance or purchase the equipment outright. The \$500,000 amount is reduced dollar for dollar for eligible equipment purchases (excluding the qualified real property items, if so elected) during the year exceeding \$2 million.

Other Items. This category includes: pre-payment of subscriptions, travel bookings, equipment repairs, and maintenance.

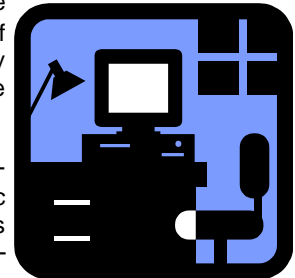
Inventory Write-Offs: Depending on your accounting methods, you may wish to check inventory for goods that have been damaged or have become obsolete. The drop in market value of the inventory can provide your company with added deductions.

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- **Home Office Deduction:** Expenses attributable to using the home office as a business office are if the home office is used regularly and exclusively: (1) as a taxpayer's principal place of business for any trade or business; (2) as a place where patients, clients, or customers regularly meet or deal with the taxpayer in the normal course of business; or (3) in the case of a separate structure not attached to the residence, in connection with a trade or business.
- **Bad Debts:** You can accelerate deductions to 2011 by analyzing your business accounts receivable and writing off those receivables that are totally or partially worthless. By identifying specific bad business debts, you should be entitled to a deduction. You may be able to complete this process after year-end if the write-off is reflected in the business' 2011 year-end financial statements.
- **Expense Business Investments.** The 2010 Tax Relief Act increased bonus depreciation from 50% to 100% for qualified investments made from September 9, 2010, through December 31, 2011. That means you can depreciate 100% of qualified investments placed in service during that period. Generally, businesses take advantage of 179 expensing before bonus depreciation, so this will be useful to large businesses spending more than \$2 million on equipment in 2011. Note that bonus depreciation applies only to new equipment while 179 expensing can apply to new and used equipment.
- **Are You A Corporate Employee-Shareholder?** S corporation shareholder-employees may consider keeping their salaries at a "reasonably" low level and increase their distributions of company income in order to avoid the Medicare tax on the distribution portion of their income. What is a "reasonable" salary depends upon the facts and circumstances. The shareholder-employee must exercise due caution in making this determination, for it is an area of great interest by the IRS. C corporation owners may prefer to take more salary (which is deductible at the corporate level) because the Medicare tax rate is typically lower than the 15% tax rate they would pay if they instead received the income as a dividend.



- **Note for future planning:** A new additional Medicare tax goes into effect in 2013. For information you need to know, see the Medicare.org website: www.medicare.org. Look for "New Medicare-Related Taxes in 2013" and "New additional Medicare payroll tax."

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JOHNSON, HEARN, VINEGAR, GEE & GLASS, PLLC

434 Fayetteville Street, Suite 2200, Raleigh, N.C. 27601

Telephone: 919.743.2200; Fax: 919.743.2201; Firm e-mail: jhvgg@jhvgglaw.com

Please visit our firm's content-rich webpage: www.jhvgglaw.com.



Individual Income Tax Strategies for 2011 Year-End Tax Planning

By F. Stephen Glass

Bunching Your Deductions for Maximum Advantage. Bunching your deductions simply means fitting as many deductible expenses into one tax year as possible. You will need to keep track of your expenses throughout the year, and if they are falling short of what you need for a deduction by the end of the year, you might prepay certain services or take care of medical expenses before the year is over. For example, if your AGI is \$50,000 then your medical expenses must total \$3,750 before you can list it as a deduction. If your medical expenses fall a thousand dollars or so short, bunching may not be an option – but if you're only a few hundred dollars short, you could consider paying for certain medical needs in advance. For example, you could purchase a year's supply of contact lenses in advance or give the whole family flu shots to bring your expenses up. Use this as a year-long tax strategy!

Increase Your business ownership in order to deduct a 2011 loss. If you own an interest in a partnership or S corporation, you can typically only deduct losses up to the value of your capital contribution to the S corporation. You may need to increase your capital, in the case of an S corporation, or in the case of a partnership, by providing cash, by loaning, or by personally signing on the entity's debt in order to deduct maximum business losses in 2011.

Special Charitable Contributions for Certain IRA Owners. This provision offers older owners of individual retirement accounts (IRAs) a different way to give to charity. An IRA owner, age 70 1/2 or over, can directly transfer tax-free up to \$100,000 per year to an eligible charity. This option is available for distributions from IRAs, regardless of whether the owners itemize their deductions. Distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pension (SEP) plans, are not eligible. To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. A charitable deduction erases taxable income after you've already calculated your AGI. However, if you make the gift straight from an IRA distribution, the amount of the gift is not included in the calculation of your income at all, thus lowering your AGI.

Rules for Clothing and Household Items. To be deductible, clothing and household items donated to charity generally must be in good used condition or better. A clothing or household item for which a taxpayer claims a deduction of over \$500 does not have to meet this standard if the taxpayer includes a qualified appraisal of the item with the return.

Reminders regarding donations:

Contributions are deductible in the year made. Donations charged to a credit card before the end of 2011 count for 2011. This is true even if the credit card bill is not paid until 2012. Also, checks count for 2011 as long as they are mailed in 2011 and clear the bank shortly thereafter.

Be sure that the organization is an IRS tax-exempt charity. If you are unsure, check the IRS website: www.irs.gov. Only donations to qualified tax-exempt organizations are tax-deductible. *Beware: Not all nonprofit organizations are qualified tax-exempt charities.*

The tax tips contained in this issue of Business Law Notes constitute general information only and may not be applicable to your particular circumstances. Consult your business attorney and tax advisor before acting on any general information.

F. Stephen Glass is the author of numerous publications on business and business entities as well as estate planning. He is a frequent presenter for the National Business Institute. His practice is concentrated in the areas of business and corporate law, business succession planning and estate planning. He serves on the Cary Board of Capital Bank. Mr. Glass has earned the highest peer-review rating for professional excellence and ethical standards by the national publication Martindale-Hubbell. He serves on the American Bar Association Business Law Committee on Corporate Governance.