CORDASCO
& COMPANY P.C.
Certified Public Accountants

2012

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

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2012 YEAR-END INCOME TAX PLANNING FOR CORPORATE AND NON-CORPORATE "BUSINESSES"

It's that time of year when businesses should consider year-end planning strategies. Year-end planning for 2012 is a bigger challenge than in previous years because we are facing the most significant tax uncertainty in recent memory, largely caused by: **1)** the scheduled expiration of the so-called *Bush-Era* tax cuts ***after 2012*** causing higher taxes on the business income of many business owners; **2)** the scheduled increase ***after 2012*** of the tax rates on dividends and capital gains, **3)** the new "Medicare Surtaxes" ***starting in 2013*** that will apply to many higher-income employees, self-employed individuals, and business owners, **4)** a host of popular business tax breaks that either ***expired*** or were ***scaled back*** after ***2011,*** **5)** another long list of business tax breaks scheduled to expire or to be scaled back ***after 2012,*** and **6)** the uncertainty as to whether, or for how long, any of these expired or expiring business tax breaks will be extended.

It is possible that Congress may address many of these uncertainties before the end of 2012. Some are predicting that Congress may address these expired or expiring tax breaks in an "extender's bill" in its lame-duck session after the Presidential election. However, others believe that Congress will not address these tax issues until early 2013. Due to this uncertainty, we believe the best approach for year-end planning in this volatile tax environment is to become familiar with the tax changes that are ***currently scheduled*** to occur ***after 2012***, and to be ***prepared to act quickly near the end of 2012*** based upon the tax climate at that time. In addition, whether or not Congress takes action by the end of 2012, there are ***"traditional" year-end planning strategies*** that can save taxes for many businesses.

We are sending this letter to: **1)** identify potential year-end tax strategies for businesses and owners that exist in light of the major tax changes currently scheduled to take effect in 2013; **2)** identify alternative considerations if Congress changes the law late in 2012; and, **3)** remind you of traditional year-end planning opportunities that could likely save businesses and owners 2012 taxes no matter what course Congress takes with future legislation.

> **Planning Alert!** Although this letter contains many planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability on the business and its owners (including the alternative minimum tax) with and without the strategy. In addition, ***this letter contains ideas for Federal income tax planning only*****.** 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.

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PREPARING FOR POTENTIAL TAX RATE INCREASES ON BUSINESSES

Unless Congress changes current law, most businesses (regardless of form) are facing a significant increase in Federal income tax rates ***after 2012.*** For individual owners of pass-through entities (e.g. S Corporations, Partnerships, LLCs), the top individual income tax rate on the pass-through business income is generally scheduled to jump from 35% to 39.6%. Although there is no scheduled increase in the maximum 35% regular "income" tax rate for "C" corporations, the "accumulated earnings" and "personal holding company" penalty taxes that can be imposed on "C" corporations are scheduled to increase from 15% to 39.6%. Furthermore, the top tax rate on a "dividend" paid to a corporate shareholder generally increases from 15% to 39.6%. Also, if a business entity (regardless of form) redeems or buys out an owner in a "capital gain" transaction, the top capital gains rate to the redeemed owner increases from 15% to 20%. Finally, ***in addition to*** these tax rate increases, the *Health Care Act* imposes on ***higher-income employees and self-employed individuals*** a new ***.9% Medicare Surtax*** on their *compensation* and *earnings from self-employment,* and a new **3.8% Medicare Surtax** on their *investment income.* The ***3.8% surtax*** applies not only to classic investment income (e.g., dividends, interest, capital gains), but also generally applies to *"rental"* income and *"business income"* reported by *"passive"* owners (that is not otherwise subject to the 2.9% Medicare Tax). Consequently, the Federal tax rates for business owners taxed in the highest income tax brackets ***in 2013*** who are also subject to these new Medicare surtaxes could be as high as: ***40.5%*** (up from the current 35%) for pass-through business income, wages, and self-employment income; ***43.4%*** (up from 35%) for certain "passive" pass-through business income; ***23.8%*** (up from the current 15%) for long-term capital gains; and ***43.4%*** (up from the current 15%) for dividend income.

Planning Alert! The uncertainty concerning the extension of the *Bush-Era* tax cuts makes tax planning during 2012 extremely challenging. It is uncertain at this point whether Congress will allow the scheduled rate increases to take effect in 2013, or continue 2012 tax rates at least for the short term. Therefore, we recommend that businesses and owners who will be significantly hurt by the scheduled 2013 rate increases begin planning now for strategies that take advantage of the current lower rates on dividends, capital gains, rental income, and pass-through business income. However, it seems prudent to postpone implementing, ***until later in 2012,*** any proposed strategy that would actually accelerate income. This will give us more time to evaluate current Congressional efforts to delay the scheduled increased rates for dividends, capital gains, etc. However, there are several basic tax strategies that businesses (and owners) should consider in anticipation of the scheduled 2013 tax rate increase, including:

S Corporation Shareholders And Limited Partners Should Consider Taking Steps Before 2013 To Minimize Exposure To The New Medicare Surtaxes On "Passive" Business Income.

Starting in 2013, there is a new 3.8% Medicare Surtax on the "net investment income" of **married individuals filing jointly** with modified adjusted gross income (MAGI) **exceeding $250,000 (exceeding $200,000 if single).** For purposes of this 3.8% surtax, *net investment income* includes *operating* business income that is taxed to a ***"passive"*** owner (unless the operating income constitutes *self-employment* income to the owner that is subject to the 2.9% Medicare tax). For this purpose, an owner is considered *"passive"* in a business activity (excluding activities conducted through a C corporation) if the owner is "passive" under the *passive loss limitation* rules that have been around for years. For example, you are deemed to *materially participate* (i.e., you're not "passive") if you spend ***more than 500 hours*** during the year working in the business.

- **Special Rule For "Passive" Operating Income.** As mentioned above, business income reported by a ***"passive"*** owner is ***not*** *"net investment income"* ***if the income is otherwise subject to the 2.9% Medicare tax.*** Pass-through business income to a ***"general"*** partner ***is*** subject to S/E tax (including the 2.9% Medicare tax and the new .9% Medicare Surtax on "earned income"), ***regardless of whether*** the partner "materially participates" in the partnership's business activities. Therefore, pass-through business income to a ***general*** partner ***is exempt*** from the 3.8% surtax on *net investment income*. However, pass-through business income to an ***S corporation shareholder*** or a ***"limited"*** partner (other than "guaranteed payments") is ***not subject*** to S/E tax (including the 2.9% Medicare tax or the new .9% Medicare surtax on "earned income"). Therefore, if you are a ***limited partner*** or ***S corporation shareholder***, your pass-through business income will generally be ***net investment income*** (and, thus exposed to the 3.8% Medicare Surtax) ***unless*** you ***"materially participate"*** in the operations of the business.

- **"Passive" S Corporation Shareholders And Limited Partners Should Consider "Materially Participating."** If you are an ***S corporation shareholder*** or ***limited partner,*** and you *materially participate* in the business, your pass-through business income will be ***exempt*** from the new 3.8% Medicare Surtax on "net investment income."

  Note! The income is also exempt from Social Security and Medicare taxes (including the new .9% Medicare Surtax on earned income). Thus, if you are currently a "passive" owner, you should begin evaluating what steps you could reasonably take to *"materially participate"* after 2012 to avoid the 3.8 Medicare Surtax on the *operating business income*. For example, one way to *materially participate* in the business would be to devote *over 500 hours* each year working for the business.

  Tax Tip. Depending on the specifics of your business operation, and the type of ownership interest you have in that business (e.g., S corporation shareholder vs. limited partner), there may be other ways you can *"materially participate"* while spending less than 500 hours working in the business.

Planning Alert! If you have other *"passive"* activities generating losses, you may prefer to remain *passive* so that your pass-through business income may be used to offset your *passive* losses from the other passive activities.

Caution! These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

Certain Owners Of Rental Real Estate May Be Able To Avoid The New Medicare Surtax.

Real estate rental income is generally **1)** presumed "passive" income, and **2)** exempt from S/E tax (including the 2.9% Medicare tax). Consequently, ***real estate rental income*** generally constitutes ***net investment income,*** and is subject to the new 3.8% Medicare Surtax ***starting in 2013.*** However, if you are a ***"qualified real estate professional"*** and you ***materially participate*** in your rental real estate activity, your real estate rental income: **1)** is ***not*** "passive," **2)** is ***not*** subject to S/E tax (including the 2.9% Medicare tax), and **3)** will presumably ***not*** be subject to the 3.8% Medicare Surtax on *net investment income*. Consequently, a ***"qualified real estate professional"*** should be able to avoid the 3.8% Medicare Surtax on real estate rental income by materially participating in the rental real estate activity. Generally, a ***qualified real estate professional (QREP)*** is an individual **1)** who performs ***more than 750 hours*** of services during the year in ***"real property"*** trades or businesses (e.g., real estate development, management, construction, rental, leasing, brokerage), **2)** who ***materially participates*** in those businesses, **and 3)** who spends ***more than 50%*** of his or her total working hours for the year performing services in *"real property"* trades or businesses.

Tax Tip. There are certain tax elections relating to your rental real estate activities that may enhance your ability to qualify for these special rules.

Owners Of Closely-Held "C" Corporations Should Prepare For Late-Breaking Tax Rate Changes.

There are several techniques shareholders of closely-held "C" corporations can use to take money out of their corporation, including: paying ***compensation*** to the shareholder-employee; having the corporation ***redeem*** all or a portion of the shareholder's stock; and/or, paying the shareholder a ***dividend.*** If *"compensation"* is paid and is "reasonable," the corporation generally gets a deduction and the owner is taxed at a maximum rate of 35% (scheduled to be as high as 40.5% after 2012). If a *"dividend"* is paid, the corporation gets no deduction, and the shareholder is taxed at a maximum rate of 15% (scheduled to be as high as 43.4% after 2012). If the corporation *"redeems"* all or a portion of the shareholder's stock in a transaction that qualifies for capital gains treatment, the corporation gets no deduction, and the shareholder's long-term capital gain is taxed at a maximum rate of 15% (scheduled to be as high as 23.8% after 2012). If you are a shareholder, the technique that is most tax advantageous overall for taking money out of your corporation depends largely on **1)** your particular situation, and **2)** what

ultimately happens with the various tax rates after 2012. If the scheduled tax rate increases do in fact go into effect after 2012, then a shareholder who wants to take money out of his or her "C" corporation might save considerable taxes overall by paying compensation, redeeming stock, and/or paying a dividend ***before 2013.***

> **Planning Alert!** Whichever technique or combination of techniques is used (i.e., compensation, redemption, or dividend), each technique should be properly structured and documented in order to be honored for tax purposes. So, if you are considering taking substantial funds from your closely-held "C" corporation at some point, please call us as soon as possible. We will help you develop a strategy that is most tax favorable to your particular situation, and that we can implement quickly if we have tax rate developments that break late in 2012.

Converted S Corporations Should Consider Distributing "E&P" As A Dividend Before 2013.

S corporations that were previously C corporations (converted S corporations) that have accumulated "earnings & profits" (E&P) from C corporation years are subject to a 35% *"passive investment"* corporate income tax if: **1)** the corporation has E&P at the end of a tax year, and **2)** more than 25% of the S corporation's gross receipts for the year is from "passive investment income" (e.g., dividends, interest, royalties, certain rents). Moreover, if this situation continues for three consecutive years, the S election automatically terminates. One way to avoid both of these tax traps is to pay all of the corporation's E&P out to the shareholders as a "taxable dividend." While maximum dividend rates are still at 15% in 2012, owners of converted S corporations with E&P accumulated while a C Corporation should carefully consider making dividend distributions of the E&P ***by the end of 2012.*** If you have a "converted" S corporation that generates income from dividends, royalties, interest, and/or rents, please call us. We will evaluate whether your converted "S" corporation has E&P, and whether it would be advisable to distribute that E&P ***before 2013.***

PAY CLOSE ATTENTION TO EXPIRED, EXPIRING, OR SCALED BACK TARGETED BUSINESS TAX BREAKS

In addition to the overall tax rate increases scheduled for individuals reporting business income, dividends, and long-term capital gains, Congress has also given us an ever-expanding list of temporary ***targeted*** business tax breaks that expire every few years. Although often waiting until the last minute, Congress has historically extended most of the more popular provisions before they actually expire. Unfortunately, as we finalize this letter, Congress has yet to extend many of the commonly-used tax breaks ***that expired at the end of 2011.*** To help you determine the status of tax breaks you may have used in the past, we list below the more popular targeted business tax breaks that ***expired or were scaled back after 2011,*** and those that are scheduled to ***expire or be reduced after 2012.***

> **Please note** that for some of the more commonly-used tax breaks listed below, we indicate parenthetically whether the provision is one that "expires" altogether after the sunset date, or is only "reduced."

Selected "Targeted" Business Tax Breaks That Expired Or Were Reduced After 2011.

The following is a list of the more popular business tax breaks that either ***expired or were scaled back after 2011*****: 1)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Leasehold Improvements;" **2)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Restaurant Improvement Property;" **3)** 15-Year (instead of 39-Year) Depreciation Period for "Qualified Retail Improvement Property;" **4)** Section 179 Deduction up to $250,000 (expired) for *Qualified Leasehold Improvements*, *Qualified Restaurant Property*, and *Qualified Retail Improvement Property*; **5)** Overall §179 Deduction Cap (Reduced From $500,000 to $139,000 after 2011); **6)** 100% First-Year Depreciation (Generally Reduced to 50% After 2011); **7)** 7-Year Depreciation Period For Motorsports Entertainment Complexes; **8)** Research and Development Credit (expired); **9)** 5-Year (Instead of 10-Year) Recognition Period For S Corporation Built-In Gains Tax; **10)** Increased Charitable Deduction Limits for Qualifying Conservation Easements; **11)** Employer Differential Wage Credit for Payments to Military Personnel (expired); **12)** Various Tax Incentives for Investing in the District of Columbia; **13)** Various Business Tax Incentives for the Gulf Opportunity Zone; **14)** Temporary Increase In Qualified Small Business Stock Gain Exclusion; **15)** Work Opportunity Tax Credit (Expired – Except for "Qualified Veterans"); **16)** Favorable S Corporation Charitable Contribution Provisions; and **17)** Enhanced Charitable Contribution Rules for Qualifying Business Entities Contributing Computer Equipment, Book, and Food Inventory.

> **Planning Alert!** If recent history is a guide, Congress may likely extend many of these provisions eventually, but there is no guarantee. Our firm will monitor the status of these expired provisions closely.

Selected "Targeted" Business Tax Breaks That Are Scheduled To Expire Or Be Reduced After 2012.

The following is a list of the more popular business tax breaks that are currently scheduled to ***expire or be scaled back after 2012:*** **1)** Overall §179 Deduction Cap (Reduced

From $139,000 to $25,000 after 2012); **2)** 50% First-Year Depreciation (Generally Eliminated after 2012); **3)** Accumulated Earnings and Personal Holding Company Penalty Tax Rates of 15% (scheduled to return to 39.6% after 2012); **4)** Work Opportunity Tax Credit (Expires for any Worker Hired After 2012); **5)** Employer-Provided Educational Assistance Tax-Free Fringe (Expires); and **6)** Credit For Employer-Provided Child Care Facilities (Expires).

> **Please note** that our firm also monitors these expiring provisions and feel free to call us if you need a status report.

TAKING MAXIMUM ADVANTAGE OF THE 50% §168(k) BONUS DEPRECIATION AND §179 DEDUCTIONS

Perhaps the most significant "targeted" business tax break ***scheduled to expire (for most qualifying property) after 2012*** is the ***50% §168(k) first-year bonus depreciation*** deduction. The amount of this deduction has fluctuated over the last several years. For *qualifying* new business property placed-in-service from **2008 through September 8, 2010,** businesses were allowed a 50% first-year §168(k) bonus depreciation deduction. Congress then increased the deduction to 100% for *qualifying* property ***acquired*** and ***placed-in-service*** after **September 8, 2010 and through December 31, 2011** (through December 31, 2012 for certain long-production-period property and qualifying noncommercial aircraft). The deduction generally reverted ***back to 50%*** for *qualifying* property ***placed-in-service during 2012,*** and generally ***expires*** for property placed-in-service ***after 2012*** (after 2013 for certain long-production-period property and qualifying noncommercial aircraft). Unless Congress extends this provision, businesses have only through the end of 2012 to take advantage of this significant up-front deduction opportunity. If you are considering capital expenditures for your business in the relatively near future, and you do not want to miss out on this deduction, your business must ***"acquire"*** and ***"place-in-service"*** qualifying property ***no later than December 31, 2012.***

> **Planning Alert!** In order to qualify for the 50% deduction, the deadline for *acquiring* and *placing-in-service* qualifying property is generally December 31, 2012, whether your business is a ***fiscal-year*** or ***calendar-year*** taxpayer.

- **"Placed-In-Service."** Generally, if you are purchasing "personal property" (equipment, computer, vehicles, etc.) "placed-in-service" means the property is ***ready and available*** for use. To be safe, qualifying property should be ***set up and tested*** on or before the ***last day of 2012.*** If you are dealing with building improvements (e.g., qualified leasehold improvement property, non-structural components of a building), a ***certificate of occupancy*** will generally constitute placing the building or improvement in service.

- **§179 Deduction.** For the last several years, Congress has temporarily increased the maximum §179 up-front deduction for the cost of qualifying "new" or "used" depreciable business property (e.g., business equipment, computers, etc.). For tax years beginning in 2010 and 2011, the overall cap was increased dramatically to **$500,000.** Although the §179 deduction traditionally applied only to depreciable ***"personal"*** property, for tax years beginning in 2010 and 2011, the deduction was temporarily expanded to "qualifying real property." However, for ***tax years beginning in 2012,*** *qualifying real property* ***no longer qualifies,*** and the overall §179 cap is ***$139,000*** (this overall cap phases out as your total purchases of §179 property for 2012 increase from $560,000 to $699,000).

  > **Planning Alert!** For tax years ***beginning after 2012,*** the maximum §179 deduction is currently scheduled to drop ***back to $25,000*** and the deduction phase-out threshold will be ***$200,000 to $225,000.***

Although the §168(k) first-year bonus depreciation and the §179 up-front deduction for 2012 are reduced from 2011 levels, both deductions are still significant. To ensure that your capital expenditures qualify for these deductions before they expire (or are reduced) after 2012, please review the following:

- **Qualifying 50% §168(k) Bonus Depreciation Property.** Property qualifying for the §168(k) bonus depreciation deduction is generally *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, modern golf course greens, depreciable computer software, farm buildings, qualified motor fuels facilities and "qualified leasehold improvements").

  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 deduction, and buildings (other than "qualified leasehold improvements," farm buildings, and qualified motor fuels facilities) generally do not.

  Planning Alert! These are only *examples* of qualifying property.

- **Qualified Leasehold Improvement Property.** Even though improvements to a commercial building *generally* do not qualify for the §168(k) bonus depreciation deduction, "qualified leasehold improvement property" (QLHIP) does qualify. *QLHIP* is generally any capital improvement to an interior portion of a building that is used for nonresidential commercial purposes, provided that **1)** the improvement is made under or pursuant to a lease either by the lessee, sublessee or lessor of that interior building portion; **2)** the interior building portion is to be occupied exclusively by the lessee or sublessee; **and 3)** the improvement is placed-in-service **more than 3 years** after the date the building was first placed-in-service.

  Planning Alert! *QLHIP* **does not include** any improvement attributable to: the enlargement of the building; any elevator or escalator; any structural component benefitting a common area; or the internal structural framework of the building.

  Caution! Leasehold improvements made to property leased between ***certain*** *related persons* **will not qualify.**

- **Newly-Constructed Or Renovated Buildings And Cost Segregation Studies.** Depreciable components of buildings that are properly classified as depreciable *personal* property under a ***cost segregation study*** are generally depreciated over 5 to 7 years. Since these non-structural components have a depreciable life of 20 years or less, they should qualify for the 50% §168(k) bonus depreciation if the building is placed-in-service in 2012.

- **Entire Cost Of Property Received In A Trade-In Qualifies For 50% §168(k) Bonus Depreciation.** Let's assume that in 2012, your business trades in a used dump truck that has a tax basis of $50,000 in return for a new dump truck plus $30,000 cash. This trade in will generally constitute a tax-deferred "like-kind" exchange for tax purposes. However, the entire $80,000 basis (i.e., the $50,000 trade-in basis plus the additional $30,000 payment) will qualify for the 50% §168(k) bonus depreciation deduction.

  Practice Alert! The §179 deduction does not apply to the $50,000 carryover basis, but it would apply to the $30,000 cash payment (up to the overall $139,000 cap for §179 deductions).

- **You May "Elect Out" Of The 50% Bonus Depreciation.** Generally, the 50% bonus depreciation is automatic unless you timely "elect out" of the deduction. You generally must elect out by the due date of your tax return (including extensions).

  Tax Tip. You may wish to elect out of this 50% deduction if you determine you will get a greater tax benefit by deferring depreciation deductions into later years.

  Planning Alert! Careful calculations (including alternative minimum tax implications) should be made before deciding to elect out of the 50% bonus depreciation.

- **Interplay Of 50% §168(k) and §179 First-Year Deductions.** The 50% §168(k) deduction and the §179 deduction can apply to the same property (e.g., new business equipment and vehicles). If both deductions are taken on the same property, the §179 deduction must be taken first.

  Example. Assume that you are a small business owner who paid $239,000 for a qualifying asset (e.g.,new equipment) that was placed-in-service in 2012. Assuming that you want maximum deductions, you would first "elect" to deduct the maximum §179 deduction of $139,000. That leaves a remaining basis of $100,000 that has not yet been depreciated. Next, you would apply the 50% §168(k) bonus depreciation deduction to the remaining $100,000 for an additional deduction of $50,000. That leaves $50,000, to which you can apply the regular depreciation rules. Assuming that the asset is 5-year property, you would generally deduct 20% of the remaining $50,000 cost basis in the first year, for an additional $10,000 depreciation deduction. So, for 2012, you would be deducting a total of $199,000 ($139,000 + $50,000 + $10,000), or approximately 83% of the $239,000 cost of the equipment.

  Tax Tip. If you have both new and used §179 property acquisitions for 2012 and your total acquisitions of §179 property are more than $139,000, you should generally elect §179 for the *used* property first. Any §179 depreciation taken on used property will not reduce the 50% bonus depreciation deduction for the year since the 50% depreciation deduction is not allowed for used assets.

- **Passenger Automobiles, Trucks and SUVs.** The maximum annual depreciation deduction (including the §179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in **calendar year 2012,** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,360 for trucks and vans not weighing over 6,000 lbs). However, if the vehicle otherwise qualifies for the 50% §168(k) bonus depreciation (i.e., the vehicle is new) the maximum depreciation deduction is increased by $8,000.

  Example. Your business is planning to purchase a *new* vehicle weighing 6,000 lbs or less that will be used 100% for business purposes. If you buy the new car and place it in service during 2012, your maximum first-year depreciation deduction will be $11,160 ($11,360 for trucks and vans not weighing over 6,000 lbs).

  Tax Tip. If you purchase a passenger auto, truck, or SUV in 2012, to qualify for the 50% §168(k) bonus depreciation deduction or the §179 deduction, your business mileage **through December 31, 2012** must ***exceed 50% of*** the total mileage. By keeping your personal use to a minimum, you will maximize your business percentage for 2012 which could significantly increase your 2012 depreciation deduction.

- **Heavy Vehicles (i.e., > 6,000 lbs.)** Trucks and SUVs with loaded rated vehicle weights over 6,000 lbs are generally exempt from the annual depreciation caps discussed above. These "heavy vehicles," if used more than 50% in business, will also qualify for the 50% §168(k) bonus depreciation deduction (if new), and the §179 deduction (whether new or used). However, the §179 deduction for an SUV is limited to $25,000 (instead of $139,000).

  Example. Assume that in 2012 you purchase a new "over 6,000 lbs" SUV ***for $50,000*** used entirely for business. If you elect to take the §179 deduction on the vehicle, for 2012 you could deduct: **1)** up to $25,000 under §179, **2)** 50% of the remaining balance as §168(k) first-year bonus depreciation, and **3)** 20% of the remaining cost as regular depreciation for the first year. Thus, for a $50,000 new heavy SUV placed-in-service in 2012, you could write off $40,000 (assuming 100% business use).

  Planning Alert! 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! If you take the §179 deduction and/or the §168(k) first-year bonus depreciation on your business vehicle, and your business use percentage later ***drops to***

  50% or below, you are required to bring into income a portion of the deductions taken in previous years.

TRADITIONAL YEAR-END PLANNING FOR "S" CORPORATIONS AND PARTNERSHIPS

Self-Employed Individuals, Partners, And S Corp Owners Should Take Maximum Advantage Of Deduction For Health Insurance Premiums.

Generally, if you are self-employed, a partner in a partnership, or a more-than-2% shareholder of an S corporation, you may qualify for an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions") for health insurance premiums you pay for yourself, your spouse, your dependents, or your children under 27 at the end of the year (even if the child is not your dependent). Until recently, there was confusion as to whether Medicare premiums paid by a self-employed individual, partner, or S corporation shareholder qualified for this treatment. The IRS has now confirmed that if you otherwise qualify for an *above-the-line* deduction for health insurance premiums, you may be able to deduct your Medicare premiums (including ***Part B*** and ***Part D***).

> **Planning Alert!** If you are a partner in a partnership or an S corporation shareholder, and you are paying your 2012 health insurance premiums directly (including Medicare premiums), the IRS says that you should have the partnership or S corporation reimburse you for those premiums ***before the end of 2012*** to qualify for the *above-the-line* deduction. The IRS also says that, if you are an S corporation shareholder, the premium reimbursement must be included in your W-2. For partners, the premium reimbursement must be treated by the partnership as a "guaranteed payment."

S Corporation Shareholders Should Check Stock And Debt Basis Before Year End.

If you own S corporation stock and you think your S corporation will have a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless and until you have adequate "basis" in your S corporation. Any pass-through loss that exceeds your "basis" in the S corporation will carry over to succeeding years. You have basis to the extent of the amounts paid for your stock (adjusted for net pass-through income, losses, and distributions), ***plus*** any amounts you have personally loaned to your S corporation.

> **Planning Alert!** If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets ***debt basis*** is to: **1)** have the shareholder personally borrow the funds from the outside lender, and **2)** then have the shareholder formally (with proper and timely documentation) loan the borrowed funds to the S corporation. It also may be possible to *restructure* (with timely and proper documentation) a pre-existing outside loan directly to an S corporation in a way that will give the shareholder debt basis.

Caution! A shareholder cannot get debt basis by merely guaranteeing a third-party loan to the S corporation. **Please do not attempt to restructure your loans without contacting us first!**

Pay Careful Attention to Payments On S Corporation Shareholder Loans.

As discussed above, let's assume that you have previously loaned funds to your S corporation which, in turn, created basis that you have used to deduct pass-through losses. If all or a portion of the loan is paid back after the loan's basis has been reduced by pass-through losses, you will recognize a gain on the repayment. The amount, character, and timing of the gain is dependent on several factors, including: **1)** when during the tax year the payment is made, **2)** whether the loan is an "open account" advance, or evidenced by a written promissory note, and **3)** the amount of the unpaid balance on an "open account" advance as of the end of the tax year. For example, if the loan is an "open account" (i.e., not evidenced by a written promissory note), any gain triggered by a payment on the loan will generally be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note and has been outstanding for over one year, any gain triggered 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. **Please consult with us before your S corporation repays shareholder loans.** We will help you structure the loans and any loan repayments to your maximum tax advantage.

Salaries For S Corporation Shareholder/Employees.

For 2012, an employer must pay FICA taxes of 7.65% of an employee's wages up to $110,100 and FICA taxes of 1.45% on wages in excess of $110,100. In addition, for 2012, an employer must withhold FICA taxes from an employee's wages of 5.65% on wages up to $110,100 (normally 7.65%, but temporarily reduced to 5.65% ***through 2012***) and 1.45% of wages in excess of $110,000. If you are a stockholder/employee of an S corporation, this FICA tax is generally applied only to your W-2 income from your S corporation. Other income that passes through to you or is distributed on your stock is generally not subject to FICA taxes or to self-employment taxes.

- **Salaries Must Be "Reasonable."** If the IRS determines that you have taken an unreasonably "low" salary from your S corporation, the Service will generally argue that other amounts you have received from your S corporation (e.g., distributions) are disguised "compensation" and should be subject to FICA taxes. Determining "reasonable salaries" for S corporation shareholder/employees is a hot audit issue, and the IRS has a winning record in the courts on this issue. The IRS has been particularly successful where S corporation owners pay themselves no salary even though they provided significant services to the corporation.

However, in a recent case, the IRS took a CPA to Court who had paid himself $24,000 of salary from his S corporation, while receiving additional cash "distributions" from the S corporation of approximately $200,000. The Court concluded that his salary (subject to payroll taxes) should be $91,000 rather than $24,000. Therefore, the Court treated $67,000 of the $200,000 of distributions from the S corporation as additional wages.

Caution! Determining a "reasonable" salary for an S corporation shareholder is a case-by-case determination, and there are no rules of thumb for determining whether the compensation is "reasonable." However, this case makes it clear that salaries to S corporation shareholders should be supported by independent data (e.g., comparable industry compensation studies), and should be properly documented and approved by the corporation.

Planning Alert! Keeping salaries low and 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."

Deductions For Business Expenses Paid By Partners And Shareholders May Be Limited.

Historically, the IRS has ruled that a partner may deduct business expenses ***paid on behalf*** of the partnership ***only if*** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership.

Tax Tip. If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership.

Planning Alert! The courts continue to hold that a corporate shareholder may not deduct expenses the shareholder pays on behalf of the corporation ***unless*** the shareholder is employed by the corporation, the shareholder is required to incur the expenses as a part of his or her duties as an employee, and there is an agreement or understanding that the corporation will not reimburse the expenses. Even if the expenses are deductible by the shareholder-employee, they are classified as *miscellaneous itemized deductions* which are subject to the 2% reduction rule, and are not deductible at all for *alternative minimum tax* purposes.

Planning Alert! These rules ***apply to both S corporation and C Corporation*** shareholders.

Tax Tip. If business expenses paid by a shareholder for an S corporation or C corporation are reimbursed to the shareholder under a qualified *"accountable plan*", the corporation can take a full deduction and the shareholder will exclude the reimbursement from taxable income.

OTHER YEAR-END GENERAL BUSINESS PLANNING

Work Opportunity Tax Credit (WOTC) Extended To 2012 Only For "Qualified Veterans."

Many employers that have taken advantage of the popular Work Opportunity Tax Credit (WOTC) for hiring workers from certain disadvantaged groups were disappointed that the WOTC generally ***expired for individuals hired after 2011.*** Although Congress ***did not*** extend the WOTC beyond 2011 for all targeted groups, in late 2011 Congress modified the WOTC to allow credits for certain military veterans ***through 2012.*** To qualify, the new employee must be *a* ***"qualified veteran"*** who is hired ***after November 21, 2011*** and ***before 2013.*** Depending on the "tax" classification of the *"qualified veteran,"* the maximum credit runs from $2,400 to $9,600. In addition, unlike previous credits under the WOTC, tax-exempt employers (other than government agencies) that hire *"qualified veterans"* may receive a *"refundable"* credit of 65% of the credit allowed for taxable employers.

> **Tax Tip.** To qualify for the credit, all employers (including tax-exempt employers) must have the veteran complete IRS ***Form 8850*** *(*"Pre-Screening Notice and Certification Request for the Work Opportunity Credit"), and submit that form to the state employment security agency ***no later than 28 days*** after the employee begins work. You can locate Form 8850 at www.irs.gov., and the instructions to the form provide detailed information on the definition of a *"qualified veteran.*"
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> **Planning Alert!** Although ***during 2012,*** the WOTC is allowed ***only for*** hiring a ***"qualified veteran,"*** it is possible that later in 2012 (or early in 2013) Congress may retroactively reinstate the WOTC for employees from the traditional targeted groups. Consequently, employers should continue having all new 2012 hires complete Form 8850 (and submit the form within 28 days to the applicable state employment agency). That way, the employer will have complied with the strict WOTC filing requirements if Congress ultimately retroactively extends the WOTC through 2012 for all targeted groups.

Take Advantage Of The Expiring 2% Social Security Tax Holiday.

Last February, Congress extended ***through December 2012*** the temporary reduction in the Social Security tax rate from 6.2% to 4.2% for employees. If you are self-employed, your S/E tax for Social Security was also reduced from 12.4% to 10.4% ***through 2012.*** Since S/E taxes for Social Security applies only to the first $110,100 of an individual's self-employed income for 2012, your ***maximum savings for 2012*** is generally ***$2,202*** (i.e., $110,100 x 2%). If you are married, and you and your spouse each earn at least as much as the wage base, your maximum combined savings will be $4,404. Likewise, ***if you are self-employed***, your Social Security taxes are reduced by 2% of your self-employment income for 2012 (up to $110,100).

Tax Tip. You and/or your spouse should consider accelerating compensation into 2012 (e.g., by accelerating a bonus, commission, etc.) or self-employed income (e.g., encouraging a customer or client to pay early) in order to save the 2% Social Security tax to the extent the income acceleration does not cause either of you to exceed the $110,100 cap, and does not cause you to pay more income taxes.

Planning For C Corporation Estimated Tax Requirements.

If your C Corporation had less than $1 million of taxable income for ***each*** of the past three tax years, it qualifies for the "small corporation safe harbor" for estimated taxes, which allows it to base its current year quarterly estimated tax payments on 100% of its ***"prior" year*** tax liability. If your corporation does not qualify for this safe harbor (i.e., it had $1 million or more of taxable income in any of the prior three tax years), 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! Even if your corporation otherwise qualifies for the *small corporation safe harbor*, but it 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 corporation currently qualifies for the *"small corporation safe harbor"* and anticipates showing a small tax loss in 2012, you may want to accelerate income (or defer expenses) in order to generate a **small income tax liability in 2012.** This will preserve the corporation's ability to use the "100% of last year's tax" safe harbor for 2013 estimates.

Caution! This technique may not be advisable if your corporation anticipates a 2012 net operating loss that can be carried back to previous years that would generate a sizeable refund.

Planning Alert! If your corporation expects taxable income of more than $1 million for the first time in 2012, consider **deferring income into 2013** or **accelerating deductions into 2012** to ensure the corporation's 2012 taxable income does not exceed $1 million, so that it retains the *small business safe harbor* for 2012.

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.**

Self-Employed Business Income.

If you are self-employed, it continues to be a good idea to defer as much income into 2013 as possible, if you believe that your marginal tax rate for 2013 (including the scheduled rate increases and the New Medicare Surtaxes) will be equal to or less than your 2012 marginal tax rate. If you think that deferring 2012 income to 2013 will save you overall taxes, and you use the cash method of accounting, consider delaying year-end billings until 2012.

> **Planning Alert!** If you have already received the check in 2012, 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 employees (nonshareholder 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."

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 businesses:**

- **Regular "C" Corporations.** If a 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 2012 is significantly greater than the more-than-50% stockholder's individual rate for 2012, the accrued amount should be paid by the **end of 2012.**

- **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 2012.

Calendar-year taxpayers wishing to establish a qualified retirement plan for 2012 (e.g. profit-sharing, 401(k), or defined benefit plan) *generally* must adopt the plan **no later than December 31, 2012.** However, a SEP may be established by the due date of the tax return (including extensions), and a SIMPLE plan must have been established no later than October 1, 2012.

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.

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.
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> **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 listing their business and personal mileage for the company car.

Mileage Reimbursement Rates.

Each year, the IRS provides an amount per mile that employers may reimburse employees for the business use of their vehicles rather than reimbursing actual expenses. This standard mileage reimbursement amount for 2012 is **55.5 cents-per-mile.**

Your Daily Transportation Might Constitute "Business Travel."

Generally, daily travel from your home to your "regular place of business" is considered a nondeductible, personal commuting expense. However, the IRS says that if you have a "regular place of business," you can deduct daily travel from your home to any "temporary work location" even if the work location is within the metropolitan area in which you live. If you have no regular place of business, the temporary work location must be outside this "metropolitan area" for your daily travel to qualify as business travel.

> **Tax Tip.** The IRS says you are considered traveling to a "temporary work location" if you realistically expect your work assignment there to last for *one year or less.* The IRS also says that if you have a qualifying home office, daily travel from your home to any other business location is generally business travel regardless of the distance or frequency.

Certain Business Modifications To Trucks And Vans Make Them 100% Business.

Generally, if you use a passenger vehicle in your business, you are required to keep a log or other documentation to support your business mileage. However, if you make certain modifications to your business "pick-up" or "van", the IRS says that, for tax purposes, the vehicle will be deemed to be used 100% for business, even though you have some nonbusiness use. For example, a pick-up truck that has either permanently affixed decals or special painting advertising your business, ***and*** is equipped with either a hydraulic lift gate, permanently installed tanks or drums, or permanently installed side boards, is deemed to be used 100% for business. The same is true of a van that has the company name permanently affixed to the vehicle, has only seats for the driver and one passenger, and the back of the van is generally filled with shelving or merchandise during on-duty and off-duty hours.

> **Tax Tip.** These specially-equipped business vehicles are not limited by the passenger automobile depreciation caps even if they do not have a gross vehicle weight of more than 6,000 lbs. Furthermore, if you inadvertently applied the depreciation limits to these vehicles in prior years, the IRS says that you may use the automatic accounting method change procedures to correct prior year returns.

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.

CONCLUSION

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional 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.