

2010 Year-End Tax Planning for Small Businesses

As 2010 draws to a close, there is still time to reduce your 2010 tax bill and plan ahead for 2011. This letter highlights several potential tax-saving opportunities for you to consider, new reporting requirements, and some 2011 changes. I would be happy to meet with you to discuss specific strategies and issues.

Deferring Income into 2011

If you expect your AGI to be higher in 2010 than in 2011, or if you anticipate being in the same or a higher tax bracket in 2010 than in 2011, you may benefit by deferring income into 2011. Deferring income will be advantageous so long as the deferral does not bump your income to the next bracket. Deferring income could be disadvantageous, however, if your deferred income is subject to § 409A, thus making the income includible in gross income and subject to additional tax. Some ways to defer income include:

Use of Cash Method of Accounting: By using the cash method of accounting instead of the accrual method of accounting, you can generally put yourself in the best position for accelerating deductions and deferring income. There is still time to accomplish this strategy, because an automatic change to the cash method can be made by the due date of the return including extensions. The following three types of businesses can make an automatic change to the cash method: (1) small businesses with average annual gross receipts of \$1 million or less (even those with inventories that are a material income producing factor); (2) certain C corporations with average annual gross receipts of \$5 million or less in which inventories are not a material income producing factor; and (3) certain taxpayers with average annual gross receipts of \$10 million or less. Provided inventories are not a material income producing factor, sole proprietors, limited liability companies (LLCs), partnerships, and S corporations can change to the cash method of accounting without regard to their average annual gross receipts.

Delay Billing: Delay year-end billing to clients so that payments are not received until 2011.

Interest and Dividends: Interest income earned on Treasury securities and bank certificates of deposit with maturities of one year or less is not includible in income until received. To defer interest income, consider buying short-term bonds or certificates that will not mature until next year. If you have control as to when dividends are paid, arrange to have them paid to you after the end of the year.

Deferral of Income in Certain Debt Restructurings: Section 108(i) provides an election to defer cancellation of indebtedness (COD) income. Ordinarily, COD income is includible in gross income for the year in which the debt is canceled or reduced. However, under § 108(i), COD income arising from a reacquisition of a debt instrument can be deferred and included in the taxpayer's gross income ratably over the five taxable years beginning with the fourth taxable year for reacquisitions occurring in 2010 (if the reacquisition occurred in 2009, the pro-rata inclusion begins with the fifth taxable year after the reacquisition).

The provision applies whether the canceled debt is acquired for cash or is acquired in the form of a new debt instrument. Recent regulations have identified what types of transactions may accelerate recognition of the deferred COD income; it is important that we discuss the triggering transactions so that you can avoid them. The regulations also address the unique application of the acceleration rules to consolidated groups.

The window for undertaking transactions to which the § 108(i) election can apply is rapidly closing.

Accelerating Income into 2010

In limited circumstances, you may benefit from accelerating income into 2010. For example, you may anticipate being in a higher tax bracket in 2011, or perhaps you will need additional income in order to take advantage of an offsetting deduction or credit that will not be available to you in future tax years. Note, however, that accelerating income into 2010 will be disadvantageous if you expect to be in the same or lower tax bracket for 2011.

If you report income and expenses on a cash basis, issue bills and attempt collection before the end of 2010. Also see if some of your clients or customers are willing to pay for January 2011 goods or services in advance. Any income received using these steps will shift income from 2011 to 2010.

Business Deductions

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. New for 2010, the deduction can be taken into account in computing self-employment taxes.

Equipment Purchases: If you purchase equipment, you may make a “§ 179 election,” which allows you to expense (i.e., currently deduct) otherwise depreciable business property. For 2010, under a new law just enacted, you may elect to expense up to \$500,000 of equipment costs (with a phase-out for purchases in excess of \$2,000,000) if the asset was placed in service during 2010. The new law also extends these amounts into 2011. Former law had the numbers at \$250,000 for 2010 and \$25,000 for 2011. Therefore, between now and the end of the year, if you previously maxed out the old \$250,000 amount for 2010, you now have an additional \$250,000 you can invest in your business and deduct. Also, new for 2010 and 2011, certain real property can qualify for the expense deduction, but the qualifying property cannot exceed \$250,000 of the allowed deduction. In 2012, these dollar amounts will be reduced to \$25,000 and \$200,000 (subject to inflation adjustments).

In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2010. In general, under the “half-year convention,” you may deduct six months' worth of depreciation for equipment that is placed in service on or before the last day of the tax year. (If more than 40% of the cost of all personal property placed in service occurs during the last quarter of the year, however, a “mid-quarter convention” applies, which lowers your depreciation deduction.) A popular strategy in recent years is to purchase a vehicle for business purposes that exceeds the depreciation limits set by statute (i.e., a vehicle rated over 6,000 pounds). Doing so would not subject the purchase to the statutory dollar limit, \$3,060 for 2010 (\$3,160 in the case of vans and trucks). (If the vehicle qualifies for the 50% bonus depreciation in effect in 2010, these dollar amounts are increased by \$8,000.) Therefore, the vehicle would qualify for the full equipment expensing dollar amount. However, for SUVs (rated between 6,000 and 14,000 pounds gross vehicle weight) the expensing amount is limited to \$25,000.

NOL Carryback Period: If your business suffers net operating losses for 2010, you generally apply those losses against taxable income going back two tax years. Thus, for example, the loss could be used to reduce taxable income—and thus generate tax refunds—for tax years as far back as 2008. Certain “eligible losses” can be carried back three years; farming losses and qualified disaster losses (for losses arising in taxable years beginning after 2007 in connection with disasters declared after December 31, 2007) can be carried back five years.

Under a special law enacted in February 2009, and amended in November 2009, businesses can carry back losses incurred in taxable years beginning after 2007 and beginning before 2010 for up to five years instead of the standard two years. One such carryback is available under the provision as originally enacted, and another under the provision as amended in November 2009.

Bonus Depreciation: Although bonus depreciation was originally not in effect for 2010, the 2010 Small Business Jobs Act, enacted in late-September, revived it for 2010. Taxpayers can claim the 50% bonus

depreciation allowance if the following requirements are met: (1) the original use of the property must begin with the taxpayer after December 31, 2007, and before January 1, 2011;(2) the property must be acquired by the taxpayer in 2008, 2009, or 2010, but only if no written binding contract for the acquisition was in effect before January 1, 2008, or acquired by the taxpayer pursuant to a written binding contract entered into in 2008, 2009, or 2010; (3) the property must be placed in service before 2011 (2012 in the case of long production period property (10 years or longer)or specified aircraft). Bonus depreciation is also allowed for machinery and equipment used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials and qualified disaster assistance property. You can take advantage of this bonus depreciation for the remainder of 2010.

A contractor using the percentage-of-completion method of determining taxable income from a long-term contract does not need to take bonus depreciation into account in determining the cost of property otherwise eligible for bonus depreciation that has a MACRS recovery period of seven years or less and is placed in service during 2010 (or 2011 in the case of long production period property).

Increase in Amount of Deductible Start-Up Expenditures: For taxable years beginning in 2010, the Small Business Jobs Act increased the amount of start-up expenditures that a taxpayer can elect to deduct from \$5,000 to \$10,000. The Act has also increased the deduction phase-out threshold from \$50,000 to \$60,000, so that the \$10,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds\$60,000.

Bad Debts: You can accelerate deductions to 2010 by analyzing your business accounts receivable and writing off those receivables that are totally or partially worthless. By identifying specific bad 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 2010 year-end financial statements.

Home Office Deduction: Expenses attributable to using the home office as a business office are deductible under § 280A 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.

Business Credits

Small Employer Pension Plan Startup Cost Credit: For 2010, certain small business employers that did not have a pension plan for the preceding three years may claim a nonrefundable income tax credit for expenses of establishing and administering a new retirement plan for employees. The credit applies to 50% of the first \$1,000 in qualified administrative and retirement-education expenses for each of the first three plan years.

Employer-Provided Child Care Credit: For 2010, employers may claim a credit of up to \$150,000 for supporting employee child care or child care resource and referral services. The credit is allowed for a percentage of "qualified child care expenditures" including for property to be used as part of a qualified child care facility, for operating costs of a qualified child care facility and for resource and referral expenditures. Unless extended by Congress, this credit is unavailable for 2011.

Work Opportunity Credit: The work opportunity credit is an incentive provided to employers who hire individuals in groups whose members historically have had difficulty obtaining employment. Unemployed veterans and disconnected youth hired in 2010 qualify as a targeted group in addition to the existing targeted groups. This gives your business an expanded opportunity to employ new workers and be eligible for a tax credit against the wages paid.

Wages do not include amounts paid to certain individuals hired in 2010 during the one-year period beginning on the hiring date that qualify for payroll forgiveness under § 3111(d).

Credit for Employee Health Insurance Expenses of Small Employers: For tax years beginning after 2009,

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.

Business Credit for Retention of Certain Newly-Hired Individuals in 2010: For qualified employers in tax years ending after March 18, 2010, the current-year general business credit is increased for each retained worker by the lesser of: (a) \$1,000, or (b) 6.2% of the wages paid to the retained worker during the 52 consecutive week period for a "retained worker."

Carryback of Business Credits: Pursuant to the 2010 Small Business Jobs Act, the credit carryback period for eligible small business credits is extended from one to five years. Eligible small business credits are defined as the sum of the general business credits determined for the taxable year with respect to an eligible small business. An eligible small business is, with respect to any taxable year, a corporation the stock of which is not publicly traded, or a partnership, that meets the gross receipts test of § 448(c) (substituting \$50 million for \$5 million each place it appears). In the case of a sole proprietorship, the gross receipts test is applied as if it were a corporation. Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current-year business credits.

Alternative Minimum Tax

AMT Suspension for Eligible Small Businesses' General Business Credits: Effective for eligible small business credits (the sum of an eligible small business's general business credits) determined in a taxpayer's first taxable year beginning after 2009, the tentative minimum tax is treated as zero. Thus, an eligible small business credit may offset both regular tax and AMT liability.

Inventories

Subnormal Goods: You should check for subnormal goods in your inventory. Subnormal goods are goods that are unsalable at normal prices or unusable in the normal way due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange. If your business has subnormal inventory as of the end of 2010, you can take a deduction for any write-downs associated with that inventory provided you offer it for sale within 30 days of your inventory date. The inventory does not have to be sold within the 30-day timeframe.

Retirement Plans

In-Plan Roth Rollovers: A much anticipated provision of the 2010 Small Business Jobs Act allows § 401(k) plan participants in elective deferral plans to rollover their pre-tax account balances to Roth-designated accounts within the plan. This will allow the Roth rollover funds to stay within the employer-sponsored plan, instead of migrating to Roth IRAs with brokers, mutual fund companies, banks, etc. The rule is effective on September 27, 2010.

However, to take advantage of this change, the plan must contain a qualified designated Roth contribution program that allows rollovers from eligible distributions. This would involve not only amending the plan but the administrative aspects of setting up new plan features and participant communications as well. The IRS is expected to provide employers with a remedial amendment period that allows the employer to offer this option to employees (and surviving spouses) for distributions during 2010 and then have sufficient time to amend the plan to reflect this feature. Thus, employers can permit conversions in 2010 and still have time to amend their plans.

Other 2010 Opportunities

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. For tax years beginning in 2009 and 2010, the special holding period is shortened to seven years. (As discussed below, it is shortened even more for tax years beginning in 2011.)

100% Exclusion of Gain Attributable to Certain Small Business Stock: The incentive for individuals to acquire qualified small business stock is higher between now and December 31, 2010. 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 is increased to 75% for qualified small business stock acquired after February 17, 2009, and before September 28, 2010. The Small Business Jobs Act excludes 100% of the gain for qualified small business stock acquired or issued after September 27, 2010, and before January 1, 2011.

Qualifying Dividends: Qualifying dividends received in 2010 are subject to rates similar to the capital gains rates. Therefore, qualifying dividends are taxed at a maximum rate of 15%. Qualifying dividends include dividends that domestic and certain foreign corporations pay to their shareholders. Note that if Congress does not act to extend the reduced dividend rates, beginning in 2011 the rates will revert back to pre-2001 levels (i.e., will be taxed at the taxpayer's ordinary income rate, up to a maximum of 39.6%). The President has proposed to keep qualifying dividend income taxed at the same rate as capital gains, which could increase to 20% in 2011.

Attribute-Carryover-Limitation Relief: Section 382(n) provides that the § 382 limitation does not apply to certain ownership changes occurring after February 17, 2009, as part of taxpayers' restructuring plans that are required under loan agreements or commitments for lines of credit entered into with Treasury under TARP.

Reporting

Uncertain Tax Positions: Starting with the 2010 tax year, new Schedule UTP, *Uncertain Tax Position Statement*, will require certain corporate taxpayers under the jurisdiction of the Large Business and International Division (LB&I)—the new name of the LMSB—to disclose their "uncertain tax positions" (UTPs) annually. A corporation will need to file Schedule UTP with its income tax return if it: (1) files Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC; (2) has assets of at least \$100 million; (3) issued (or a related party issued) audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year; and (4) has one or more UTPs. A UTP is a tax position that will result in an adjustment to a line item on a return if the position is not sustained, provided the corporation has taken the position for the current or a prior tax year and the corporation (or a related party) either recorded a reserve for the position or did not record a reserve because it expects to litigate the position.

Planning Ahead for 2011

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. For tax years beginning in 2009 and 2010, the special holding period is shortened to seven years, and—since enactment of the Small Business Jobs Act—the special holding period is shortened to five years for tax years beginning in 2011.

Information Reporting Requirements for Transfers of Securities: The Energy Improvement and Extension Act of 2008 added three provisions to the Code that impose reporting requirements related to the transfer of securities. Every broker required to report the gross proceeds from the sale of a “covered security” must also report the customer’s adjusted basis in the security and whether any gain or loss with respect to the security is long-term or short-term. “Covered securities” include most stock acquired beginning in 2011. Also beginning in 2011, a broker transferring covered securities to another account must furnish the receiving broker with a written statement that allows the receiving broker to satisfy the new basis reporting requirements. (The IRS, however, has decided not to assert penalties for failure to furnish the transfer statement for certain types of transfers occurring in 2011.) Moreover, if an issuer of stock takes a major corporate action (such as a stock split, merger, or acquisition) that affects basis, then—beginning in 2011—the issuer must report to the IRS and to each stockholder a description of the action and the effect the action has on basis.

If you have any questions, please do not hesitate to call. I would be happy to meet with you at your convenience to discuss the strategies and requirements outlined above. There is still time to implement these strategies to minimize your 2010 tax liability, as well as plan ahead to reduce your 2011 tax liability.

This letter reflects the passage of the Small Business Jobs Act of 2010, P.L. 111-240, which was signed into law on September 27, 2010. These are planning considerations and there may be changes to the tax law that would change the considerations in this letter. Please consult with us before implementing any tax planning strategies.

Sincerely,

A handwritten signature in cursive script, appearing to read "Ed Lloyd".

Ed Lloyd CPA, PFS, CTC