YEAR-END INCOME TAX PLANNING

FOR CORPORATIONS AND BUSINESSES

NEW TAX BENEFITS AVAILABLE FOR 2001/2002

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INTRODUCTION

Each year we work with our corporate and business clients to maximize tax savings through year-end planning. Traditionally, year-end tax planning includes taking steps to make sure your business income is taxed at the lowest possible rate, and to postpone the payment of taxes by deferring taxable income or accelerating deductions. Over the past several years, Congress has enacted tax legislation designed primarily to give new tax breaks to individuals. However, the legislation also provides several new tax breaks to corporate and business taxpayers. Therefore, 2000 may offer an opportunity to arrange your transactions to take advantage of recent tax legislation. The planning considerations included in this letter are divided into three sections:

- Planning Ideas For C Corporations
- Planning For S Corporations
- General Business Planning

WILL CONGRESS PASS A LAST-MINUTE TAX BILL

As we go to press with this letter, Congress is still considering passage of the "Taxpayer Relief Act of 2000." If passed, this tax bill would increase significantly the amount you could contribute to IRAs, 401(k) plans, and most employer-sponsored retirement plans. Most of these changes would be phased in beginning in 2001. This bill also contains tax relief for businesses, including: increased deductions for equipment, and health insurance premiums; relief for installment sales by accrual method businesses and small businesses using the accrual method of accounting; and many other miscellaneous pro-taxpayer provisions. If you think any of these proposals could impact your year-end tax planning – please call our office and we will be glad to give you a status report.

NOTE! This letter contains ideas for Federal Income Tax Planning only, state income tax issues are not addressed. **We suggest 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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PLANNING IDEAS FOR C CORPORATIONS

Year-End Planning With Corporate Tax Rates. Your regular (non-"S") corporation may be able to shift income between 2000 and 2001 and save taxes by taking advantage of the progressive corporate tax rates. For example, corporate income between $100,000 and $335,000 is taxed at 39%, while income between $50,000 and $75,000 is taxed at only 25%. If, for instance, your corporation expects $50,000 of income in 2000 and $125,000 in 2001, your company could save taxes of $3,500 by accelerating $25,000 of 2001 income into 2000 (i.e., $25,000 X 14%). On the other hand, if your corporation is expecting lower tax rates in 2001 than in 2000, deferring income into 2001 will not only save overall taxes but would defer taxes as well. **Planning Alert!** Please call us before accelerating income from 2001 into 2000 so that we can help you evaluate other considerations such as the time value of money.

Year-End Planning For Personal Service Corporations. If you own a regular (non-"S") personal service corporation ("PSC"), all income retained in that corporation is taxed at a flat rate of 35%. Your 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.** You should leave as little income as possible in your corporation in order to avoid the flat corporate tax rate of 35%. You can accomplish this by paying reasonable salaries and compensation to the stockholder/employees by year-end.

- **Planning Alert!** If your PSC has a tax year other than the calendar year, you should, generally, pay the owners a proportionate part of last year's payments by December 31, 2000, in order to avoid the 35% corporate tax.

Avoiding Personal Holding Company Status. If more than 50% of your regular (non-"S") corporation is owned by five or fewer individuals during the last half of 2000, it could be classified as a "personal holding company" if 60% or more of its adjusted ordinary gross income is from interest, dividends, specified levels of rents, royalties, or income from certain personal service contracts. A personal holding company pays an additional tax of 39.6% (in addition to the regular corporate tax) on its personal holding company (PHC) income.

- **Planning Alert!** If you think that your closely-held regular corporation is in danger of having 60% or more of its 2000 income from interest, dividends, rents, royalties, etc., please call us **before year end**. We may be able to help you avoid this 39.6% additional tax by accelerating business income into 2000, or deferring your PHC income into 2001.

Avoiding The Accumulated Earnings Tax. If your regular corporation has accumulated earnings exceeding its reasonable business needs, it could be subject to a corporate accumulated earnings penalty tax

of 39.6%, in addition to the regular corporate tax. Your corporation can generally accumulate $250,000 ($150,000 for personal service corporations) of income before this penalty tax is triggered.

- **Tax Tip.** Your corporation can accumulate an unlimited amount of earnings to the extent it can establish a reasonable business need for the accumulation. This can include reasonable income accumulations for: bona fide business expansion, replacement of plant buildings and equipment, acquisition of another business enterprise through purchase of stock or assets, retirement of bona fide business debt, maintaining necessary working capital for business needs, and others.

- **Planning Alert!** Proper documentation is vital to defeating an IRS assessment of the accumulated earnings tax. If your regular corporation is accumulating earnings this year, be sure to document the business reasons for the accumulations through corporate minutes, memoranda, business studies, etc. Your documentation should occur contemporaneously with the accumulation.

Make Sure Your Corporation Pays Sufficient Estimated Tax. If your regular corporation had less than one million dollars of taxable income for each of the past three tax years, it will be classified as a "small corporation" and may base its quarterly estimated tax payment on 100% of its "prior" year tax liability. If your corporation is not a "small corporation," it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its "current" year tax liability, or 100% of its annualized tax liability.

- **Planning Alert!** If your "small corporation" paid no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the "current" year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty.

- **Tax Tip.** If your "small corporation" anticipates showing a small tax loss in 2000, you may want to accelerate enough income (or defer enough expenses) to generate a small income tax liability in 2000. This will preserve your "small corporation's" ability to use the "100% of last year's tax" safe harbor in 2001. If the corporation expects taxable income of more than $1,000,000 for the first time in 2000, you may defer income or accelerate deductions to ensure that your corporation's 2000 taxable income does not exceed one million dollars, so that it maintains its "small corporation" status for 2001.

Be Sure To Properly Document Loans To Shareholders. If you borrow from your closely-held corporation, you should make sure that there is a written agreement to repay your loan, a fair interest rate is charged, and the loan is authorized by a corporate resolution. Without adequate interest, the IRS may treat your loans as constructive distributions which could result in dividend treatment.

- **Planning Alert!** A corporation should charge interest at least equal to the applicable federal rate on loans to more than 5% shareholders. Otherwise, subject to certain exceptions, the IRS will impute interest and the imputed interest will result in dividend treatment if the corporation has earnings and profits.

Document Uncollectible Debts. If you have previously loaned money to your corporation and the corporation cannot repay the loan, you may be entitled to a bad debt deduction. To take that deduction in 2000, you must establish that you began efforts to collect the debt well before December 31, 2000, in order to establish the debt's worthlessness in 2000.

- **Tax Tip.** Generally, a shareholder's bad debt from the corporation is treated as a short-term capital loss (i.e., deductible up to the shareholder's capital gains plus $3,000). However, if you can establish that the primary purpose for loaning the funds to your corporation was to preserve your employment by the corporation, you may be entitled to a deductible "business bad debt" and avoid the limitations on capital losses. The IRS typically requires significant evidence to satisfy this requirement, and proper documentation establishing a business bad debt is critical. Also, an employee business bad debt could have adverse alternative minimum tax (AMT) consequences.

Charitable Contribution Planning. If your regular corporation uses the accrual method for tax purposes, it can deduct an accrued charitable contribution if the contribution is authorized by the company's Board of Directors by year-end, and paid on or before the 15th day of the third month after that year-end (e.g., 3/15/2001 for December 31, 2000 year-ends). Your corporation should have a "Board of Directors Charitable Contribution Resolution" on its year-end tax planning checklist.

Remember, a regular corporation's charitable contributions cannot exceed 10% of its taxable income (after certain adjustments). Furthermore, contributions in excess of the 10% cap cannot be carried back to previous years, but may be carried forward for up to five years.

- **Tax Tip.** If you own a closely-held regular corporation, it may be more beneficial for you to make the charitable contribution individually, rather than your corporation making a contribution in excess of the 10% corporate limitation.

- **Planning Alert!** Don't forget, all taxpayers (including corporations) making charitable contributions of $250 or more must receive a written acknowledgment by the due date of the corporation's return, or by the date the corporate return is filed, if filed before the due date. This written receipt must describe the amount of money and a description of any property contributed, and the value and description of any services provided to the corporation by the charity. If you own a pass-through entity (S corp, partnership, LLC) which contributes $250 or more, the entity (not the owners) must obtain this receipt.

AMT Relief For Small Corporations. If you own a "qualified small corporation", it is exempt from the alternative minimum tax (AMT). Your regular (non-"S") corporation qualifies for this exemption if**:** **(1)** it had average gross receipts of $5 million or less for 1994, 1995, and 1996, **and (2)** it has average gross receipts of $7.5 million or less for subsequent years. If a corporation's first year of existence is after 1997, the corporation is exempt from AMT for that first year regardless of the amount of its gross receipts. If

your corporation is exempt in 2000 because of the $5,000,000 rule, it will qualify in 2001 if its average gross receipts for the 3-year period from 1998 through 2000 is $7.5 million or less.

- **Tax Tip!** If your corporation meets the $5,000,000 exemption in 2000, it should consider deferring income to 2001, if needed, to keep average gross receipts from '98 through 2000 at a level of $7.5 million or less. This will preserve the AMT exemption for 2001.

AMT Depreciation! As a result of recent legislation, all taxpayers will use the "same depreciation life" for both regular tax and alternative minimum tax purposes, **for property first placed in service after December 31, 1998.** **Planning!** If your corporation is subject to AMT, you may wish to use 150% declining balance depreciation rather than 200% declining balance depreciation for machinery, equipment, etc. to prevent an alternative minimum tax adjustment for these assets first placed in service after 1998.

Use Your Corporation's Capital Loss Carryback. Regular (non-"S") corporations can generally carry back capital losses for 3 years, and forward for 5 years. **Planning Alert!** If your corporation had net capital gains in 1997, this year will be the last year you can realize corporate capital losses to recover the tax paid on the 1997 gains.

Recent Court Cases Suggest That "Goodwill" May Be A Stockholder Asset. If you are planning to sell your regular "C" corporation and the assets have a value greater than the tax basis, the buyer will probably want to buy the "assets" of the corporation, instead of buying your stock. It is quite common for the most highly-appreciated corporate asset to be going concern value or "goodwill." This means that if your corporation sells its goodwill along with its other assets, the gain on the goodwill will be taxed first to the corporation, and then will be taxed a second time when you distribute the sales proceeds to the stockholders. From the seller's tax standpoint, selling corporate assets of a regular corporation is extremely costly.

- **Tax Tip!** Several recent cases suggest that, in certain situations, the goodwill of a corporate business operation may in fact be owned by the individual stockholder. These cases suggest that it may be possible (given the appropriate facts) to exclude gain on goodwill from corporate taxation, if the corporate assets are sold or the corporation is dissolved.

- **Planning Alert!** This is an extremely hot tax issue for the IRS, and will probably be scrutinized closely if examined. If you are considering selling your corporate business, converting to "S" status, or dissolving your corporation--and you think this new case law may apply to your corporation--please call our office. We will be glad to help evaluate this potentially valuable (but tricky) tax planning opportunity.

PLANNING FOR S CORPORATIONS

Check Your Stock And Debt Basis Before Year End. If your S corporation is anticipating a taxable loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless you have adequate "basis" in your S corporation. You will have basis to the extent of the amounts paid for your stock (adjusted for net pass-through items and distributions) plus any amounts you have personally loaned to your S corporation. If you merely guarantee an outside loan made to your S corporation, this will not give you basis for loss pass-through purposes.

- **Tax Tip.** It may be possible to restructure an outside loan to your corporation in a way that will give you adequate basis. However, this restructuring must occur before the end of the tax year.

- **Planning Alert!** The courts are becoming increasingly strict on restructuring loans to an S corporation. Please do not attempt to restructure your loans without contacting us first. Also, if you finance losses of an S corporation with loans from other corporations controlled by you, or if you borrow from another shareholder, the IRS may take the position that a restructuring of these loans does not give you basis. It is best not to finance S operations with funds loaned directly from related corporations or from other shareholders.

Monitor Excess Investment Income. If your S corporation has earnings and profits from years when it was a regular C corporation, and more than 25% of its gross receipts are from passive investment income (e.g., interest, dividends, and certain royalties and rents), your S corporation may be subject to a 35% corporate tax. Furthermore, your corporation's S election will automatically terminate if it is subject to this tax for three consecutive years.

- **Tax Tip!** It may be possible to avoid this problem by electing to distribute your S corporation's earnings and profits to its shareholders as a taxable dividend by year-end. Please call our office if you think your S corporation may have this problem.

Minimizing FICA Taxes To Stockholder/Employees. The combined employer and employee FICA tax rate is 15.3% on all of your wages up to $76,200 for 2000 ($80,400 for 2001). The combined rate drops to 2.9% for all wages in excess of $76,200 ($80,400 for 2001).

- **Tax Tip.** If you are a stockholder/employee of an S corporation, you should take no more than a "reasonable salary" from your corporation to minimize your FICA tax. Other income that passes through to you as a shareholder of your S corporation is not subject to FICA tax.

- **Planning Alert!** Determining "reasonable salaries" for S corporation stockholder/employees is a hot audit issue for the IRS. Be very careful in setting compensation levels. Also, minimizing your FICA tax could also reduce your social security benefits when you retire.

Don't Forget Recent Changes In S Corporation Rules. Tax legislation enacted over the past several years has changed many of the S corporation tax rules to make them more taxpayer friendly. As a result,

more corporations can qualify under subchapter S, and existing S corporations may be able to engage in transactions that were previously unavailable. Your S corporation can now take advantage of the following new rules:

- **Number Of Shareholders Increases.** Your S Corporation can have up to 75 shareholders.

- **"Electing Small Business Trust" Can Own S Corporation Stock.** An "electing small business trust" (ESBT) can own the stock of your S corporation. All beneficiaries of this trust generally must be either individuals or estates, and no interest in the trust can be acquired by purchase (i.e., generally must be acquired by gift or inheritance). **Tax Tip.** This provision may provide more flexibility when planning your estate. If your estate plan includes a "credit shelter trust", a "family spray trust," a "sprinkle trust," or a "discretionary trust," you should be able to structure these trusts as an ESBT. Furthermore, if your "C corporation" has avoided making an "S election" because some of its stock is owned by a disqualifying trust, it is possible that the trust may now qualify as an ESBT. **Planning Alert!** All S corporation income passing through to the ESBT (to the extent of its stock ownership) is automatically taxed to the trust at the highest individual tax rates (i.e., 39.6% on ordinary income). The pass-through income is not taxed to the trust beneficiaries, even if distributed to them.

- **Your S Corporations Can Own Corporate Subsidiaries.** Your S corporation is allowed to own any percentage of the stock of a "C" corporation. Furthermore, if your S corporation owns 100% of a qualifying C corporation, the S corporation may elect to report all of the subsidiary's operations on the parent S corporation's income tax return. The 100%-owned corporate subsidiary will not file a separate return and, for tax purposes, will effectively be treated as a branch or division of the parent S corporation. **Tax Tip.** This rule enables your S corporation to purchase any amount of the stock of a target corporation without terminating the acquiring corporation's S election. Also, your S corporation may divide its various operations into separate legal entities by setting up a 100%-owned corporate subsidiary -- without losing its S status. The IRS has recently issued regulations explaining these rules. Call us if you need more information.
- **IRS Can Waive Faulty "S" Elections.** Historically, one of the most common tax traps involving S corporations was failing to file a timely S election. In many cases, taxpayers failed to file the S election by its due date (2 ½ months after the beginning of the S corporation's year). Now, if your S election is not filed on time you may be able to get the IRS to allow the late election if you send the election in within twelve months following the original due date of the S election. **Planning Alert!** To qualify for this relief, you must demonstrate to the IRS service center that you have "reasonable cause" for filing late. **Tax Tip! Clearly the best policy is to file the election on time!** Please call us if you need assistance in filing your S election. These elections (Form 2553) should **always be sent certified mail.**

- **Certain Tax Exempt Organizations Can Own S Corporation Stock.** Traditionally, you could not transfer your S corporation stock to a tax exempt organization without terminating the corporation's S election. Exempt charities and most qualified retirement plans (e.g., profit sharing plans, employee

stock ownership plans, etc.) are now able to own S corporation stock without terminating the S election. **Tax Tip.** This new rule will allow you, as an S corporation shareholder, to contribute your S corporation stock directly to a tax exempt charity. **Planning Alert!** There are exceptions to the types of tax exempt organizations and qualified retirement plans that can own S corporation stock under this new rule. Furthermore, all S corporation income that passes through to a tax exempt shareholder will generally be taxed to the charity as "unrelated business taxable income" (except as discussed below for ESOPs).

- **Employee Stock Ownership Plans (ESOPs).** Your S Corporation can now sponsor an employee stock ownership plan (ESOP). If your S corporation sponsors an ESOP, the S corporation income that passes through to the ESOP as a shareholder will be tax exempt. If your regular "C" corporation currently sponsors an ESOP, this new rule creates another tax incentive to consider making an S election. There are many tax issues you must evaluate before converting your regular "C" corporation to an S corporation, including the impact of the built-in gains tax. Please call us if you need more information. **Note!** Other qualified retirement plans can own S corporation stock. However, the S corporation income that passes through to "Non-ESOP" qualified retirement plans is subject to "unrelated business income tax."

IRS Clarifies Capital Gains Treatment Of Selling Your S Corporation (Or Partnership) Interest. Recent tax legislation has created at least three different rates of taxation on long-term capital gains: **(1)** a maximum 28% on "collectibles" (artwork, antiques, etc.), **(2)** a maximum 25% to the extent of straight-line depreciation taken on business real estate, and **(3)** a maximum 20% on all remaining long-term capital gains. In its newly-released regulations, the IRS explains how to apply these rules if you are selling stock of an S Corporation, or an interest in a partnership or an LLC. If the S corporation owns appreciated collectibles, some gain on the sale of your S Corporation stock will be taxed at a maximum 28%, instead of a maximum 20% long-term capital gain rate. More alarming, the regulations provide that the gain on the sale of a partnership interest or an interest in an LLC could be taxed as a combination of "ordinary income", 28% capital gain, 25% capital gain, and 20% capital gain.

- **Planning Alert!** If you are considering the sale of the stock of an S Corporation that owns appreciated collectibles or an interest in a partnership or an LLC, your gain will not, generally, be taxed entirely at a maximum 20% capital gain rate. Please call our office before you sell, and we will be glad to help you determine the tax consequences.

GENERAL BUSINESS PLANNING

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

- **Regular "C" Corporations.** If your regular C corporation accrues an expense 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 2000 is significantly greater than the stockholder's individual rate for 2000 and 2001, the accrued amount should be paid by the end of the year.

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

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

Other Year-End Accruals. Generally, if an accrual-basis business accrues year-end compensation to its 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 accruals are 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.).

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

Deduction For Self-Employed Health Insurance. If you are self-employed, a partner, or own more than 2% of an S corporation, your tax deduction for health insurance premiums will be rising over the next several years. For 2000 and 2001, you can deduct 60% of your health insurance premiums as an "above the line" deduction, the remaining 40% is an itemized medical deduction. After 2001, the "above the line" deduction will increase as follows: 2002 (70%), 2003 and thereafter (100%).

Your Daily Transportation Might Constitute "Business Travel." Generally, daily travel from your home to your "regular place of business" is considered a nondeductible commute. However, the IRS says that if you have a "regular place of business away from your home," 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.

- **Good News!** In a recent ruling, 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!

- **Tax Tip!** In light of this new rule, you may have daily travel for prior tax years that you previously assumed was a nondeductible "commute", but is now, retroactively, deductible business travel. The IRS says we can amend a prior year's return (assuming the three-year statute of limitations has not run) to take advantage of this pro-taxpayer rule. **We will gladly help you decide if an amended return is necessary.**

Employee's Personal Use Of Company Cars. If your company provides its employees with company-owned cars, the company is required to include personal use of the car in the employee's 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, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost, to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion.

- **Tax Tip.** If the employee chooses to reimburse your company for personal use of the company car, the obligation for reimburement should be established before December 31st so the employee will not have income in one year and a deduction in the next. This can be accomplished by your company establishing a published policy for reimbursement of personal use. Furthermore, your company should obtain signed statements from its employees to document their business and personal use of company assets.

Trucks, Vans, Etc. If your business purchases a "luxury vehicle" (cost over $38,000) in 2000, it is required to pay a 5% luxury auto excise tax. The excise tax for 2001 will be 4% of the cost over $38,000.

- **Tax Tip.** A truck or van is exempt from this excise tax if it has a "gross vehicle weight" exceeding 6,000 pounds (e.g., Expedition, Range Rover, Tahoe, Durango, Suburban). These vehicles are also exempt from the annual depreciation limits generally imposed on automobiles used for business.

Recent Legislation Increases §179 Deduction. Recent tax legislation increased the §179 deduction to $20,000 in 2000 and to $24,000 in 2001 and 2002.

- **Tax Tip.** Your company may save taxes by splitting its purchases between two tax years, instead of bunching them into one year. For example, if your business purchases $44,000 worth of equipment in

2000, and none in 2001, it can expense $20,000 in 2000, but must depreciate the remaining $24,000 over the equipment's tax life. However, if instead, your company purchases equipment of $20,000 in late 2000, and $24,000 in early 2001, it can expense the entire $20,000 in 2000 and the entire $24,000 in 2001.

- **Planning Alert!** If your company's total equipment purchases for a tax year exceed $200,000, the amount it can immediately deduct as a §179 deduction will be reduced, and possibly eliminated. Also, your company's immediate write off cannot exceed the company's business income, computed without regard to the §179 deduction.

Depreciating and Expensing Equipment. Generally, your company is entitled to one-half year of depreciation on equipment placed in service anytime during 2000, even if the equipment is purchased at or near the end of the tax year.

- **Planning Alert!** If your company purchases more than 40% of all of its depreciable personal property in the last three months of the tax year, the company will be allowed only 1½ months depreciation for the purchases in the last three months of 2000.

- **Tax Tip.** Remember, if your company qualifies, it can deduct immediately up to $20,000 for the cost of depreciable personal property (known as "§179 Property") purchased in 2000. If the half-year depreciation convention produces more depreciation than the mid-quarter convention, your company should consider electing the §179 deduction for equipment acquired during the last three months of the year. This "may" allow the company to avoid the 40% rule discussed above.

Consider Depreciating Nonstructural Components Of Buildings Over Shorter Depreciable Lives. For tax purposes, commercial buildings are depreciated over 39 years, and residential rental buildings (e.g., apartment buildings) are depreciated over 27½ years. However, the Tax Court says that certain nonstructural components of a building may be depreciated over a much shorter life (perhaps five to seven years). For example, the Tax Court recently allowed a hospital to treat its internal movable walls, carpet, wallpaper, floor tile, handrails, and the portion of its electrical systems used by machinery and equipment as property separate from the building itself--with a 5 year depreciable life.

- **Planning Alert!** Although the IRS now concedes that taxpayers can break out (for depreciation purposes) certain nonstructural parts of a building--it also warns that it may challenge a taxpayer's allocations. For example, they do not necessarily agree that the above items listed by the Tax Court are not structural components.

- **Tax Tip!** If your business is acquiring or constructing a new building and you believe the Tax Court is correct, you may be able to save significant taxes by identifying the nonstructural parts of the building which may warrant a shorter depreciable life. An experienced architect and/or engineer is extremely

helpful for allocating costs to the various assets. Furthermore, if your existing building has nonstructural parts that may, under the Tax Court's theory, be depreciated over a shorter life, please call our office.

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Phone: 888 TAXX-911

We may be able to put the portions of the building that are not structural components on shorter lives and take the increased deductions either in the current year or over four years depending on the amount.

Pay Careful Attention To "Start-Up Expenses." If you are planning to start a new business, or acquire a new business, you should be aware of a new set of IRS regulations that impact the tax treatment of costs relating to those transactions. Generally, expenses that would normally be deductible, but are related to starting a new trade or business, cannot be deducted at all unless a specific election is made to amortize these "start-up" expenses. The amortization election must be made by the due date of the return for the year in which business begins. If you do make a timely election, you will be able to amortize "qualified" start-up expenses over a 60-month period.

- **Tax Tip!** These rules are very complex. If you think you have (or may in the future) incur "start-up expenses", the expenditures should be carefully scrutinized in light of these new regulations. A timely election (and proper classification) of these expenditures might preserve a deduction that could otherwise be lost. Please call our office if you need more information on these rules.

"SIMPLE" Retirement Plans Are Becoming Popular With Small Businesses. Businesses that generally employ 100 or less employees, may set up a simplified retirement plan ("SIMPLE" plan). SIMPLE plans are similar to 401(k) plans but are less costly and easier to administer. Under the SIMPLE plan, if your business makes certain mandatory minimum contributions to the plan, it will be exempt from the onerous anti-discrimination rules, top heavy rules, minimum participation rules, and many of the reporting requirements that are currently imposed on regular qualified plans. SIMPLE plans also have low administrative costs.

- **Planning Alert!** There are many factors to consider before adopting a SIMPLE plan. For example, you generally cannot set up a SIMPLE plan after October 1, 2000, for the 2000 tax year. Also, you generally cannot set up a SIMPLE plan if your company had another plan during the same calendar year.

- **Tax Tip.** If you plan to form a new company between October 1 and December 31, 2000, your company may still be able to set up a SIMPLE plan for 2000 if it satisfies certain notification requirements.

Increased Meal Deduction For Certain Transportation Workers. Most taxpayers can deduct only 50% of meals incurred during business travel. However, if your company employs a transportation worker subject to the hours of service limitations of the Department of Transportation, your business meals deduction for that worker is 60% for 2000, and will eventually increase to 80% by the year 2008. Workers qualifying for this increase include: **(1)** certain air transportation employees such as pilots, crew dispatchers, mechanics, and control tower operators; **(2)** interstate truck operators and interstate bus

drivers; **(3)** certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel; **and (4)** certain merchant mariners.

Worker Classification Continues To Be An Extremely Hot Tax Issue. If you hire independent contractors as workers in your business, you run some risk of the IRS later arguing that these workers should have been treated as your "employees." If successful, the IRS could impose an array of tax penalties on your business.

- **Tax Tip!** Even if your independent contractors should have been treated as employees, the IRS now agrees that you can avoid reclassification (and related penalties) if you have a "reasonable basis" for treating the workers as independent contractors. One way to satisfy this "reasonable basis" test is to: **(1)** file all necessary 1099 forms for the workers on a timely basis, **(2)** consistently treat all employees performing similar duties as independent contractors, **and (3)** before you hire the workers, obtain an opinion from a knowledgeable tax person that it is appropriate to treat the workers as independent contractors for tax purposes.

- **Planning Alert!** The rules for determining whether a worker is an independent contractor or an employee are very complex. Please call our office if you need help.

New Automatic Accounting Change Procedure Could Save You Time And Money. Generally, if your business needs to change its tax accounting method, it must: get approval from the IRS, pay a user fee of $500 or $1,200 if gross receipts are more than $1,000,000, and follow complex administrative IRS requirements. **Good News!** The IRS now says that you can get "automatic approval" for many common accounting method changes simply by filing a request with your timely filed tax returns (including extensions) for the year of the change. You can even ask for the automatic approval on an "amended return" so long as you file the amendment within six months following the original (unextended) tax return due date for the year of change. This is great news for anyone who has ever wrestled with the old accounting change procedures.

- **Planning Alert!** Please do not attempt any accounting change without contacting our office first. The new automatic approval procedure **does not apply to all accounting changes and still requires the proper completion of Form 3115.**

Don't Forget The New AMT Relief For Farmers. Congress recently confirmed that qualified farmers are eligible to use the installment method for both regular and alternative minimum tax (AMT) purposes. This clarification is retroactive.

- **Tax Tip.** If you are a qualified farmer and you paid AMT on installment sales from previous years, please call our firm. If the statute of limitations has not run on that prior year, we will help you file an amended return to get your taxes back.

3-Year Averaging For Individual Farmers. Individuals that are farmers (including owners of partnerships and S corporations) may elect to compute their current year tax liability by averaging all or a portion of their "farming" income over a 3-year period. **Good News!** Although this 3-year averaging rule was originally set to expire after 2000, Congress has now made the rule permanent.

- **Planning Alert!** Unfortunately, using the 3-year averaging method could cause you adverse alternative minimum tax (AMT) consequences.

Don't Miss The Welfare-To-Work And Work Opportunity Tax Credits. If your business hires workers who may possibly qualify for the "work opportunity tax credit" or the "welfare-to-work credit" (e.g., certain low-income workers), you should have these workers complete a Form 8850 ("Pre-Screening Notice") along with their employment application and apply for certification of the employees with the proper government agency. There are strict filing deadlines regarding Form 8850, please call our office if you need more information. **Planning Alert!** Be sure to follow the instructions on Form 8850 precisely.

NOL Carrybacks And Carryforwards. For losses incurred in tax years beginning after August 5, 1997, the net operating loss (NOL) carryback period is reduced from 3 years to 2 years. The carryforward period is increased from 15 years to 20 years. If you are a qualifying small business and incur your losses in a "Presidentially Declared Disaster Area," you may still be able to carry back your loss 3 years. Please call our firm if you need additional information.

- **Tax Break For Farmers.** Late in 1998, Congress increased the NOL carryback period for "farming losses" from two years to five years. This new carryback rule is effective for losses arising in taxable years beginning after 1997.

- **Tax Tip!** Farmers can elect to use the normal 2-year carryback provision if it is more beneficial.

Business Tax Credit Carrybacks and Carryforwards. Effective for credits arising in tax years beginning after 1997, your business tax credits can be carried back only 1 year (rather than 3) and the carryover period is increased from 15 to 20 years.

Accounting For Inventory Shrinkage Clarified. In several recent court cases, the IRS argued that businesses could not deduct year-end inventory shrinkage (lost and stolen merchandise, etc.) unless a physical inventory is actually taken at year end. Several courts disagreed with the IRS.

- **Tax Tip.** A recent law change allows taxpayers to deduct year-end inventory shrinkage based on reliable estimates, without taking a physical inventory at every location at year-end. However, the business is required to take periodic physical inventories. Please call our firm if you need more information.

FINAL COMMENTS

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

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