

## **YEAR-END INCOME TAX PLANNING FOR CORPORATIONS AND BUSINESSES**

### **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. Although these “tried and true” strategies are still generally beneficial for 2004, we have a growing list of new year-end strategies flowing from recent changes in the tax law. Many of these new strategies result from provisions of the “American Jobs Creation Act of 2004” that was signed into law on October 22, 2004. These new planning provisions, as well as others, are contained in this letter. To help you locate items of interest, we have divided the planning ideas into the following categories:

- Highlights of Recently Enacted Legislation
- Other Recent Developments
- Planning For “C” Corporations
- Planning For “S” Corporations
- General Business Planning

**Please 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 additional information.**

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## HIGHLIGHTS OF RECENTLY ENACTED LEGISLATION

### AMERICAN JOBS CREATION ACT OF 2004

The "American Jobs Creation Act of 2004" ("Jobs Act") is far too large and complex to cover in depth in this letter. Instead, the following summary highlights selected provisions that we feel have the greatest impact on small and mid-sized businesses. This mammoth tax bill includes: Repeal of the FSC/ETI (Foreign Sales Corporation/Extraterritorial Income) regime; creation of a new tax deduction for "manufacturers" and other "producers;" extension of the increased §179 deduction; increased depreciation deductions for qualified leasehold improvements and restaurant improvements; modification of many of the qualification rules for S corporations; changes to the international taxation rules and much more.

#### *New Deduction for U. S. Production Activities*

The Jobs Act phases out the extraterritorial income (ETI) exclusion, which provides tax benefits for exporters. The ETI benefits will be reduced 20% in 2005, 40% in 2006 and will be repealed after 2006. To compensate U.S. producers, **effective for tax years beginning after December 31, 2004**, the Act creates a new deduction for eligible businesses which may include manufacturers, U.S. construction companies, U.S. engineering and architectural firms, energy producers, extraction activities, U.S. film production, farmers, and those who process or store food products. This new deduction is based on the following percentages of **the lesser of 1)** "qualified domestic production income" or **2)** taxable income: 2005-2006 (3%), 2007-2009 (6%), after 2009 (9%). The deduction cannot exceed 50% of the wages paid by the business. **Planning Alert!** The technical requirements for a business to qualify for this new deduction are too lengthy and complex to discuss in this letter. Please contact our firm and we will be glad to give you more details. **Tax Tip.** Any type of business entity can qualify for this deduction, including a "C" corporation, an "S" corporation, a partnership, an LLC, a sole proprietor, etc. However, it appears that a **one-person sole proprietorship** (with no employees) would not qualify for a deduction, because the income from that business is not paid to the owner in the form of wages. Consequently, with no wages, no deduction would be allowed because the deduction is limited to 50% of wages paid by the business. Therefore, it may be advantageous for a proprietor that is conducting qualifying activities, to become an "S" corporation and pay wages to the proprietor to qualify for the deduction for U.S. production activities.

#### *New Restrictions on Charitable Contributions*

The Jobs Act made the following changes to the charitable contribution rules:

#### *Donations of Motor Vehicles, Boats, and Aircraft*

The Jobs Act adds stringent reporting and documentation requirements, for the donor and the charity, that must be satisfied in order to claim a charitable deduction in excess of \$500 for motor vehicles designed for highway use, boats, or airplanes. **These new rules apply to all taxpayers (including corporations) and are effective for contributions made after December 31, 2004.** Generally, under the new rules, your business will be required to receive a detailed, written receipt

from the charity. If the charity sells the vehicle without any material improvement or significant use of the

vehicle by the charity, **the charitable deduction cannot exceed the gross sales price of the vehicle which must be listed on the receipt.** The charity will be required to send a copy of the receipt to the IRS, and your business will be required to attach a copy of the receipt to its tax return. Furthermore, significant penalties are imposed if the charity fails to provide a timely, accurate and complete receipt. **Tax Tip.** Your business will not be subject to these new stringent reporting requirements if it contributes a vehicle to charity by December 31, 2004. However, if the vehicle has a value of more than \$5,000, an appraisal is generally required.

### **Other Non-Cash Charitable Contribution Requirements Expanded to “C” Corporations**

Before this legislation, regular “C” corporations (other than closely-held corporations and personal service corporations) were exempt from certain charitable contribution reporting requirements that applied to all other taxpayers. To create parity among taxpayers, **effective for contributions made after June 3, 2004**, the Jobs Act extends charitable contribution reporting requirements of non-cash property (other than publicly-traded securities, inventory, and certain qualified vehicles) to all “C” corporations and adds a new rule for contributions in excess of \$500,000. If the property is valued at more than \$500, all taxpayers must attach to their return a written description of the donated property using Form 8283. If the property is valued at more than \$5,000, all taxpayers must obtain a “qualified appraisal” and include a summary of the appraisal along with Form 8283. If the contribution is more than \$500,000, the qualified appraisal must be attached to the tax return. **Planning Alert!** If your business fails to meet these reporting requirements, the charitable deduction could be denied altogether.

### **“S” Corporation Reform**

With strong support from the business community, the Jobs Act includes several pro-taxpayer changes to the “S” corporation rules, including:

#### **Increased “S” Corporation Shareholder Limit**

In 1996, Congress increased the maximum number of shareholders in an “S” corporation from 35 to 75. **Effective for tax years beginning after December 31, 2004**, the Jobs Act increases the maximum number of “S” corporation shareholders to 100.

#### **Family Members Treated as One “S” Corporation Shareholder**

**Effective for tax years beginning after December 31, 2004**, for purposes of counting the number of “S” corporation shareholders, all “members of a family” may elect to be treated as one shareholder. Generally, the term “members of a family” include a common ancestor, the lineal descendants of that common ancestor, and their spouses (or former spouses). The common ancestor cannot be more than six generations removed from the youngest generation of shareholders on the later of **1)** the date the “S” election is made **or 2)** the first day of the first tax year of the “S” corporation beginning after 2004. This election may be made by any family member and will remain in effect until terminated.

#### **Suspended “S” Corporation Losses Can be Transferred to Spouse**

If you own stock in an “S” corporation, any loss that passes through to you cannot exceed the tax

basis in your stock plus amounts loaned by you to the corporation. If your loss exceeds both your stock and debt basis, the loss will be suspended and carried over to subsequent years until you have

sufficient stock or debt basis to absorb the loss. IRS regulations generally provide that if you dispose of your "S" corporation stock with suspended losses, neither you nor the new owner of the stock will ever be allowed to utilize those losses. **For tax years beginning after 2004**, the Jobs Act provides that if you transfer your "S" corporation stock with a suspended loss to your spouse (or former spouse in a divorce), the suspended loss carries over to the spouse and is not lost.

### **Relief From QSUB Violations**

If an "S" corporation owns 100% of a corporate subsidiary, it can elect to treat the subsidiary as a "Qualified Subchapter S Subsidiary" (QSUB). A QSUB is disregarded for tax purposes, and its operations are taxed on the tax return of the parent "S" corporation. If the "S" corporation parent loses its 100% ownership of this subsidiary corporation, the QSUB election automatically terminates, and adverse tax consequences can occur. Prior to the Jobs Act, the IRS had authority to provide relief for invalid "S" corporation elections and terminations, but had no statutory authority to waive faulty QSUB elections or inadvertent terminations of QSUB elections. **Effective for QSUB elections and terminations made after December 31, 2004**, the IRS now has the authority to waive those violations if they are inadvertent.

### **Relief For Banks Operating as "S" Corporations**

Although banks have generally been able to operate as "S" corporations since 1997, they often run into practical problems. For example, bank employees often own bank stock in their individual retirement accounts (IRAs). Since IRAs cannot own stock of an "S" corporation, banks with IRA shareholders cannot elect "S" status until the stock is removed from those accounts. This created practical problems for the bank and its employees. In addition, "C" corporations with "earnings and profits" that convert to "S" status may be subject to a penalty tax (and even "S" termination) if the corporation has too much "net passive investment income." Passive investment income generally includes, among other items, interest income and dividend income. Since banks are often required to own assets generating interest and dividends, they may be reluctant to convert to "S" status for fear of being subjected to the passive investment income penalty tax, or a loss of "S" status. The Jobs Act provides relief provisions allowing a bank to elect "S" status even though some of its stock is owned by IRAs, but, only if the stock held by the IRAs was held on October 22, 2004. Furthermore, **effective for tax years beginning after December 31, 2004**, the Jobs Act excludes interest income and certain dividends on assets required to be held by the bank from the definition of passive investment income.

### **Other Miscellaneous Changes**

The Jobs Act makes several technical "S" corporation changes including: Allowing beneficiaries of qualified subchapter "S" trusts to use suspended at-risk or passive activity losses upon the trust's disposition of the stock; disregarding unexercised powers of appointment in determining potential current beneficiaries of an "electing small business trust;" allowing an ESOP to repay loans used to buy the "S" corporation's stock with distributions on the "S" corporation's stock; and authorizing IRS to require information returns for qualified subchapter "S" subsidiaries.

### **Increased §179 Deduction Extended Through 2007**

The Act extends the increased §179 deduction (\$102,000 for 2004) to **taxable years beginning before 2008**. Before this change, the §179 deduction was to revert to \$25,000 beginning in 2006.

### **§179 Deduction for SUVs Reduced**

The maximum annual depreciation deduction for business, passenger automobiles are capped at certain dollar amounts. However, trucks, vans and SUVs are exempt from these “passenger auto” depreciation limitations if the “gross vehicle weight” exceeds 6,000 lbs. (e.g., a full-size pick-up; a full-size van; or a sport utility vehicle, including: Expedition, Range Rover, Tahoe, Durango, Suburban, BMW X-5, etc.). Consequently, prior to the Jobs Act, if more than 50% of the use of one of these vehicles was for business purposes, you could have taken the §179 limitation (up to \$102,000 in 2004) with respect to the business portion of the vehicle. For example, if the vehicle had 100% business use, you could have immediately deducted up to \$102,000 of its cost in 2004 (if it otherwise qualified under §179). Under the Jobs Act, SUVs, vans and certain other vehicles that have a gross vehicle weight of 14,000 lbs. or less are limited to a §179 deduction of up to \$25,000 (reduced from \$102,000). This new rule is **effective for vehicles placed in service after October 22, 2004**. **Example.** Assume that on December 1, 2004, your business purchases an SUV (weighing 6,005 lbs.) for \$70,000, which you use 100% for business. Assume further that this SUV qualifies for the maximum §179 deduction, the 50% additional first-year depreciation, and the normal accelerated depreciation deductions (using the mid-quarter convention). The total deductions in 2004 on this SUV would be \$48,625, computed as follows: **(i)** a §179 deduction of \$25,000, plus **(ii)** additional 50% first-year depreciation of \$22,500 on the remaining basis ( $[\$70,000 - \$25,000] \times 50\%$ ), plus **(iii)** \$1,125 of MACRS depreciation ( $[\$45,000 - \$22,500] \times 5\%$  [using mid-quarter convention and 200% declining balance]). The remaining \$21,375 of cost would be recovered in 2005 and later years under the general depreciation rules. **Planning Alert!** If the SUV is instead placed in service on January 2, 2005 (when the 50% depreciation is no longer available), the total depreciation deductions for 2005 would be only \$34,000 (using the mid-year convention). Therefore, if you want maximum up-front depreciation deductions, you must place the SUV in service before 2005. **Tax Tip.** As you evaluate the impact of this new rule, please keep the following points in mind:

Any truck, van, or SUV weighing over 6,000 lbs is still fully exempt from the passenger auto depreciation limitations. It is only the §179 deduction amount that has been changed. **Planning Alert!** Subject to limited exceptions, the 50% additional first-year depreciation deduction sunsets for all depreciable property (not just SUVs) **if placed in service after December 31, 2004**.

The Jobs Act provides that some vehicles weighing over 6,000 lbs. (even though not over 14,000 lbs.) are still entitled to the maximum §179 deduction (\$102,000 for 2004). For example, a pick-up truck with a cargo area of at least 6 feet of interior length and a van with a seating capacity of more than 9 persons behind the driver are not limited to a \$25,000 §179 deduction.

### **More Depreciation for Certain Leasehold Improvements and Restaurant Improvements**

Generally, if a lessor or lessee makes leasehold improvements to a commercial building, the improvements must be depreciated using a 39-year recovery period. However, a 50% additional depreciation deduction is available for “qualified leasehold improvements” **placed in service before January 1, 2005**. A qualified leasehold improvement is generally an improvement made to the

interior portion of a commercial building (i.e., non-residential real property) by the lessor or the lessee **pursuant to a lease**. The leasehold improvement also must be placed in service more than

three years after the building was first placed in service (so the building must be a commercial building more than three years old). In addition, certain leases between related parties will not qualify. **Effective for property placed in service after October 22, 2004, and before January 1, 2006**, the Jobs Act provides that “qualified leasehold improvements” will be depreciated over 15 years rather than 39 years. “qualified leasehold improvement” has the same definition as used for the 50% first year bonus depreciation (explained above). **Restaurant Property.** The Jobs Act also allows “qualified restaurant property” to be depreciated over 15 years, **if placed in service after October 22, 2004 and before January 1, 2006**. Qualified restaurant property means any improvement to a building (whether or not a leasehold improvement), if the improvement is placed in service more than three years after the building was first placed in service. Furthermore, more than 50% of the building’s square footage must be devoted to the preparation of, and seating for, on-premises consumption of prepared meals. **Tax Tip.** If the qualified restaurant property is placed in service **after October 22, 2004, and before January 1, 2005**, it will also qualify for the 50% additional depreciation deduction.

#### **50% Bonus Depreciation Generally Sunsets After 2004**

The 50% bonus depreciation provision, mentioned above, generally sunsets for any property **placed in service after December 31, 2004**. **Tax Tip.** An asset is considered “placed-in-service” in 2004 if it is ready and available for use by December 31, 2004. For example, if a new copier is on hand and available by December 31, 2004, it should qualify for the 50% deduction. If the property needs to be assembled, it should be set up and tested by December 31, 2004. The placed-in-service date is extended one year (i.e., for property placed in service before 2006) for certain property with a recovery period of 10 years or longer and certain transportation property. To qualify, the property must have a production period exceeding 2 years or a cost exceeding \$1 million and a production period exceeding 1 year. However, the 50% deduction is only allowed for expenditures through December 31, 2004.

Also, the Jobs Act adds “**qualified non-commercial aircraft**” to the list of property that qualifies for an extended placed-in-service date. If your business acquires a “qualified non-commercial aircraft,” the entire cost should qualify for the 50% bonus depreciation, **if the aircraft is placed in service before January 1, 2006**. A “qualified non-commercial aircraft” (which is entitled to the extended placed-in-service date) cannot be used for transporting persons or property (except for agricultural or firefighting purposes), must have an estimated production period exceeding 4 months, a cost exceeding \$200,000, and there must have been a deposit of the lesser of 10% of the cost or \$100,000 at the time the purchase contract was entered into. Generally, to qualify, you must also have a binding, written contract to purchase the aircraft by December 31, 2004.

#### **Qualifying Property**

Generally, the 50% deduction applies only to property that has a depreciable life for tax purposes of 20 years or less. **The following are selected examples of the types of property that could qualify:**

## **General**

Machinery and equipment; furniture and fixtures; breeding hogs; cars and light general purpose trucks; taxis and buses; airplanes; typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment; computer-based telephone central office switching

equipment; computers and peripheral equipment; breeding cattle; dairy cattle; certain livestock 12 years old or less when placed in service; fishing vessels; barges; tugs; and single purpose agriculture or horticultural structures; land improvements (e.g., **sidewalks, roads, shrubbery, sewers, drainage facilities, fences, landscaping, etc.**); service station buildings and certain convenience store buildings that sell gasoline; farm **buildings**; and depreciable computer software. **Planning Alert!** Remember, **this is only a partial list** of qualifying property. If you have a question about property that we have not listed, call us and we will help you determine if it qualifies.

## **Qualified Leasehold Improvements**

As discussed above, “qualified leasehold improvements” also qualify for the 50% deduction. **Planning Alert!** The following leasehold improvements will not qualify: Improvements that enlarge the building; any elevator or escalator; any structural component benefiting a common area; and any cost relating to the internal structural framework of the building. Don’t forget, improvements under **a lease between “related persons”** do not qualify. The definition of a related person is quite technical. Please call our office if you need further information.

## **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% additional depreciation, and buildings generally do not. Furthermore, recent court cases provide that “nonstructural” items in a building may be treated as “tangible personal property.” For example, some courts have held that carpeting; wallpaper; decorative fixtures and millwork; movable partitions; and other portions of a building that are not structural components qualify as tangible personal property. If you can effectively segregate these costs, you may qualify for three favorable depreciation benefits: **(1)** the asset may qualify as §179 property, **(2)** you may qualify for the 50% additional depreciation deduction, **and (3)** you will qualify for more accelerated depreciation.

## **“Previously Used” Property Generally Does Not Qualify for the Additional 50% Depreciation Deduction**

You will qualify for the additional 50% depreciation deduction **only if** your business is the first taxpayer to actually use the qualified property. If your business purchases “used property,” it will generally not qualify for the 50% deduction. Moreover, “factory reconditioned” or “rebuilt” machinery or equipment will not qualify for the deduction. However, if your business incurs capital expenditures to recondition, rebuild, or refurbish qualifying property it acquires (or already owns), the capital expenditures will qualify for the 50% deduction. **Tax Tip.** You will receive larger depreciation deductions if you buy used equipment and recondition it yourself than if you buy reconditioned equipment. Also, the IRS recently announced that equipment that contains used parts is not “used” (and therefore may qualify for the 50% additional depreciation) if the cost of the used parts do not represent more than 20% of the total cost of the equipment.

### **Converting From Personal to Business Use**

In an unexpected pro-taxpayer release, the IRS says that if you acquire “qualifying property” for personal use after September 10, 2001 (for 30% additional depreciation), or after May 5, 2003 (for 50% additional depreciation), and convert it to business use before January 1, 2005, you can take the

additional depreciation deduction for the year the property is converted to business use. **Planning Alert!** The depreciable basis of the property is the lower of the property’s cost or fair market value on the date it is converted to business use.

### **Like-kind Exchanges and Involuntary Conversions**

Recently released IRS regulations clarify that the entire depreciable basis of qualifying property acquired in a like-kind exchange or an involuntary conversion qualifies for the first year additional 50% depreciation deduction. IRS had previously indicated that the additional deduction only applied to the “boot” paid to acquire the new asset. If you failed to take this deduction on the entire basis, please call our office and we will help you determine whether you can take the deduction on an amended return, or by applying for a change in accounting method.

### **Congress Closes Airplane Deduction Loophole**

The Jobs Act closes a perceived tax loophole involving company owned aircraft. Here’s how it worked. A business would buy an expensive airplane, deduct all of the operating expenses with regard to the airplane, and allow employees to use the company airplane for personal travel. The company would include the value of the personal travel in the employees’ taxable compensation based on an inclusion formula (using the SIFL rates) established by the IRS. Based on recent case law, the company was allowed to deduct all of the operating expenses of the aircraft which related to the employees’ personal travel, as long as they included the personal use of the aircraft in employees’ incomes using the IRS formula. In one documented case, the actual expenses allocable to the personal use of the airplane were 10 times the amount included in the employees’ incomes for personal use. **Effective for expenses incurred after October 22, 2004**, the Jobs Act provides that a company’s deductions for the personal use of the aircraft by “specified employees” is limited to the dollar amount included in the W-2 of these specified employees for the personal flights. “Specified employees” generally include officers, directors, and 10%-or-greater owners of private and publicly-held businesses.

### **New Restrictions on Non-Qualified Deferred Compensation Plans**

Non-qualified deferred compensation plans are frequently used as part of a compensation package providing financial incentives to executives and middle management employees. Congress believes that many companies are too aggressive with their non-qualified deferred compensation plans and are deferring compensation income without sufficient restrictions on the funds. Consequently, **generally effective for compensation amounts deferred after 2004**, the Jobs Act for the first time establishes comprehensive statutory criteria that must be satisfied to defer compensation income under non-qualified plans. Generally, amounts deferred under these plans **before January 1, 2005**, will not be subject to these new rules. However, if the plan is “**materially modified**” **after October 3, 2004**, amounts deferred prior to 2005 could be subject to taxation, an interest charge and a 20% penalty.

**Caution! Materially modifying a deferred compensation plan after October 3, 2004 could result in serious tax consequences unless the plan already complies with the Jobs Act requirements! Planning Alert!** If your company sponsors, or you are a beneficiary of, a non-qualified deferred compensation plan, it is imperative that this plan be reviewed by us and an attorney responsible for the plan. At least a preliminary review should take place before December 31, 2004 and before any additional deferrals are elected for 2005. Please call our office if you want us to assist you in this review.

### **Farmer and Fisherman Income Averaging**

If you are an individual engaged in a qualified farming business, you are allowed to compute your current year regular tax liability using a special income averaging calculation. **For taxable years beginning after December 31, 2003**, the Jobs Act extends the benefits of this income averaging rule to qualified fishermen. Furthermore, the Act prevents farmers and fishermen from incurring additional alternative minimum tax liability because income averaging reduces their regular tax.

### **Partnership Cancellation of Debt Income**

A corporation that satisfies a debt by transferring its stock to a creditor must recognize cancellation of indebtedness (COD) income to the extent that the satisfied debt exceeds the fair market value of the stock transferred. **Effective for debt cancellations after October 22, 2004**, the Jobs Act applies this same rule to a partnership that satisfies its partnership debt with an interest in the partnership. That is, if a partnership satisfies a recourse or non-recourse debt by transferring an interest in the partnership to a creditor, the partnership will recognize COD income to the extent the debt satisfied exceeds the fair market value of the transferred partnership interest. This COD income is allocated among the partners who held an interest in the partnership immediately prior to the satisfaction of the debt.

### **New Rules for Business Start-Up and Organizational Expenses**

Expenses incurred to start a new trade or business (start-up expenditures) or to set up a new corporation or partnership (organizational expenditures), are not immediately deductible. However, prior to the Jobs Act, if a business filed the proper election, it could amortize the start-up expenditures and/or organizational expenditures generally over a 60 month period (beginning with the month the business began operations). For **“start-up expenditures” and “organizational expenditures” incurred after October 22, 2004**, the Jobs Act extends the amortization period from 60 months to 180 months. However, under the Act, a business may elect to deduct up to \$5,000 of start-up expenses and separately elect to deduct an additional \$5,000 of organizational expenditures (if applicable) in the taxable year in which the business begins. However, each of these \$5,000 amounts is reduced by each dollar the total start-up expenditures or organizational expenditures exceed \$50,000, respectively. **Planning Alert!** These elections must be made by the due date of the return for the year in which the business begins. Missing this due date, in some situations, could cost your business the deduction entirely. **Tax Tip!** If you, as a shareholder of your corporation or partner in your partnership pay these expenditures out of your personal funds, make sure your corporation or partnership formally reimburses you. Otherwise, it is possible these deductions may be lost.

### **Amortization of Sports Franchises**

**Effective for acquisitions after October 22, 2004**, the Jobs Act provides that the acquisition of

franchises to engage in professional sports and any intangible assets acquired with respect to that franchise (including player contracts) are amortized over a 15-year period.

### **Miscellaneous Provisions**

The Jobs Act contains many other provisions not covered in this letter. The following are a few of those provisions:

- Special rules for livestock sold on account of weather-related conditions.
- Capital gain treatment for sales of timber without a retained economic interest.
- New rules for reforestation expenditures.
- Repeal of tobacco subsidies and buyout of tobacco quotas.
- New reporting requirements for taxable mergers and acquisitions.
- 7-Year recovery period for motor sports tracks.
- New provisions cracking down on tax shelters and other tax avoidance schemes and their promoters.
- Increase in penalties and fines for certain off-shore financial arrangements.
- Increased withholding for supplemental wage payments exceeding \$1 million.
- Bonus depreciation for certain syndication property.
- Simplification of international taxation reducing the foreign tax credit baskets from nine to two.
- AMT relief for foreign tax credit.
- New 85% dividend received deduction (for one year) for dividends paid from a controlled foreign corporation to a U.S. corporation shareholder.

## **WORKING FAMILIES TAX RELIEF ACT OF 2004**

**On October 4, 2004**, President Bush signed the Working Families Tax Relief Act of 2004 (“Family Tax Act”) into law. This \$146 billion tax bill not only extends a long list of tax breaks that were scheduled to sunset, but also contains several tax relief provisions.

### **Research Credit**

The credit for qualified research expired June 30, 2004. The Family Tax Act extends the 20% research credit for qualified research expenses **paid or incurred after June 30, 2004 and before 2006**.

### **Work Opportunity Tax Credit**

A business employing certain targeted individuals (e.g. qualified veterans, members of families receiving food stamps, high-risk youth), might qualify for the “work opportunity tax credit” based on a percentage of first-year wages paid to those employees. Form 8850 contains a summary of qualified employees. This credit expired for individuals who began work after December 31, 2003. The Family Tax Act reinstates the credit and extends it to **any amount paid or incurred to qualified individuals who begin work before 2006**. **Tax Tip**. If a qualifying employee is hired no later than December 31, 2005, the wages paid to that employee for a period of 1 year after the date of employment will qualify for the credit, even if those wages are paid after December 31, 2005.

### **Welfare-to-Work Credit**

The “welfare-to-work credit” is available to employers who pay eligible wages to qualified long-term family assistance recipients during the first 2 years of employment (see Form 8850 for additional information). This credit expired for wages paid to qualified individuals who began work after

December 31, 2003. The Family Tax Act reinstates the credit and extends it to **any amount paid or incurred to a qualified individual who begins work before 2006. Planning Alert!** If a qualifying employee is hired no later than December 31, 2005, the wages paid to that employee for a period of 2 years after the date of employment will qualify for the credit, even if those wages are paid after December 31, 2005.

### **Qualified Computer Contributions**

Corporations, other than “S” corporations, personal holding companies, and personal service organizations, get an enhanced charitable deduction for “qualified computer contributions.” This provision expired for tax years beginning after December 31, 2003. The Family Tax Act reinstates and extends this enhanced deduction rule for contributions **made during any tax year beginning before 2006.**

## **OTHER RECENT DEVELOPMENTS**

### **Tax Court Says Expenses Paid by Partner for Partnership May Not Be Deductible**

It is not uncommon for a partner in a partnership to individually incur and pay business expenses of the partnership. Historically, the IRS has said 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 were to be paid by the partner, and that the expenses would not be reimbursed by the partnership. The Tax Court recently denied a deduction for a partnership expense paid by a partner where the Court was unable to find any agreement between the partner and the partnership that the partner pay the expense. The Court concluded that a verbal agreement was not enough, where the Court found no routine partnership practice that rose to the level of an agreement. **Tax Tip.** If you are a partner paying 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 they will not be reimbursed by the partnership.

### **IRS Allows §179 Election on Amended Returns**

For 2003, you could take an up-front deduction of up to \$100,000 (\$102,000 for 2004) for the cost of qualifying §179 property (e.g., machinery, equipment, furniture, fixtures, etc.). Last year, this deduction was reduced for each dollar the total of your §179 property purchases exceeded \$400,000 (\$410,000 for 2004). Historically, the §179 election was required to be made on the originally filed return for the year the property was placed in service, and could not be made on an amended return. **Good News!** The IRS issued regulations in 2004 that allow you to elect or revoke an election under §179 on an amended return for the years 2003, 2004, 2005, 2006, or 2007. This new relief provision creates opportunities that have been previously unavailable. **Example.** Assume your business constructed a \$500,000 commercial building in 2003, which you have depreciated over 39 years using the straight-line depreciation method. In 2004, you discover that \$100,000 of the original

\$500,000 cost of the building represents nonstructural components of the building (tangible personal property) which qualify for §179 treatment. Also, assume that you had no other §179 property placed in service in 2003. Under these new rules, you should be able to amend your 2003 return and deduct under §179 the \$100,000 portion of the building that represents tangible, personal property.

### **New IRS Rules For Computing Depreciation on Tax-Deferred Exchanges**

The IRS has recently released a voluminous and complex set of regulations **for determining MACRS depreciation** on replacement property in a tax-deferred exchange (e.g., §1031 like-kind exchange, §1033 involuntary conversion). The tax basis of replacement property in a tax-deferred exchange is generally comprised of “carryover basis” (representing the old basis of the property you gave up) and “new basis” (comprised of additional amounts you paid for replacement property in excess of the value of the relinquished property). Basically, the new regulations state that the “carryover basis” is depreciated over the remaining depreciable life of the relinquished property or the replacement property, whichever is longer. Furthermore, the “carryover basis” is depreciated using the depreciable method of the relinquished property, or the replacement property, whichever is slower. By contrast, the “new basis” is depreciated using the depreciable life and the depreciable method of the replacement property as though it were newly purchased. **Tax Tip.** You can “elect out” of these regulations. In certain situations, electing out will produce a larger depreciation deduction. For example, if you are trading in a business luxury automobile for another business luxury automobile, it will generally work to your advantage if you elect out. If you are exchanging a business auto (e.g., a BMW 740 IL) for an SUV (e.g., a BMW X-5) electing out could produce substantially larger deductions. **Planning Alert.** If you are about to trade a luxury auto (e.g., a BMW 750 IL) for another luxury auto (e.g., a Lexus 400), please call us. Since the tax basis of the old vehicle is usually significantly greater than the fair market value at the date of the trade, a sale of the old car (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.

If you plan to engage in a tax-deferred exchange (or trade-in), please contact us and we will assist you in planning for the exchange and in calculating maximum depreciation under these new regulations.

### **IRS Removes Depreciation Limits on Qualified Non-Personal Use Trucks and Vans**

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 non-business 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% 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. However, if this specially equipped pick-up or van has an unloaded gross vehicle weight of 6,000

lbs. or less, the IRS historically said that the depreciation was limited by the luxury automobile caps (\$10,610 for 2004 if the vehicle qualifies for the 50% bonus depreciation). **Good News!** IRS now says that these specially equipped business vehicles are not limited by the passenger automobile depreciation caps even if they do not have a GVW of more than 6000 lbs. Furthermore, the IRS says this rule is retroactive, and we may correct prior year returns (if we limited the depreciation) by filing an amended return **on or before December 31, 2004**. Otherwise, we may use the automatic accounting method change procedures to correct prior year's returns.

## **PLANNING FOR "C" CORPORATIONS**

### **Year-End Planning With Corporate Tax Rates**

Your "C" corporation (a corporation that is not an "S" corporation) may be able to shift income between 2004 and 2005 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 2004 and \$125,000 in 2005, your company could save taxes of \$3,500 by accelerating \$25,000 of 2005 income into 2004 (i.e., \$25,000 X 14%). On the other hand, if your corporation is expecting lower tax rates in 2005 than in 2004, deferring income into 2005 will not only save overall taxes but would defer taxes as well. **Planning Alert!** Please call us before accelerating income from 2005 into 2004 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 "C" corporation that is a 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.** 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 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 compensation payments by December 31, 2004. Failing to pay the proper compensation by December 31 could have severe tax consequences.

### **Newly-Formed Corporations**

If you have started a new business this year and have filed articles of incorporation with the Secretary of State, you generally must treat the corporation as a regular "C" corporation. This can create a tax trap if your new business generates a tax loss in its first year. In that event, the loss will be trapped inside the corporation and you will not be able to use the loss to offset income on your personal income tax return. **Tax Tip.** You may, however, be able to take this loss on your personal return if you file a timely "S" election for the first year of the new corporation. Generally, this election must be made no later than the 15<sup>th</sup> day of the third month following the date your corporation starts business. However, in certain situations, the IRS may allow a late "S" election. Please call our office before you set up a new corporation, and we will help you decide whether an S

election is advisable. **Caution!** It is always best to call us before you set up any new business so we can help select the “best” business entity from a tax planning standpoint, and so we can help file any necessary elections, etc. **Planning Alert!** Your corporation cannot deduct the costs of setting up the corporation (e.g., professional and filing fees, etc.) unless it makes a formal election on its timely filed tax return to amortize these costs over 60 months (180 months if incurred after October 22, 2004). If a shareholder pays these “organizational fees” out of personal funds, make sure that the corporation formally reimburses the shareholder. Otherwise, these deductions may be lost.

### **Pay Sufficient Estimated Tax**

If your “C” 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 the corporation is not a “small corporation,” it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its “current” year tax liability, or 100% of its annualized tax liability. **Planning Alert!** If your “small corporation” had no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the “current” year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty. **Tax Tip.** If your “small corporation” anticipates showing a small tax loss in 2004, you may want to accelerate income (or defer expenses) in order to generate a small income tax liability in 2004. This will preserve the corporation’s ability to use the “100% of last year’s tax” safe harbor for 2005 estimates. If the corporation expects taxable income of more than \$1,000,000 for the first time in 2004, you should consider deferring income into 2005 or accelerating deductions into 2004 to ensure that your corporation’s 2004 taxable income does not exceed \$1,000,000, so that it maintains its “small corporation” status for 2005.

### **Properly Document Loans To Shareholders**

If you borrow from your closely-held corporation, you should make sure 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 and proper documentation, the IRS may treat your loans as constructive distributions which could result in dividend treatment and double taxation. **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 2004, you must establish that you began efforts to collect the debt well before December 31, 2004, in order to establish the debt’s worthlessness in 2004. **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. **Planning Alert!** The Tax Court has recently held that your business bad debt is classified as a

“miscellaneous itemized deduction” which is subject to the 2% reduction rule, and is not deductible at all for alternative minimum tax purposes.

### **Charitable Contribution Planning**

If your regular “C” 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 the contribution is paid on or before the 15th day of the third month after that year-end (e.g.,

March 15, 2005 for December 31, 2004 year-ends). Your corporation should have a “Board of Directors Charitable Contribution Resolution” on its year-end tax planning checklist. **Caution!** A regular “C” 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. This rule for accruing charitable contributions applies to regular corporations but not to “S” corporations. **Tax Tip.** If you own a closely-held “C” corporation, it may be more beneficial for you to make charitable contributions individually, rather than allowing your corporation to make contributions in excess of the 10% of taxable income limitation. **Planning Alert!** Don’t forget, all taxpayers (including corporations) making non-cash charitable contributions may have new reporting and documentation requirements under the American Jobs Creation Act of 2004, as discussed previously in this letter.

### **Use Your Corporation’s Capital Loss Carryback**

“C” corporations can generally carry back capital losses for 3 years, and forward for 5 years. Capital losses may only be deducted to the extent of capital gains. **Planning Alert!** If your corporation had net capital gains in 2001, you may wish to recognize unrecognized capital losses (if any) this year up to the 2001 capital gains.

### **Several Court Cases Suggest That "Goodwill" May Be A Stockholder Asset**

If you are planning to sell your “C” corporation and the assets have a value greater than the tax basis, the buyer will probably want to buy the "assets" of your corporation, instead of buying your stock. In many cases, the most highly-appreciated corporate asset is going concern value or "goodwill." This means that if your corporation sells goodwill along with its other assets, the gain on the goodwill and the other assets will be taxed first to the corporation, and then will be taxed a second time when you distribute the sales proceeds to the stockholders if the corporation is liquidated. In addition, corporations have no special tax rate for capital gains. So, the gain from the sale of the goodwill and any other capital assets will be taxed at the regular corporate rates. From a tax standpoint, it is better for you to sell stock. Generally, when stock is sold, there is only one tax for federal income tax purposes the 15% capital gains tax. **Tax Tip.** Several 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 if the shareholder owns the goodwill, then the shareholder may sell the goodwill directly to the buyer and pay only one tax (the capital gains tax) on the sale. **Caution!** This is a hot tax issue for the IRS, and will probably be scrutinized closely if examined. If you are considering selling your “C” corporation assets, converting a “C” corporation to an “S” corporation, or dissolving 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 rules for restructuring loans to an “S” corporation are complicated. Please do not attempt to restructure your loans without contacting us first. Also, if you finance losses of an “S” corporation with loans from other 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 borrowed directly from related corporations or from other shareholders.

### **Salaries For “S” Corporation Stockholder/Employees**

The combined employer and employee FICA tax rate is 15.3% of your wages up to \$87,900 (\$90,000 for 2005). For 2004, the combined rate drops to 2.9% for wages in excess of \$87,900. **Tax Tip.** If you are a stockholder/employee of an “S” corporation, you may wish to take no more than a “reasonable salary” from your corporation to minimize your FICA tax. Other income that passes through to you or is distributed to you as a distribution on your stock is not subject to FICA tax.

### **Planning Alert!**

Determining “reasonable salaries” for “S” corporation stockholder/employees is a hot audit issue and this past year the IRS has taken many taxpayers to court on this issue and won! The IRS has been particularly successful where “S” corporation owners pay themselves no salary even though they provided significant services to the corporation. In these cases, the courts generally held that all amounts paid out to the “S” corporation owner/employees were wages subject to FICA and Medicare taxation. **Caution!** Minimizing your FICA tax could also reduce your social security benefits when you retire. Furthermore, if your “S” corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your “wages.”

### **IRS Releases Procedures for Making Late S Elections for Non-Corporate Entities**

If you are an owner of a general partnership, limited partnership, limited liability company, or limited liability partnership, the business income that passes through to you is generally subject to Social Security and Medicare taxes. **Tax Tip.** You might save taxes if you elect to treat your general partnership, limited partnership, limited liability company, or limited liability partnership as an “S” corporation, and then pay yourself a “reasonable salary” for your services. You can generally accomplish this by electing to tax the pass-through entity as an “association” (by timely filing Form 8832), followed by a “S” election (by timely filing Form 2553). This only works if your non-

corporate pass-through entity meets all of the other qualification requirements of an “S” corporation (e.g., proper number of shareholders, all income allocated pro-rata to the owners, etc.). **Good News!** The IRS has recently released a procedure that allows a non-corporate pass-through entity to elect “S corporation” treatment by filing a single form. **Planning Alert!** Notwithstanding the potential for FICA tax savings, an “S” election could have adverse tax consequences. For example, gain may be triggered when the “S” election is made if the liabilities of the business exceed the tax basis of its assets. Please call us before making an “S” election. We will help you decide if it is feasible.

## **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 an accrual-basis business to deduct the accruals. These rules apply to fiscal year as well as calendar year-end businesses:

#### **Regular “C” Corporations**

If your regular “C” corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning more than 50% (directly or indirectly) of the company’s stock, the accrual is not deductible by the corporation until the “**day**” it is includable in the stockholder’s income. **Tax Tip.** If the corporation’s tax rate for 2004 is significantly greater than the stockholder’s individual rate for 2004 and 2005, the accrued amount should be paid by the end of 2004.

#### **“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 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 the day it is 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 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.).

#### **FICA Withholding On Deferred Compensation**

If your business sponsors a nonqualified deferred compensation plan, you may have certain FICA

tax withholding and reporting responsibilities. IRS regulations provide that FICA taxes are due on most deferred compensation in the year the compensation is **earned rather than the year it is paid.**

The IRS says that your business can pay its portion of the FICA tax (and can withhold the executive's portion) with the final payroll of the year. The specifics of these regulations are too lengthy to address in detail in this letter. Please call us if you have questions. **Planning Alert!** As discussed previously in this letter, the 2004 Jobs Act imposes numerous requirements on nonqualified deferred compensation plans, effective for amounts deferred after 2004.

### **Personal Use Of Company Cars**

If your company provides employees with company-owned cars, the company is required to include personal use of the car in the employees' W-2 income. However, this is not required if the employee reimburses the company for the personal use. **Planning Alert!** If your company does not report the employee's personal use as W-2 income and the employee does not reimburse the company for the personal use, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost, to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion. **Tax Tip.** If the employee chooses to reimburse the company for personal use of the car, the obligation for reimbursement should be established 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 its employees documenting their business and personal mileage for the car.

### **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, the business meals deduction for that worker is 70% for 2004, 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 A 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 these independent contractors should have been treated as employees, the IRS says that you can avoid reclassification (and related penalties) if you have a "reasonable basis" for treating the workers as independent contractors. Here is one way you can satisfy this "reasonable basis" test: **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 assistance with this determination.

### Automatic Accounting Change Procedure

Generally, if your business needs to change its tax accounting method, it must submit a request for approval to the IRS, pay a user fee, and wait until the IRS approves the change in writing. **Good News!** The IRS has issued an updated procedure allowing businesses to obtain IRS approval for many common accounting method changes by submitting an accounting method change request with

a timely filed tax return (including extensions) for the year of the change. There is no user fee and if the request is properly completed, the request is “deemed” granted. In some cases, the request may even be filed with an amended return.

**Example:** Let's assume your business discovers it has taken too little depreciation on a company vehicle. For instance, your company uses in its business a van or a truck (including an SUV) with a "gross vehicle weight" exceeding 6,000 pounds (e.g., full-size van, full-size pickup, Expedition, Range Rover, Tahoe, Durango, Suburban, etc.). The vehicle is used 100% for business purposes. Your company erroneously limited the depreciation for prior years using the auto depreciation limits. Your company can deduct the additional depreciation it is entitled to by using this new automatic accounting change procedure. By attaching a properly completed accounting method change form to the current year's tax return and sending a copy to the IRS, your business may deduct, in the current year, all the depreciation it failed to deduct in prior years. **Please Note!** This automatic accounting change procedure applies to many other accounting method changes listed within the procedure.

**Planning Alert!** Please do not attempt any accounting method change without contacting our office first. The approval procedure **does not apply to all accounting method changes and depends upon the proper completion of Form 3115 and compliance with specific guidelines.**

### Safe Harbor For Cash Method Taxpayers

In the past, the IRS took an aggressive position against certain cash method businesses, arguing that they should switch to the accrual method. The IRS generally argued that your business should convert to the accrual method if it utilizes inventory, or is abusing the cash method (e.g., unnecessarily deferring revenues or accelerating expenses). After losing a series of cases on this issue, the IRS released a revenue procedure allowing “qualified small businesses” to use the “modified” cash method of accounting even if inventories are present. To qualify, the average gross receipts of the business for the past three years must be \$1 million or less. **Good News!** The IRS has also released a second safe harbor allowing “qualified taxpayers” to use the “modified” cash method even if their average gross receipts for the preceding three years exceed \$1 million as long as the average gross receipts do not exceed \$10 million. **Planning Alert!** With some exceptions, manufacturing, wholesale, retail, mining, and publishing businesses may not use the \$10,000,000 rule. However, they may use the \$1,000,000 rule. Most service businesses will qualify for both the \$10,000,000 rule as well as the \$1,000,000 rule. Also, under both the \$1,000,000 and the \$10,000,000 rule, inventories may not be expensed until the later of **(1)** the date payment is made for the goods **or (2)** the date the goods are sold or consumed in the business. **Tax Tip.** If your business is currently reporting its taxable income using the accrual method, and you believe it may qualify for either the \$1 million or \$10 million safe harbor, please call us. We will help you determine whether your business qualifies and whether the switch will reduce your taxable income. We will also help

you apply to the IRS for a change in accounting method.

**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 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!** 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!

**FINAL COMMENTS**

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