

Management



Tax Concepts



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Stimulus Act Tax Breaks for Businesses and Individuals

By Jay Trien, CPA, Esq., CM&AA-Senior Partner

On Feb. 17, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA). In this article I summarize those tax changes I consider the most relevant to our reader's personal and business taxes and the taxes paid by their family members and employees.



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AMT relief granted. ARRA provides a one-year “patch” that increases the AMT exemption. For married couples filing jointly, the 2009 exemption is \$70,950, for singles \$46,700 and the phase out ranges are now \$150,000 to \$433,800 for married filing jointly and \$112,500 to \$299,300 for singles.

Credit for first-time homebuyers. Last year, a refundable credit equal to 10% of the purchase price of a principal residence was made available to qualified first-time homebuyers, but was set to expire July 1, 2009. ARRA extends it to purchases made before Dec. 1, 2009. For qualifying purchases made after Dec. 31, 2008, the act increases the maximum credit from \$7,500 to \$8,000. Significantly, the act eliminates the repayment obligation for taxpayers whose qualifying purchase occurs after Dec. 31, 2008, except where the home is sold within three years of purchase.

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Taxing matters

You could owe taxes in another state — and not know it

Does your company own or lease property outside of its home state? Does it conduct sales or operations in more than one state? Do members of your staff live in a state different from the one in which they work? If you answered “yes” to any of these questions, you could owe taxes in more than one jurisdiction.

Multistate income taxation affects many companies — and some don’t even realize it.

Are you exposed?

It’s up to the individual state to decide if a company is subject to its income tax by determining whether or not the company has a nexus — or a connection — with it.

Although nexus is determined on a state-by-state basis, certain activities or circumstances within a state usually guarantee it exists, including:

- Having legal domicile or a principal place of business,
- Maintaining an office or other facility, or owning property,
- Having payroll,

- Rendering services, and
- Soliciting orders.

The level of nexus required varies depending on the tax involved. The three most prevalent state taxes are: 1) sales and use, 2) corporate income, and 3) franchise.

Federal law prevents states from claiming income tax nexus if contact within the state is limited to the employment of salespersons or independent contractors whose only function is to solicit sales for out-of-state approval and fulfillment.

How can you reduce liability?

Establishing nexus with a state doesn’t necessarily increase your tax exposure. Take corporate income taxes: Many states determine the portion of your income subject to their tax using a three-factor formula based on the percentage of your sales, property and payroll attributable to the state. Others use a single-factor formula based just on sales. You may be able to reduce your tax bill by apportioning some of your income to a state with a lower tax rate.

For example, say your company is based in State X but makes substantial Internet and mail order sales in State Y, where it has no physical presence. State X’s business income tax rate is 8%, while State Y’s is only 4%. Both states apportion income using the same formula.

Assume your company’s taxable income is \$1.5 million. If your company has no nexus with State Y, all of its income will be taxed by State X, for a tax liability of \$120,000 (\$1.5 million x 8%). But if your company established nexus with State Y, some of its income could be taxed at the lower 4% rate, reducing its overall tax bill.

Exactly how much tax could be saved would depend on a variety of factors. And of course, before taking steps to establish nexus with State Y, you’d also need to consider the other potential business and tax consequences.

Are you in compliance?

To avoid paying too high a tax bill or being exposed to penalties for not filing in required states, carefully consider state income tax filing requirements in all states for which nexus potentially exists. Discussing your business’s interstate activities with your tax and legal advisors can help ensure you stay in compliance. ♦



Check sibling rivalry before transferring the family business

In families with multiple adult children, transferring ownership of the business to the next generation can be a sensitive matter. Sibling rivalry — especially when it comes to determining roles and responsibilities — can intensify and spark battles that can hurt the business *and* the family.

Sources of contention

There are many factors that can contribute to sibling conflicts, power struggles and, ultimately, a failed succession plan. For example, siblings may have differing visions for the business or opposing management styles and business strategies. Or one may lack confidence in another's ability to perform his or her job.

But sibling-owner conflicts typically aren't just about business matters. Often, they arise from interpersonal issues.

Case in point

Katherine and Rose became business partners after their parents retired from the furniture manufacturing company they founded. Rose was displeased that their parents made Katherine — who'd been with the company for only two years — a 50% co-owner. Katherine had an MBA and several years of experience as an executive at a Fortune 500 company. Rose had been the creative force with the company for many years.

Their parents describe both daughters as natural leaders and strong visionaries. So, they knew they'd have differing visions for the company. But they never imagined there would be constant conflict and power struggles.

7 possible solutions

So what can Katherine and Rose's parents do to help keep the burgeoning sibling rivalry in check and ensure their company's continued success? Here are seven possible solutions:

1. Establish a leadership model. The family should collectively decide on a basic leadership model that spells out how the two daughters will work together, both day-to-day and long term. It doesn't have to be just one sibling taking on the role as leader. They could be co-CEOs or a leader could be designated for a set



period of time and then the position would pass to the other sibling.

2. Conduct strategic planning. This will help establish a shared vision of the company's future and provide a foundation for each sibling's role and responsibilities. The process also will help reinforce goals and values and identify areas of disagreement.

3. Share the power. Regardless of who is CEO, each sister should have a degree of power — particularly within a well-defined area of expertise — and the authority to respectfully challenge the designated leader. The sisters should listen to all points of view, accept the final decision and work toward its implementation.

4. Establish an outside board. To avoid deadlock on key decisions, the family could establish an independent board of advisors to facilitate debates and provide a resolution when Katherine and Rose are unable to agree.

5. Create communication agreements. The family could develop a communication agreement to help create a culture in which effective communication becomes an everyday practice. The agreement would document how the sisters should interact, resolve disagreements and make decisions.

6. Get professional help. To keep deep-seated sibling rivalry and personality clashes from penetrating into and damaging business ventures and operations, the family could hire a family business coach. The coach, often a trained psychologist, would work out the transfer of power, help the sisters work together as business partners, and mediate agreements on who is to do what and each sister's expectations.

7. Have an exit strategy. In case either Katherine or Rose chooses to retire or withdraw from the company altogether, the family should execute an exit strategy before transferring the business. The exit strategy should outline the conditions for the sibling withdrawing and address pertinent issues such as compensation and retirement benefits.

Whatever steps they take, Katherine and Rose — as well as any siblings looking to share management of a company — should document all arrangements and agreements in writing. This includes anything pertaining to compensation; responsibilities; stock transfer capability; and the disposition of stock in the event of death, disability or retirement.

Keep the peace

Transferring ownership can be a complex proposition for any business, but in a family-run operation the intricacies of personal relationships often lend an extra measure of complexity. Learning how to work together can strengthen relationships — and the family business — for generations to come. ♦

Expand your markets with barter

Barter — the exchange of goods and services without an exchange of money — is big business. How big? Barter transactions generated over \$10 billion in revenue in 2007, according to the International Reciprocal Trade Association (IRTA).

In its simplest form, barter occurs when one entity exchanges goods or services with another. For example, an orthodontist provides braces to the child of a small contractor in exchange for bathroom remodeling.

Today, however, most transactions take place through a barter exchange. In this scenario, a business providing the goods or services is compensated in trade credits. The company can then use these credits to make purchases from any other members of the exchange willing to accept them.

So, even if the orthodontist from our above example doesn't need remodeling, but rather an advertising campaign developed, the contractor's child could still get his or her braces. How? The contractor would pay for the service with trade credits and then the orthodontist could spend those credits with an advertising agency that's also an exchange member.

As long as the barter exchange has a large membership roster with many potential customers, bartering can be a good way to generate additional revenue because members have an incentive to buy from other members to use their accumulated trade credits. Of course, before joining a certain exchange, make sure it has plenty of members that offer goods or services that will be of use to your business.

There are hundreds of exchanges throughout the country, which you can find at the IRTA (irta.com) and the National Association of Trade Exchanges (nate.org). Some have reciprocal privileges with other exchanges, providing an even larger "universe" of companies to deal with. Exchanges typically charge a membership fee as well as a commission on each transaction. But, because exchanges are essentially financial intermediaries, check references carefully before joining one.

Finally, even though no cash changes hands, the tax authorities still treat a barter transaction the same as they do a cash sale. Barter exchanges are required to generate an IRS Form 1099-B for most transactions, and income generated is taxable.

Leveraging charitable gifts with life insurance

Using life insurance to make contributions to the charities of your choice can be a win-win for both parties. You make tax-advantaged gifts while paying on the “installment plan” with minimal impact on your estate, and the charities receive substantial gifts with a predictable value.

The basic concept

To make a charitable gift with life insurance, you, as the donor, buy a policy and designate the charity as the beneficiary. Typically, cash value, as opposed to term, life insurance is used. Because the charity is designated as the *beneficiary*, it immediately becomes eligible to receive cash equal to at least the face value of the policy upon your death.

Additionally, if you make the charity the *owner* of the policy rather than the beneficiary, the charity

has access to the policy’s accrued cash value at any time. As long as the premiums are paid, the charity is assured a substantial gift.

Even modest annual contributions for the annual premium will provide the charity with a large gift. For instance, say you purchase a policy with a face value (death benefit) of \$100,000 for an annual premium of \$2,500. If you live for a long time after the policy goes into effect, you have essentially made a large donation in annual increments on the installment plan.

And if your life is cut short, the charity would receive a much larger donation than it would have if you had pledged a series of annual contributions that couldn’t be completed because of your death. Moreover, if the policy contains a waiver of premium rider, the policy will become fully paid up even if you become disabled.

“*One advantage to using life insurance for charitable gifts is that it can remove an asset from your estate, thus simplifying the estate’s disposition.*”

Tax considerations

Depending on the structure of the arrangement, different tax benefits can accrue. If the life insurance policy is irrevocably given to the charity, you receive a current income tax deduction either upon the donation of an existing policy or upon each premium payment. However, like other charitable contributions, deductions can’t exceed a certain percentage of your adjusted gross income in any given year, though excess amounts can be carried forward for up to five years. (See “AGI limitations on charitable contribution deductions” on page 6.)

If you don’t turn over the policy to the charity, your annual premiums won’t be tax deductible. But as long as the charity is the beneficiary, the proceeds will be considered a deduction for estate tax purposes. Even if you turn the policy over to the charity as owner and beneficiary, any gifts of life insurance within three years of your death will be considered part of your estate.



AGI limitations on charitable contribution deductions

The deduction for your total charitable contributions for the year is subject to a limitation based on your adjusted gross income (AGI) and the type of gift and charity.

Contribution type	Public charities	Private foundations	
		Operating ¹	Nonoperating
Cash, ordinary-income property and unappreciated property	50%	50%	30%
Long-term capital gains property deducted at fair market value	30%	30%	20%

¹ An operating foundation spends at least 85% of the lesser of its adjusted net income or its minimum investment return in carrying out its exempt activities and meets certain other tests. Others not meeting this definition are nonoperating foundations.

Source: U.S. Internal Revenue Code

IRS requires substantiation

The IRS requires defensible appraisals of all charitable contributions over \$5,000 other than cash or marketable securities, and this includes life insurance policies.



While some of the specifics are still being debated in Washington, this is generally understood to mean that the valuation of the policy must be done by a qualified individual who isn't the donor and not associated with either the insurance broker who sold the policy or the company that issued it.

Other benefits

Another advantage to using life insurance for charitable gifts is that it can remove an asset from your estate, thus simplifying the estate's disposition.

Plus, though the benefit is paid at death, because it was previously funded, the insurance proceeds don't directly deplete the amount of the estate available for distribution to heirs. This, along with the fact that the insurance policy is a legal contract, discourages heirs from challenging the validity of the gift.

Alternatively, if you wish to donate other assets to charity upon death, you could use life insurance to make up the difference for your heirs by naming them as policy beneficiaries.

Work with the pros

Using life insurance to fund charitable contributions opens up a variety of estate planning options and can be paired with other vehicles, such as trusts and family limited partnerships. However, life insurance products are often complex, the options are many, and the tax rules can be vexing. Working with an estate planning advisor is a must to attain the best outcome for you, your heirs and your designated charities. ♦

Should your business own real estate too? Probably not

Many business owners own not only typical business assets, such as equipment, inventory and furnishings, but also the land on which the building and parking lot sit — and possibly other real estate as well. But there can be negative consequences when a business's real estate is included in its general corporate assets. For example, your business could be liable for injuries suffered on the property or, vice versa, legal liabilities encountered by the corporation could affect your ownership of the property.

By holding real estate in a separate entity, you'll reap some tax advantages and be able to pursue more real estate ownership options without affecting your core business. Let's take a closer look.

Capturing tax savings

Many businesses operate as C corporations so they can buy and hold real estate just as they do equipment, inventory and other assets. The expenses of owning the property are treated as ordinary expenses on the company's income statement. However, when the real estate is sold, any profit is subject to double taxation: first at the corporate level and then at the owner's individual level when a distribution is made. As a result, putting real estate in a C corporation can be a costly mistake.

If the real estate were held instead by the business owner(s) or in a pass-through entity, such as a limited liability company (LLC) or limited partnership, and then leased to the corporation, the profit upon a sale of the property would be taxed only once — at the individual level.

Limiting liability

The most straightforward and seemingly least expensive way for an owner to maximize the tax benefits is to buy the property outright. However, this could transfer liabilities related to the property directly to the owner, putting other assets — including the business — at risk. In essence, it would negate part of the rationale for organizing the business as a corporation in the first place.

So, truly, it's best to put real estate in its own limited liability entity. The LLC is most often the vehicle of

choice for this, but limited partnerships can accomplish the same ends if there are multiple owners.

The disadvantage of a limited partnership, however, is that you'll incur more expense by setting up two entities: the partnership itself and typically a corporation to serve as the general partner. As a result, the LLC has often become the entity of choice. No matter which structure is used, though, make sure all entities are adequately insured.



Staying flexible

Separating real estate ownership from the business also creates more options to meet the needs of multiple owners. Let's say that a family business is passing from one generation to the next. One child is very interested in owning and operating the business but doesn't have the means to finance the purchase of both the business and its real estate.

If the two are separated, it's possible for one sibling to take over the business while other siblings hold the real estate. In this case everyone can benefit: The child who buys the business doesn't have to share control with the other siblings, yet they can still reap benefits as property owners.

Examine your options

Treating real estate like any other business asset can get you in trouble. Work with your advisors to create a plan of ownership that best suits your situation. ♦

Depreciation breaks extended. ARRA extends the Section 179 limit for initial year expensing to \$250,000 (from \$125,000 indexed for inflation), but phases out when total asset acquisitions for the tax year exceed \$800,000 (up from \$500,000). The new higher limit applies for calendar year 2009 or a fiscal year that begins in 2009. For passenger automobiles that are eligible property under the 50% bonus depreciation rule, the \$8,000 increase for the first-year limit on depreciation is also extended to new vehicles placed in service in 2009.

Net operating loss carry back. Currently a net operating loss (NOL) may be carried back two years to generate a current tax refund. For 2008 (not 2009), ARRA extends the maximum NOL carry back to five years for small businesses with gross receipts of \$15 million or less.

New sales tax deduction for vehicle purchases. ARRA creates a new above-the-line deduction for state and local sales and excise taxes paid on the purchase of new cars, light trucks, motorcycles and recreational vehicles. The deduction is available for vehicles purchased from Feb. 17, 2009, through Dec. 31, 2009. The deduction is not available for tax attributable to vehicles valued in excess of \$49,500 and phases out for joint filers with AGIs exceeding \$250,000 and \$125,000 for single filers.

Residential Energy Property Credit. The credit is increased from 10% to 30%, raises the maximum cap to a \$1,500 aggregate amount for 2009 and 2010 installations, and eliminates the \$500 lifetime cap.

S corporation built-in gains tax. The holding period to avoid the tax is temporarily reduced from ten to seven years. Prior to enactment of the new legislation, a C corporation converting to S corporation status had to hold assets for at least ten years to avoid tax on any built in gains in the assets. The legislation reduces the threshold to seven years, but only for sales occurring in 2009 and 2010.

Qualified small business stock gain exclusion. Generally, taxpayers selling qualified small business (QSB) stock are allowed to exclude 50% of their gain as long as they've held the stock for at least five years. ARRA increases the exclusion to 75% if the stock is issued after Feb. 17, 2009, and before Jan. 1, 2011.

529 savings plans. 529 plan distributions used to pay qualified education expenses are generally tax free. For expenses paid in 2009 and 2010, ARRA expands the definition of qualified education expenses to include computers and computer technology.

Each of the above is a short summary of only some the major tax provisions in ARRA. Every taxpayer is different and ARRA may significantly affect your tax liability in a variety of ways. If you would like more detailed information about this new tax law, please call the partner that you deal with at our firm. We can help you determine exactly how ARRA will affect your tax liability and what you should do to take full advantage of the act.

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