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Taxing Matters

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Small Business Capital Gains Soon to be Tax Exempt—Or Will They?

The Small Business Jobs Act of 2010 (H.R. 5297) was signed into law by President Obama on September 27, 2010. Included in the Act is a 100% tax exemption for capital gains on the sale of a small business. The elimination of this small business capital gains tax was a cornerstone of Obama's campaign for the presidency.

Does this mean one should run right out and sell one's business at zero tax cost? In most cases, no. It actually may be difficult for most small businesses to qualify for this tax exemption. Here's why.

In the Small Business Jobs Act of 2010, Internal Revenue Code Section 1202 was amended to permit a noncorporate taxpayer to exclude from tax 100% of the gain realized on the sale of eligible small business stock. The amount of gain which may be excluded in this manner is limited, on a "per issuer" basis, to the greater of $10 million or ten times the taxpayer's basis in the stock. The gain excluded under §1202 will not count as a preference for alternative minimum tax

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The Benefits of Hiring Unemployed Workers: New Tax Incentives Await

With so many people seeking employment in this difficult economy, the federal government is offering two new incentives to employers who hire previously unemployed or part-time workers. On March 18, 2010, the Hiring Incentives to Restore Employment (HIRE) Act became law. This Act strives to stimulate our struggling employment situation while helping those who are out of work find full-time jobs. To help accomplish these goals, the HIRE Act has incentivized the hiring of unemployed workers through special tax benefits that can be claimed under certain circumstances.

Employers pay a 6.2% Social Security tax on employees' wages, in addition to the 6.2% that is deducted from the employees' paychecks for Social Security, with Social Security tax collections capped at wages of $106,800 or less. By hiring unemployed workers between February 3, 2010 and December 31, 2010, employers would be exempt from paying their 6.2% share of Social Security taxes on those unemployed hires' paychecks. Employers would not have to pay their portion of Social Security taxes for those unemployed hires' paychecks that are paid to the qualifying employees between March 19, 2010 and December 31, 2010. Employers would need to continue withholding the 6.2% for the employees' share of the Social Security tax on those paychecks. This benefit would be claimed on an employer's quarterly federal employment tax return.

Employers would also be able to claim a general business tax credit of up to $1,000 per unemployed worker hired during the 2010 calendar year, so long as those employees are retained for at least one year. If an unemployed hire is terminated or leaves voluntarily before the end of their first year, those employees cannot qualify the employer for the $1,000 credit. Employers would claim the business tax credit on their 2011 business income tax returns.

As is the case with most tax incentives, there are caveats to how businesses can reap the benefits of this legislation. In order for businesses to take advantage of these new tax incentives, unemployed hires must meet certain criteria. New hires will qualify if they are filling new positions within the business or if they are filling existing positions, as long as the previous em-

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Should Our C Corporations Pay Corporate Dividends This Year?

Business owners often grow their business by continually reinvesting earnings and profits. This is a good strategy, but eventually most business owners want to tap into these earnings. The problem is that withdrawing cash from a corporation can be very tax inefficient. The purpose of this letter is to alert you to tax planning opportunities that exist this year that will allow you to tap into the hard-earned cash of your business at historically low tax costs.

Normally, dividend treatment is something to avoid because of the double taxation issue. In effect, dividends are subject to double taxation. Your corporation pays income taxes on the earnings that generate the dividends, then you have to pay income taxes too when the earnings are paid out to you. This harsh effect has been softened somewhat for the last several years because the maximum dividend tax rate was only 15%. However, in 2011, barring any tax legislation, this favorable maximum rate is scheduled to skyrocket. The actual tax rate you will pay on dividends will depend on your marginal ordinary tax rate. However, for taxpayers in the top ordinary tax rate bracket, it looks like the federal tax rate could be as high as 39.6 % next year and beginning in 2013 it could go up another 3.8% to 43.4%.

If your corporation has built up substantial earnings and profits over the years, now—before the end of 2010—is an ideal time to consider paying some dividends. Although double taxation is assured, a 15% tax rate may be quite manageable. In addition to getting cash into your hands at historically low tax rates, paying dividends this year may have additional benefits for your corporation:

- *Reduce Future Exposure to Accumulated Earnings Penalty Tax.* A profitable corporation becomes exposed to the accumulated earnings penalty tax when it accumulates earnings in excess of reasonable business needs and does not pay dividends. Right now, the accumulated earnings tax rate is only 15%. Absent a law change, after 2010, the accumulated earnings tax rate will return to the maximum individual federal rate on ordinary income—39.6% for 2011. Therefore, now is a great time to pay out dividends and reduce your corporation's exposure to this penalty tax.

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Small Business Capital Gains cont. from Page 1

purposes; however, there is a mandatory five year holding period before any gain can be excluded.

So, let's say a prospect wishes to buy your business. Can you sell it tax free? Here are the answers:

- No, if the buyer wishes to buy only the assets of the business, as buyers and their attorneys typically do so that they can quickly write off part of the purchase price.
- No, if the buyer agrees to buy the stock of the business, but wants the seller to agree to a Section 338 election to treat the stock sale as an asset sale for tax purposes.
- No, if the seller's company is an S corporation. This tax benefit is only permitted with C corporations.
- No, if the stock was issued before August 10, 1993.
- No, if the stock wasn't held at least 5 years by the seller.
- No, if the corporation's total assets (without reduction for liabilities) ever exceeded $50 million.
- No, if the corporation is not an active business. For example, an investment or real estate holding company cannot qualify.
- No, if the selling stockholder is not the original stockholder. So, if you bought the stock of the business from someone else, or if you inherited or were gifted the stock, you are ineligible.
- No, if any of your stock has been redeemed, either from yourself or a related person, either two years before or after the issuance of new shares to you.
- No, if, within one year before or after issuance, the corporation redeems more than 5% of the aggregate value of all of its stock as of the beginning of such period, although redemptions incident to certain events, such as death, divorce, disability, incompetency, and certain de minimis redemptions are disregarded for these purposes.
- No, if your stock was issued by the company before September 28, 2010 or if it sells after December 31, 2010.

So, as you can see, there are a number of hurdles to overcome in qualifying for the 100% tax exemption on capital gain. The exemption is only temporary. If the stock is recently acquired, the date of acquisition is key: If the stock is acquired before February 18, 2009, you receive a 50% exclusion. If the stock is acquired between February 18, 2009 and September 27, 2010, you receive a 75% exclusion. If the stock is acquired between September 28, 2010 and December 31, 2010, you receive a 100% exclusion. And, don't forget, you must hold the stock for five years before you can exclude your gain.

Nonetheless, our lawmakers and our President can revel in the fact that they eliminated taxes on sales of small businesses. Even if only a few businesses might qualify for this loophole. Even if the measure is only temporary. Even if the provision does not reflect the reality of the marketplace for purchases of small businesses.

Significant FDIC Insurance Coverage Updates

In response to the recent instability of the economy, the Federal Deposit Insurance Corporation (FDIC) has changed the way funds at FDIC-insured banking institutions are protected in the event of a bank failure. The FDIC first temporarily raised the $100,000 limit to $250,000 until December 31, 2013. With the signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act into law this past summer, the $250,000 limit (which applies per depositor per FDIC-insured institution for each account ownership category) has been permanently set.

The FDIC is exploring the possibility of implementing a new rule that would provide temporary unlimited FDIC deposit insurance for all noninterest-bearing transaction accounts at FDIC-insured banks. If approved, the temporary unlimited protection would last for two years, beginning on December 31, 2010 and running through December 31, 2012. A new temporary account ownership category would be created for these noninterest-bearing transactional accounts, which typically include individual and business checking accounts that do not accrue or pay out interest.

The new proposed rule sounds very much like the current FDIC Transaction Account Guarantee (TAG) Program, but they are not the same. The FDIC TAG Program is a voluntary program offered by the FDIC and protects a few other accounts not covered under the proposed Dodd-Frank rule, such as low-interest checking accounts and interest on Lawyer Trust Accounts (IOLTAs). Currently, the TAG Program is set to expire on January 1, 2011 and according to the FDIC, it will not be extended. If you are currently getting unlimited protection on these low-interest checking accounts or IOLTAs, please remember that the unlimited protection will end on January 1, 2011 and will not carry over through the new proposed Dodd-Frank rule.

Comments on the proposed rule are being accepted until October 15, 2010, and the FDIC will decide on the implementation of the rule shortly thereafter. FDIC-insured banks should also be issuing any necessary notices and disclosures as changes occur in the coming weeks.

So You Want To Deduct A Rental Loss...

Maybe you bought a condo on the Florida Panhandle and you rent it out to tourists. Or you moved and now lease out your former home to tenants. Or you rent a building to your business. Or you rent out a boat? Or an airplane? What if you lose money on the rental? Is that loss deductible?

The simple answer is a definite "maybe." All because there are quite complex rules to muddle through to determine if your loss is deductible.

The Passive Loss Rules

Before 1986, it was fairly certain that rental losses could be deducted, except in unusual cases where the taxpayer derived too much personal use, as with a vacation home. Unfortunately, things got more complicated when President Reagan simplified the tax system in 1986.

As you may recall, Reagan implemented a two tier tax rate system of 15% and 28%. Simultaneously, his tax legislation limited losses from tax shelters, defined as a trade or business in which the taxpayer does not "materially participate". This was done to prevent people from investing in bad economic deals just because they created tax losses.

Effect on Real Estate Rental

One casualty of the 1986 tax act was rental real estate because all rentals were automatically deemed to be passive activities. Losses from those rentals were therefore rendered non-deductible against salaries, investment income, capital gains, etc., and rental losses could be deducted only against other passive income.

Limited Relief for Active Participation

Some limited relief was given by Congress to mid and low income taxpayers. Up to $25,000 of losses from rental real estate could be deducted if a person's adjusted gross income is less than $100,000 ($200,000 on a joint return), provided the taxpayer "actively participates" in the rental.

Relief for Business Owners in a Real Property Trade or Business

It wasn't until 1993, under the Clinton administration, that Congress expanded the tax relief to certain business owners, regardless of income level. To be eligible for this relief, the taxpayer must show that at least 750 hours

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ployee in that position quit voluntarily or left for cause. New hires must also be able to certify that they were unemployed for 60 or more days prior to being hired. New hires who worked less than 40 hours per week for a different employer for 60 or more days prior to being hired as a full-time employee will also qualify as long as they can certify that employment history. Employers will be required to obtain a statement of certification from each new hire who qualifies for the new tax incentives. IRS Form W-11 is an acceptable statement and should be completed by all qualifying new hires. Information concerning Form W-11 and the process for claiming the credit can be found on the IRS's website at http://www.irs.gov/newsroom/article/0,,id=221036,00.html.

General information regarding these new employer tax incentives is available at http://www.irs.gov/businesses/small/article/0,,id=220745,00.html.

Corporations Paying Dividends cont. from Page 2

- *Better Tax Treatment for Distributions in Future Years.* To the extent 2010 cash distributions reduce the corporation's earnings and profits, there's a greater likelihood that distributions in future years will be treated as tax-free returns of capital or as long-term capital gains (which may once again be taxed at lower rates than dividends).
- *Establish a Dividend Paying Record.* A history of paying dividends will make it more difficult for the IRS to characterize compensation paid to business owners (which is deducible by the corporation) as disguised dividends (which aren't deductible). In other words, future compensation amounts will be easier to defend as reasonable if at least some dividends have been paid in the past.

As you can see, the current low federal tax rates on dividends through December 31, 2010, make the idea of taking corporate distributions a better idea than at any time in recent memory. With careful planning, we can help you determine whether you would benefit from having your corporation make dividend distributions this year.

Am I A Real Estate Investor or Dealer? Which Is Better And Why?

A real estate partnership recently won a court case in which the partners argued that their land, though subdivided, was still a capital asset. Classification as a capital asset is important for a number of reasons, including: (a) eligibility for long term capital gains tax rates; (b) ability to claim a substantial deduction for the grant of a conservation easement; and (c) entitlement to tax deferral via a Section 1031 exchange.

In this particular case, five acres of land was originally acquired for investment in 1996, then subdivided into 27 lots, then improved, then sold to a builder as a bulk sale under a 1031 exchange. The partnership consisted of a married couple along with a sister and brother-in-law. In 2001, some of the partners began building a personal residence on the property. The partnership applied to subdivide the raw land in 2004, and when the application was submitted, it agreed to sell 22 of the lots to a developer. Per the contract with the developer, the partnership built infrastructure such as roads, underground utilities, excavation work, engineering work, obtained permits and incurred various indirect costs. The developer closed on the purchase of the lots in 2005.

The Oregon Department of Revenue claimed that the partners no longer had an investment intent after getting the developer's offer and subdividing the property. The State contended that the land was held "primarily for sale" instead of "for investment" thus disqualifying it as a capital asset and denying §1031 tax deferral.

The partners took the case to State Tax Court and won. Bahr v. Oregon Department of Revenue, Oregon Tax Court – Magistrate Division, TC-MD 080525B (2009). In ruling that the land was indeed a capital asset, the court addressed the nine factors that are typically considered in capital gain cases: (1) purpose for which the land was originally acquired; (2) purpose for which the land was subsequently held; (3) extent to which subsequent improvements, if any, were made to the property; (4) frequency, number and continuity of sales; (5) extent and nature of the transactions involved; (6) ordinary business of the taxpayer; (7) extent of advertising, promotion or other active efforts used in soliciting buyers for the sale of the property; (8) listing of the property with brokers; and (9) purpose for which the property was held at the time of sale. The court ruled that, based on the length of time the property was held and the taxpayers' lack of experience in subdividing and selling lots, these factors weighed in favor of investor status for the partners. The court gave great weight to the fact that the taxpayers engaged in the development activities only to maximize their investment return, and then doing only enough development to complete the sale.

Because this case was decided by an Oregon state court, it cannot be cited as binding authority before the IRS. However, it does show that, subdivision of land, even coupled with substantial land improvements, is not necessarily enough to convert a property owner from investor status to dealer status where there is no actual building going on, no active marketing of the subdivided property, and no established sales office.

The case does give us a good roadmap of the things we need to do to qualify for investor status, since that can give us nice tax benefits when the property is sold or exchanged at a profit, or when a conservation easement is placed on the property. Please call upon us to help if you are trying to protect investor status for any particular piece of property and we will happy to guide you along.

Deducting Rental Losses cont. from Page 3

and over half of his/her working time is spent in a real property trade or business (including construction or development). In addition, the business owner must own at least 5 percent of the business—a rule designed to prevent a mere employee of a construction company from taking advantage of this tax loophole. If those requirements are met, then rental real estate losses may indeed be deductible.

IRS Counter-Attack

Recently, the IRS, on audit, has been stretching the rules by asserting that if the rental activity is contained in an LLC, all members should be treated as limited partners with the result that the taxpayers must demonstrate that they worked at least 500 hours in that particular LLC during the year of the tax loss or in any 5 of the last 10 tax years. Naturally, this is an almost impossible test to meet.

Courts Rule Against IRS

Fortunately, a few recent court cases have ruled that the IRS is wrong to treat LLC members as limited partners. Based upon those court cases, construction company business owners should be able to deduct real estate rental losses.

What About Boats and Planes?

It should be noted that if an LLC rents out, not real estate, but rather a boat or a plane, the IRS could still treat any losses as passive if the taxpayers cannot prove they spent at least 100 hours in that activity during the year of the loss, and that no other individual spent more than 100 hours in that activity. If, say, a plane pilot or boat captain or caretaker spent more than 100 hours with the craft, that knocks you out of eligibility for loss deduction, unless you can show that you spent more than 500 hours on that activity during the year. And believe me, the IRS will ask for a log of hours you have spent and second-guess which hours count toward either the 100 or 500 hour minimum. They do not permit time incurred in your capacity as an investor, so studying financial statements, preparing an analysis of the finances or operations, or monitoring the finances or operations are considered investor-related time that does not count. Mere passenger time does not count either.

You might still be able to rely on a facts and circumstances qualifications test that you participate in the activity on a "regular, continuous and substantial basis" throughout the year, but this is the type of standard that the IRS loves to litigate.

Other Ways for IRS to Deny Losses

On audit, the IRS will also look for other ways to limit losses claimed on tax returns. These include the following arguments by an auditor:

- The taxpayer was not "at risk" with respect to the investment in the activity (the individual does not bear the economic risk of loss incurred in an entity).
- The taxpayer did not have adequate "basis" for deducting losses (often a problem with S corporations; less so with LLCs provided member guarantees financing).
- The activity was the taxpayer's "hobby" and there was no profit motive (more likely with planes, boats and vacation homes as opposed to other real estate).

FAA Rules

With airplanes, it is also important to be careful about FAA rules when entering into a rental arrangement. If the airplane activity is considered a chartering operation, there are a whole host of FAA rules that come into play, and steep penalties for non-compliance.

Conclusion

It used to be fairly easy to claim tax losses from the rental of real estate, planes and boats. However, Congress has since muddied up the waters in its attempts to remove incentives for tax shelters. Given aggressive enforcement of arcane rules by IRS auditors, the mud has thickened. Fortunately, our judicial system has prevented the IRS from muddying outside the lines. Therefore, construction company owners may still deduct losses from the rental of real estate, boats and planes, provided they are able to document compliance with the rules. If you need help documenting your compliance, please call upon us and we will be glad to help you build your IRS defense arsenal even before an audit occurs.

Eliminating Estate Taxes On Real Estate By Putting It In A Family Private Foundation And Then Buying It Back

The threat of estate taxes when a business owner and land owner dies is often quite challenging for the surviving family members, who may be forced to come up with cash within 9 months of death to pay the IRS. Sometimes, estate taxes can be avoided through various techniques like lifetime gifting. Other times, life insurance is used to help pay the expected estate taxes.

But what if the business owner/land owner cannot gift any more without gift taxes? What if he or she is uninsurable or does not wish to buy life insurance for the benefit of the IRS? That's where it may be beneficial to leave the real estate to charity. Not just any charity but a private family foundation. After all, the estate tax allows a charitable deduction for the value of the business that goes to a tax exempt organization. And this eliminates the estate tax on that business.

Normally, you cannot leave real estate to a Foundation and then allow your business to buy it back. This is because there are punitive excise taxes on self-dealing that can be as high as 200%!

Fortunately, what cannot be done directly can sometimes be done indirectly under our tax code. The Treasury recently ruled that this result can be achieved if properly structured. Here's an example of how it can be done:

Let's assume Father owns $2MM of business real estate, which if nothing was done would result in estate tax of $950,000. To avoid this, the following plan is set in motion. Father ultimately dies, leaving business real estate to a Family Foundation founded by Mother. Mother, Son and Daughter are the Officers and Directors of the foundation. There is no estate tax because the real estate went to charity. The real estate was subject to an <u>option agreement</u> that gave the Family Corporation the right to buy the real estate from Father's estate at appraised fair market value ($2MM) for cash (or an installment note). The Family Corporation chooses to make payments on the note to the Family Foundation, a cash outflow of about $100,000 per year to the business. This is better than having to come up with $950,000 to pay to the IRS immediately.

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L&G's MISSION:
TO HELP OUR CLIENTS AND STAFF ACHIEVE FINANCIAL SUCCESS AND RETIRE COMFORTABLY

Large & Gilbert has specialized in the construction industry for over 40 years.

We have built our reputation on client service and on understanding the construction industry better than anyone else.

We strive to assist our clients with reaching their goals, both corporate and personal.

When you become our client, we willingly "go the extra mile" to assist you.

We want to help you reach your business, financial, and personal retirement goals.

We want to be your pipeline to financial success.

The Inside Corner — Focus on L&G Staff

It's been a busy time for members of the L&G staff this year! Here's a look at some of the recent happenings:

A very big welcome goes out to our new staff members!! Erica Weatherford came on board this December to assist in our billing department. Lindsay Holl has been gracing the phones with her voice as our receptionist since November. Chris Savage joined our staff in May as a member of our Accounting and Auditing department. Matthew Kaynard, a staff attorney for our financial planning department, and Lesley Fleming, Administrative Assistant to Sydnee Roberts, joined the L&G staff in July. Trish Kelley has been working with L&G since August as the Executive Assistant to Rhonda Gilbert. We are very happy to have all of them on board!

In our sister firm, Keystone Financial Group, we also have some new members to introduce to you. AJ Gilbert joined Keystone last year as an Investment Advisor Representative. Heather Yi began working with us in January as an Administrative Representative. A big welcome goes out to them as well!

We have wonderful wedding news to announce from our accounting and tax departments! Alesha Blair, a staff accountant, married Tim Tyler at the Gardens at Kennesaw Mountain in Marietta, Georgia on June 5, 2010. Chris Savage, another staff accountant, married Kelsi Williams at Good Shepherd Catholic Church in Huntsville, Alabama on July 17, 2010. Just a few weeks later, on July 31, 2010, Amanda Bilich, a member of our tax department, married Trevor Ramos at Flint Hill in Norcross, Georgia.

We also have exciting baby news to report! Dustin Zabrocki, one of our Accounting Supervisors, and his wife, Kimberly, welcomed their second child, Chelsea Alexis Zabrocki on January 26, 2010 at about 8:30 AM. She weighed 7 pounds 7 ounces and was 21.5 inches long. Chelsea joins a sister, Karlie, age 2. Nathan Worthey, one of L&G's Partners, and his wife, Hester, had their third child on February 26, 2010. Elyn Grace Worthey was 8 pounds 7 ounces and was 21 inches long. Elyn joins brother Jacob, age 4, and sister Kinley, age 3.

L&G held their 9th Annual Surety Seminar on Friday, October 1, at the Westin Atlanta North at Perimeter. Rhonda Gilbert, Tom Savage, and Joe Skalski gave presentations on topics ranging from how to survive these difficult economic times to benchmarking trends to the recent "Obamanable" taxes. We also had two wonderful guest speakers for our seminar. Robert Billue from the Bank of North Georgia discussed the state of the banking industry and how it's affected lending to contractors. We also had Dr. Roger Tutterow, an Economist from Mercer University, who talked about the current economic, business, and political environment. The seminar was very successful and informative!