March 2012

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

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Dear Clients and Friends,

We are deep into the traditional "busy season" now. It comes as a surprise to most people that September 15 (extended due date for most entity returns) and October 15 (extended due date for individual returns) are probably bigger deadlines for us than March 15 and April 15. Nevertheless, this is clearly a busy time of the year for us as we try to get out audited financial statements and K-1s, along with structuring transactions, handling IRS and DOR matters, and doing ongoing planning for our clients.

While our clients are spread across the country (and, to some degree, around the world), we obviously have a concentration of clients in Georgia. Accordingly, this issue includes a summary of the many credits against Georgia income tax available to businesses and individuals. We also discuss reasons to use your lifetime gift tax exemption in 2012, various education related tax benefits, new rules for distributing K-1s electronically, an incentive for exporters, and while this newsletter (as its name implies) is mostly focused on tax-related topics, we are a full-service firm, so we include a discussion of audits, reviews and compilation of financial statements.

Kent Bridges,
Managing Partner

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

Georgia Tax Credits

Georgia, like most states, offers a bounty of credits against its income tax; some of which fall into the almost too good to be true category. Some (e.g. the jobs credit, research credit and retraining credit) must be generated by a business entity, some can essentially be purchased (e.g. the low-income housing credit and the film credit), and others are based on taking some sort of action which the government is encouraging (e.g. the Georgia credit for donations to Student Scholarship Organizations). No matter your situation (and whether a business entity or an individual), the odds are that at least one of these credits is available to you.

Qualified education expense credit - Individuals and businesses can receive a credit against their Georgia tax for contributions to qualified student scholarship organizations (SSOs). An SSO is a 501(c)(3) organization which allocates at least 90% of its annual revenue for scholarships to enable students in grades K through 12 to attend a Georgia school of their parents' choice. Married couples can claim a credit of up to \$2,500, singles a credit of up to \$1,000, and corporations a credit up to 75% of the amount of their Georgia tax liability. This is quite a deal, as the combined tax benefit from the Federal income tax deduction and the Georgia credit can actually exceed the amount of the contribution made. There is a cap each year on the amount of credits that the Georgia Department of Revenue can award (\$51,500,000 for 2012). You must pre-qualify your credit by sending a form to the DOR for approval. For 2011, the cap was reached before the end of the year. Accordingly, if you want to participate, you should send in your request early in the year.

Low-income housing tax credit – In order to encourage the development of affordable apartments for lower income persons, Georgia offers a tax credit for investment in such projects. Often, the credit cannot be fully utilized by the owner of the apartment project, so it is sold at a discount (e.g. 75 cents per dollar of credit) to others who can utilize it. Technically, the credit is not "transferable", but Georgia law generously permits the credit to be allocated to any partner in a partnership or any member of an LLC, such that the credit can essentially be purchased.

Film tax credit – In order to encourage the production of films in Georgia, the state provides film production companies a credit of up to 30% of their qualified expenditures in Georgia. To the extent the credit exceeds a company's Georgia income tax, it can be claimed as a credit against its withholding tax, and then further can also be sold to another taxpayer. Typically, the credit is sold to taxpayers who can use it for approximately 85 – 90 cents per dollar of tax credit.

Conservation credit – A Georgia tax credit of up to 25% may be claimed for the value of property donated for conservation purposes, or for the value of a conservation easement donated. A Federal income tax deduction is also available for such donations. The Georgia credit, to the extent not utilized by the taxpayer, may be sold to another taxpayer.

R&D tax credit – Businesses can claim a Georgia credit for 10%

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Georgia Tax Credits — continued

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of the amount by which their qualifying Georgia research expenses exceed a base amount; with the base amount generally determined by multiplying the company's ratio of R&D to revenue for the preceding 3 years by current year revenue. The credit can only offset 50% of current year tax liability, with any excess carrying forward for up to 10 years. Owners of S-corps and LLCs can claim the credit on their personal returns. Also, companies in their first 5 years of existence in Georgia can claim the credit against their Georgia withholding tax.

Seed-capital research fund investment credit – A credit of up to 25% is available for the amount invested in a research fund which provides early-stage financing for businesses formed based on intellectual property resulting from research conducted in Georgia research universities; and a credit of up to 10% is available for investments made directly into entities in which a qualifying research fund has invested. Any unused credit carries forward for up to 10 years.

Taxes paid to other states – Georgia residents are subject to Georgia tax on their worldwide income. However, Georgia permits a credit for taxes paid to other states, so long as the effective rate paid to the other state(s) does not exceed the Georgia rate on the same income.

Jobs tax credits – Employers can receive tax credits of up to $5,250 per year for 5 years for each new job created in Georgia. The amount of the credit, the number of new jobs which must be created in order to be eligible for the credit, and the types of businesses eligible for the credit all depend on the geographic location of the employer (with more generous terms for new jobs created in less prosperous areas) and the type of new job created. The credit can be used to offset income tax and, in some situations, the employer's withholding tax obligation.

Employee training programs – Employers can receive a credit of up to $1,250 per employee for approved retraining programs, and a credit of up to $150 per employee for approved basic skills education.

Angel investors – Investments made in early stage companies during 2011 – 2013 are eligible for a Georgia tax credit of up to 35% of the amount invested (with utilization of the credit limited to $50,000 per year). The credit is claimed in the year following the year the investment is made. It is available to accredited individuals and special purpose flow-through entities which are investment vehicles. A maximum of $10,000,000 per year of credit is available for the entire state. Qualified companies have to be less than three years old, employ fewer than 20 people, have less than $500,000 in revenue in any prior year, be headquartered in Georgia, have raised less than $1,000,000 in equity and debt financing (other than commercial loans), and can<u>not</u> be engaged in retail, real estate, professional services, membership based activities, gambling, natural resource extraction, investment activities, insurance, entertainment, amusement, recreation, etc.

Other tax credits – Additional tax credits available include those for child care, caregiver's expenses, adoption of a foster child, purchase of a low-emission vehicle (or conversion of existing vehicle to such), diesel particulate emission reduction equipment, disaster assistance, driver's education expenses, employer-provided daycare, rehabilitation of historic homes and other structures, increasing port traffic, investment in manufacturing equipment and facilities, life insurance for national guard members on active duty, low-income persons, enterprise transportation vehicles (for transporting employees in less-developed counties to and from work), high-deductible health insurance, purchasing or retrofitting a home with accessibility features, rural physicians, and water resource conservation and development.

2012 May Be the Year to Make Significant Gifts

For those with sizable estates who are concerned about the potential for estate tax, 2012 may be the year to consider making a significant transfer of wealth to your heirs.

For 2012, the exemption equivalent for the unified credit against estate and gift tax is $5,120,000. This is an extremely high amount by historical standards, and, absent Congressional action to extend it, the amount will drop to $1,000,000 effective January 1, 2013. This means that a married couple could potentially move over $10,000,000 of wealth out of their estate tax-free in 2012, versus only $2,000,000 in 2013. The estate tax savings involved could be in excess of $4,000,000.

While you might not be ready to turn control over this amount of wealth to your children, effective control can generally be retained through the use of a family limited partnership and/or trust.

Education Deductions, Credits and Exclusions

The Internal Revenue Code provides a variety of tax benefits for higher education expenses. Unfortunately, most of these are phased out for higher income taxpayers, making them unavailable for most of our clients. However, whenever we are preparing returns for our clients and their college-aged children, we consider which of these potential benefits may apply, and which is most advantageous when more than one may be available.

Tuition and fees deduction – For singles with income of up to $80,000 and married couples with income up to $160,000, a deduction of up to $4,000 per year may be taken for tuition and

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Education Deductions, Credits and Exclusions—continued

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fees. This deduction expired at the end of 2011, but may be extended.

Deduction of student loan interest – Singles with income of up to $75,000 and married couples with income up to $150,000 can deduct up to $2,500 per year of student loan interest.

American opportunity tax credit – For singles with income of up to $90,000 and married couples with income up to $180,000, a tax credit of up to $2,500 per student is available for each of their first 4 years of college.

Lifetime learning credit – For singles with income of up to $61,000 and married couples with income up to $122,000, a tax credit of up to $2,000 per year is available. Unlike the American opportunity tax credit, this credit is not limited to the first 4 years of college. However, this credit is limited to $2,000 for the family, regardless of the number of students in the family.

Exclusion for qualified scholarships – Amounts received from a qualified scholarship are excluded from the recipient's taxable income. There is no income limitation on this benefit.

Section 529 plans – Earnings on amounts contributed to a state-sponsored section 529 plan (qualified tuition plan) are excluded from taxable income, so long as amounts from the plan are expended only for qualifying higher education expenses. There is no income limitation on this benefit. However, contributions to 529 plans can potentially be subject to gift tax (subject to annual gift tax exclusions), so careful planning is necessary in this regard.

Coverdell education saving accounts – Singles with income of up to $110,000 and married couples with income up to $220,000 can make annual contributions of up to $2,000 per year per beneficiary to Coverdell education savings accounts. The contribution is not tax deductible, but the earnings on the account escape taxation, so long as used for education expenses.

Audits, Reviews and Compilations of Financial Statements

As CPAs, we are often asked to report on the financial statements of our clients in order to satisfy the requirements of various third parties or the owners themselves. For example, a financial institution lending money to a business, an outside investor looking to invest in a business, or a bonding company guaranteeing business commitments will all likely require some form of assurance. In other instances, business owners decide to have us report on their financial statements for personal piece of mind or to facilitate a future sale of the business. Whatever the reason, there are essentially three levels of service that a CPA firm may provide with respect to financial statements: audit, review or compilation. All three are performed in accordance with generally accepted accounting principles (GAAP) or another comprehensive basis of accounting (such as the income tax basis of accounting). Beyond this similarity, there are significant differences in the level of assurance offered and therefore the work involved. Each is a term of art, and we often get questions about the differences between the three, so here is a brief overview from lowest level of assurance to highest level.

Compilation – A compilation involves assisting management in presenting financial information in the form of financial statements using information provided by the client, without audit or other verification of the information provided. Although no level of assurance is provided in a compilation, we never want our name associated with financial statements that are inaccurate. Therefore, we typically perform some limited procedures to verify the accuracy of the financial information provided to us. However, because of the limited scope of such, our report on the financial statements will indicate that a compilation is limited to presenting in the form of financial statements information that is the representation of management and that we have not audited or reviewed the financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Review – The procedures performed as part of a review fall somewhere in between those performed in a compilation and those performed in an audit. Performing a review does require the CPA firm to perform certain analytical procedures and inquiries of management in order to provide limited assurance on the accuracy of the financial statements. However, unlike in an audit, a review does not require obtaining an understanding of internal control and performing tests of the accounting records. As with a compilation, our firm will typically perform additional procedures beyond the minimum required to gain a higher level of comfort that the financial statements are accurate. With a review, our report indicates that we are not aware of any material modifications that need to be made to the financial statements in order for them to be in conformity with GAAP or another comprehensive basis of accounting.

Philip R. Poovey, CPA
Partner in Charge of
Accounting and Attestation

Audit – With an audit, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Audits are performed in accordance with Generally Accepted Auditing Standards (GAAS) that include general, fieldwork and reporting standards which dictate how an audit is conducted. Audit procedures include evaluating the Company's system of internal control, assessing the risks of material misstatement of the financial statements, and designing and performing tests of the underlying transactions supporting the financial statement balances to address the risks identified. A clean audit opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the entity. This is the highest level of assurance that a CPA firm can give with respect to financial statements.

Distributing K-1s by Electronic Means

Partnerships, LLCs, S-corps and trusts are required to distribute annual K-1s to their partners, members, shareholders and beneficiaries, respectively, reflecting their respective share of the taxable income or loss and other tax-related items of the entity.

Historically, this was done largely in paper format. However, in recent years the trend has increasingly been to distribute K-1s electronically (either via e-mail of a password protected pdf file or by download from a secure portal or website). The IRS has now issued a revenue procedure providing requirements for partnerships and LLCs which wish to furnish K-1s electronically rather than in paper format.

In order to comply with the revenue procedure, you must obtain the K-1 recipient's consent to receive K-1s electronically rather than in paper format. The K-1 recipient's consent can be provided electronically in any manner that reasonably demonstrates that the recipient can access the K-1 in the electronic format in which it will be furnished to the recipient, or the consent can be made in a paper document if the consent is confirmed electronically in a manner that demonstrates that the recipient can access the K-1 in the electronic format in which it will be furnished. In other words, if you plan to e-mail a pdf of the K-1, then getting the recipient's consent via e-mail is probably sufficient; whereas if the K-1 recipient will need to download from your website, then the recipient should probably confirm consent at your website in the same manner.

In addition to obtaining the K-1 recipient's consent, you must provide them certain required disclosures pertaining to their ability to otherwise or additionally receive a paper statement, the scope and duration of their consent, post-consent requests for a paper statement, withdrawal of consent, notice of termination, updating of information, and hardware and software requirements.

It should be noted that the revenue procedure appears to only apply in situations where you wish to distribute K-1s electronically in lieu of distributing on paper. Accordingly, it appears that you can distribute K-1s electronically (e.g. for the convenience of the recipient) without complying with the terms of the revenue procedure, so long as you also timely distribute on paper. However, in an era of great concern over potential identity theft and safeguarding of personal information like social security numbers, it is probably prudent to obtain a K-1 recipient's consent to electronic distribution prior to doing so, even in the absence of these IRS rules. Further, it is prudent to use passwords and other means to safeguard the recipient's social security number (which is reflected on their K-1) and other confidential information.

IC-DISCs — A Tax Incentive for Exporters

Over the years, the U.S. has offered a number of tax incentives for exporters. Some of these (e.g. the foreign sales corporation and extra-territorial income exclusion) have been repealed after being found by the World Trade Organization to be an illegal export subsidy under our agreements with our trading partners. The Interest-Charge Domestic International Sales Corporation (IC-DISC), however, has survived.

An IC-DISC is a corporation formed for the purpose of receiving commissions from a related U.S. company with respect to export sales. The IC-DISC is permitted to defer taxation on up to $10,000,000 of qualified export receipts each year, with the shareholders of the IC-DISC paying an interest charge on this deferral. The greater (and more permanent) savings from the IC-DISC, however, can come from the significant current spread between the highest ordinary Federal rate (35%) and the rate on qualified dividends (15%). This differential arises because the payment of the commission by the related operating company provides an ordinary deduction, while the dividend from the IC-DISC (which itself is tax-exempt) is taxed at the more favorable qualified dividends rate.

The IC-DISC transfer pricing rules generally permit it to have profit of up to 4% of the gross receipts from exports or 50% of the profit from such, whichever is expected to be higher, plus in each case an amount equal to 10% of the export promotion expenses.

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Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.

April 17 is the Deadline this Year

We always love to see April 15 fall on a Saturday or Sunday (that extends the due date by a day or two), and this year with the 15th falling on a Sunday and the 16th being Emancipation Day (a D.C. holiday) the deadline is extended to April 17; so don't panic if your returns (or extensions) are not filed this year until the 17th.