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Tax Talk

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Dear Clients and Friends,

October 16 marked the passing of our last major tax-filing deadline of the year. So now we get to catch up on deferred administrative tasks and begin year-end planning for our clients.

There has been no new major tax legislation to report since the last issue of our newsletter, but we did have an election in which the Democrats gained control of both the House and the Senate. My crystal ball is far from perfect, but I will make a few bold (or maybe not so bold) predictions: With the Democrats in control of Congress there will be no repeal of the estate tax, no repeal of the income tax, and no reduction in income tax rates.

In this quarter's newsletter, we will discuss year-end tax planning strategies, the advantages of a "defective grantor trust", and a potential limitation on the use of loss and credit carryforwards for corporations to be aware of. We also welcome a new member to our firm, congratulate a member on the passing the CPA exam, as always highlight a member of our firm, and, this quarter, highlight two clients who recently made the Inc. 500 list.

Kent Bridges,
Managing Partner

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

Sincerely,

Kent Bridges

Year-end Tax Planning Strategies

Late November through December is the time for year-end tax planning. While every client's situation is unique, here are some of the more common strategies we employ.

Timing of payment of state income taxes – There seems to be a commonly-held belief that you should always accelerate the payment of your state income taxes into December in order to get the tax deduction in the current year. While that is sometimes a good strategy, such is not always the case. Individuals in the alternative minimum tax (AMT) posture receive no Federal tax benefit from their payment of state income tax. Further, the 3% of income limitation on itemized deductions can substantially limit the benefit in a high income year. By running tax projections for the current and upcoming year, you can determine the optimal timing for payment of state income tax, sometimes resulting in a substantial permanent tax savings. This is especially true with respect to a year in which you have a substantial gain, such as from the sale of your business.

Timing of charitable donations – It is generally advantageous to time significant charitable donations to coincide with a year in which you have significant income and are in a higher rate bracket. Because of the percentage of income limitations on charitable donation deductions (e.g. 50% of income for cash donations and 30% of income for donations of appreciated property) and the inability to carry the deduction back to earlier years, making a substantial donation in the year after a big gain can potentially result in the permanent loss of a tax benefit versus having made the donation in the same year as the substantial gain. On the other hand, if you have charitable carryforwards that are in danger of expiring, deferring additional donations to the next tax year may be prudent. Likewise, if your charitable deduction would be substantially limited by the 3% of income limitation on itemized deductions in a year of high income or if your income is already offset by other deductions and exemptions in a year of low income, then deferring your deduction may be advantageous.

Harvesting of capital losses – Capital losses can, for the most part, only be deducted against capital gains. And while capital losses can be carried forward, for individuals they cannot be carried back to previous years. Accordingly, it is generally a good strategy to go ahead and recognize any potential capital losses you have, at least up to the amount of your capital gains for the year.

Estimated tax payments – In order to avoid a penalty, you are generally required to pay in through withholding or quarterly estimated tax payments the lesser of 90% of your current year

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M. Chad Cottingim, CPA

Member in the Spotlight — Chad Cottingim

Chad Cottingim will soon celebrate his 6th anniversary with Bridges & Dunn Rankin. A native of Greenville, South Carolina, Chad holds a Bachelor of Science in Accounting degree and a Masters of Professional Accountancy with Emphasis in Tax, both from Clemson University.

Chad is an avid fan of college sports, most particularly Clemson football and basketball, and is the office expert in sports-related statistics and trivia. He and fiancé Julie are scheduled to tie the knot in December 2007.

Bridges & Dunn-Rankin is proud to have Chad Cottingim as a member of our firm.

Year-end Tax Planning Strategies - continued

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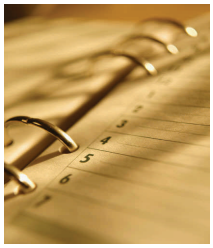
tax liability or 110% of your prior year tax liability. With respect to estimated tax payments, you get credit the day you actually make the payment. Withholding, however, is generally deemed to have occurred ratably throughout the year, regardless of when actually withheld. Accordingly, if you realize late in the year that you have a shortfall for earlier quarters, you can sometimes avoid the penalty by increasing your withholding late in the year; e.g. having all of a year-end bonus withheld for taxes.

Acceleration or deferral of income and deductions – Businesses which use the cash basis of accounting for income tax purposes often have a great deal of control over the timing of income and deductions. Shifting income from a high-rate bracket year to a low-rate bracket year can obviously result in a permanent tax savings. And even where your rate bracket will be the same from year to year, deferring income to the next year can result in a time-value-of-money savings, which can be particularly valuable now that short-term interest rates have risen substantially.

S-corp and LLC basis and at-risk limitations – In general, you can deduct your share of losses from S-corps, LLCs and partnerships, and distributions from such entities are generally tax-free. However, the ability to deduct losses or receive tax-free distributions is limited by the "basis" and "at-risk" rules. Basically, the amount of loss you can deduct or distributions you can receive tax-free is limited to your unreturned investment in the entity (including past undistributed profits and, in the case of partnerships and LLCs, your share of the entity's liabilities which are either bank debt on a real estate project or debts for which you are personally liable). With respect to flow-through entities in which you own a stake, you should review your basis and at-risk amounts prior to year end to determine whether any tax advantage can be gained by increasing such amounts and whether such is prudent from an economic standpoint.

Exercise of ISOs in year not in AMT – "Incentive stock options" (ISOs) hold out the promise of being able to potentially convert what would otherwise be ordinary income (taxed at the highest rates) into long-term capital gain (taxed at more favorable rates). However, because the bargain element is an "alternative minimum tax" (AMT) adjustment on the date of exercise, the AMT often eliminates much of the hoped-for benefit. A tax year in which you will <u>not</u> be in the AMT represents an opportunity to exercise some ISOs at no tax cost, meaning a potential permanent tax savings if you hold the stock for the requisite period of at least one year from date of exercise and two years from date of grant.



Sale of ISO shares that have fallen in value - If you exercise ISOs and sell in the same tax year, then the AMT issue goes away. Accordingly, we typically advise our clients who want to exercise and hold ISOs to do so early in the year, giving us almost a full year to watch the stock price and to sell the stock before year end if necessary in order to cure the AMT problem. If you exercised ISOs earlier this year, you still hold the shares, and the value of the shares has fallen dramatically, then now may be the time to sell.

Section 179 expense – Small companies (which for these purposes means those which have purchased less than $430,000 in furniture and equipment for the year) can elect to immediately expense up to $108,000 of the cost of furniture and equipment against otherwise taxable profit. If your capital expenditures for the year will be less than $430,000 and you will be in a high rate bracket for the year, then accelerating the purchase of some equipment may be advantageous.

Selection of accounting methods – New businesses can, within certain limitations, select the tax accounting methods (e.g. cash or accrual) which are most beneficial for them. And existing businesses have some latitude to later change their accounting methods. Your situation should be reviewed each year in order to determine which accounting methods are most advantageous for you.

Conversion of IRA to Roth status - With a traditional deductible IRA, you get a tax deduction on the front end when you make the contribution, but then are subject to ordinary income tax rates on any withdrawals (with an additional 10% penalty generally applying if you make withdrawals before age 59 ½). With a nondeductible traditional IRA, you get no tax deduction on the front end and then are subject to ordinary

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Year-end Tax Planning Strategies - continued

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income tax rates on a portion of your withdrawals (the portion representing the income earned by the IRA account). The Taxpayer Relief Act of 1997 introduced a third type of IRA, called the "Roth IRA", with which you get no front-end tax deduction but the appreciation in value permanently escapes tax. Traditional IRAs can be converted to Roth IRAs, but only if your income for the year of conversion is less than $100,000. The conversion is a taxable event. We sometimes suggest the Roth conversion as a strategy in a tax year in which a client is in a very low tax rate bracket or is in danger of wasting deductions (e.g. a substantial amount of itemized deductions and exemptions, but no income to utilize them against and no ability to create a net operating loss carryback or carryforward). In this situation, you may be able to gain a significant permanent tax benefit at little or no current tax cost.

Utilization of annual gifting exclusion – With respect to the estate and gift tax, there is an annual exclusion which permits you to give up to $12,000 per year per donee, without incurring any gift tax or eating into your lifetime exemption against such. For married couples electing gift-splitting, this amount is effectively doubled to $24,000 per year per donee. For those with a significant number of potential heirs, this represents an opportunity to remove a substantial amount of value from their taxable estate, especially where gifting assets that may be subject to discounted valuation (e.g. an interest in a family partnership). The annual exclusion is on a use-it-or-lose-it basis with no carryover, so if you haven't maximized your annual exclusion gifts yet for 2006, consider doing so before year end.

Setting expectations and avoiding surprises – One of the key advantages to engaging in year-end planning is that it enables you to appropriately plan your required cash outlay for taxes and avoid any unpleasant surprises at April 15 or any regrets as to actions that could have been taken by year end but weren't.

Two Bridges & Dunn-Rankin Clients Make Inc. 500 List

Emerging-growth companies have always been a key part of our practice at Bridges & Dunn-Rankin. Accordingly, it came as no surprise to see that that two of our clients, **ReachView Technologies** and **DOW Networks**, recently made Inc. Magazine's annual list of America's 500 fastest-growing private companies.

ReachView, which under the leadership of founders Ian Bresnahan, Todd Cochran and Josh Shipman has enjoyed a 3-year growth rate of 374%, provides software and consulting services to the telecommunications industry.

DOW Networks, which under the leadership of founder and CEO David Wise has enjoyed a 3-year growth rate of 354%, provides international tele-communications and enhanced voice over IP solutions.

Congratulations to ReachView Technologies and DOW Networks.

C-corp with Net Operating Loss Carryforwards? Watch out for IRC §382

Early stage companies often incur tax losses in their first few years of existence. And even mature companies can have loss years; particularly companies in cyclical industries. Fortunately, the tax law generally provides that operating losses can be carried back 2 years or forward 20 years.

In order to prevent "trafficking" in net operating losses (NOLs), tax rules place potentially severe limitations on the use of a company's tax losses and tax credits following a change in ownership. These rules can be a trap for the unwary.

IRC sections 382 and 383 provide that, where the ownership of a company changes by more than 50 percentage points in any 3-year period, the ability of the company to deduct its tax carryforwards in any future year is limited to the value of the company on the date the 50-percentage point threshold is crossed multiplied by a fluctuating rate that is currently around 4%. In other words, if the value of the company is $1 million at the time of the ownership change, then its ability to use its loss carryforwards is limited to $40,000 per year, no matter how large its carryforward may be.

In situations where all of the stock of a company is sold, it is pretty clear that these rules apply, unless the value of the company is more than 25 times the amount of its loss carryforwards. However, where these rules can sneak up and bite you is when you are raising equity capital; particularly, in situations where you have multiple rounds of venture capital, for example. The 50-percentage point test is based on value of shares, not number of shares, so even if the founders continue to hold greater than 50% of the common stock, the limitation can be triggered by the issuance of preferred stock (which typically has greater value due to its liquidation preferences).

An entrepreneur trying to build a company certainly doesn't want to let the tax tail wag the dog, and we generally wouldn't recommend foregoing needed equity capital to avoid these rules. However, with knowledge of the rules and careful planning you can generally avoid unnecessarily triggering these limitations and wasting a potentially valuable asset.

The Advantages of a "Defective Grantor Trust"

In connection with estate planning for our clients, we often suggest the use of a "defective grantor trust". On the surface, this sounds like a bad thing since the term "defective" generally implies something bad. However, from a tax planning perspective, it can be quite good.

A "defective grantor trust" (DGT) is a trust that is recognized for estate and gift tax purposes (meaning that you have removed the assets contributed to it and any future appreciation thereon from your taxable estate), but is ignored for income tax purposes. It is considered "defective" because the grantor has retained a power (typically the right to substitute assets of equal value) that causes the trust to be treated as a "grantor trust" for income tax purposes.

Because the trust is a "grantor trust" for income tax purposes, it is effectively ignored for income tax purposes. This enables the grantor to engage in transactions with the trust without incurring any income tax cost, and it means that the grantor is taxed on any income earned by the trust. At first blush this latter consequence (the grantor being taxed on the income of the trust) sounds terrible. However, it is great estate planning since it effectively enables the grantor to make a gift of the income tax amount to his descendants free from any estate or gift tax and without eating into his or her lifetime exemption.

The best assets for gifting to a DGT are typically those which are expected to appreciate substantially in value. If in fact the contributed assets do appreciate, then the grantor can potentially later substitute nonappreciated assets (e.g. cash) for the appreciated assets, putting the appreciated assets back in his estate where they will get a tax basis step-up at death. Thus, the DGT can effectively accomplish a triple play: removal of assets (and appreciation thereon) from the taxable estate, removal of the income tax amount from the estate, and a basis step-up at death on the assets substituted out.

Member News

The new voice you have heard recently when calling our office is that of **Alexis Bischoff.** Alexis, a native Atlantan, joined us in late August as an administrative assistant following a 5-year career with a law firm, and has been a terrific addition to our firm.

Congratulations to firm member **Nadine Swain** for passing all 4 parts of the CPA exam.

Bridges & Dunn-Rankin, LLP
CERTIFIED PUBLIC ACCOUNTANTS

200 Galleria Parkway
Suite 1950
Atlanta, GA 30339

Phone: 770-563-8888
Fax: 770-563-8885
www.bridgesdunnrankin.com

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The information provided in this newsletter is presented for educational and informational purposes only, and is not intended to constitute legal, tax or accounting advice. The articles provide only a very general summary of complex rules. For advice on how these rules may apply to your specific situation, contact a professional tax advisor.

Tax Trivia

Last quarter's trivia question was "What date is Tax Freedom Day in the U.S. for 2006?" The first person to respond with the correct answer of April 26 was John Patton of Abax Ventures.

Now, for this quarter's contest. In light of high gasoline prices and record profits for the oil companies, some have called for the return of a special tax on the industry, similar to that which was previously enacted in 1980 and repealed in 1988. This quarter's trivia question is "What was the name of the special tax on the oil companies which was enacted in 1980 and repealed in 1988?"

The first person to provide the correct answer will receive 4 tickets to a Braves game of their choice next season. E-mail your answer to alexis.bischoff@bridgesdunnrankin.com.