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Tax Talk

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Inside this issue:

Dear Clients and Friends,

"Are you glad that "tax season" is over?" I seem to get that question a lot this time of the year. Actually (and thankfully), "tax season" is never over for those of us at Bridges & Dunn-Rankin. We are as busy as ever right now, working on financial statements and tax returns that have been extended or for non-calendar year companies, structuring transactions, handling IRS and DOR matters, and doing ongoing planning for our clients.

Congress has also been busy, having recently enacted new income tax legislation, *The Small Business and Work Opportunity Tax Act of 2007*, which we discuss below.

We have added two new members to our firm since the last issue of this newsletter. Jen Curran, CPA, who holds both an undergraduate degree and a masters in accounting from the University of Notre Dame, has joined us after two years with Deloitte in Chicago and a year at Emory working on her PhD; and Brittany Lovvorn, a recent graduate of Auburn University, has joined our administrative team.

In this issue we will review highlights of the recent tax legislation, discuss the pros and cons of various types of legal entities, and, as always, highlight a member of our firm and one of our clients.

Kent Bridges, Managing Partner

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

Sincerely,

Kent Bridges

The Small Business and Work Opportunity Tax Act of 2007

On May 25, 2007, President Bush signed into law the *Small Business and Work Opportunity Tax Act of 2007* (the "Act"). Highlights of the Act include:

Increase in minimum wage – The minimum wage will increase from $5.15 per hour to $7.25 per hour in three $0.70 increments over the next two years. It will increase to $5.85 per hour 60 days after the bill's enactment, to $6.55 one year after enactment, and to $7.25 two years after enactment.

Code section 179 expensing enhanced and extended – Most small businesses can elect to immediately expense up to $100,000 each year ($112,000 for 2007, as adjusted for inflation) of the cost of furniture and equipment purchased for use in the business. For tax years beginning after 2009, this amount was scheduled to revert to the old $25,000 per year limit. The Act increases the amount which can be expensed to $125,000 and extends the favorable higher amount through the end of 2010. Further, the Act increases to $500,000 the amount of furniture and equipment which can be purchased during the year before the deduction amount begins to be phased out.

GO Zone tax incentives extended – Businesses in the "Gulf Opportunity Zone" (areas impacted by Hurricane Katrina) can have the amount of their section 179 expensing limit increased by up to an additional $100,000. This additional benefit was scheduled to expire at the end of 2007. For businesses in the hardest hit areas, the benefit is extended through 2008.

Work opportunity tax credit extended – Employers who hire members of certain target groups are permitted a tax credit of up to 40% of the first $6,000 of wages paid to each member of a targeted group (such as recipients of public assistance, qualified veterans on assistance, high risk youth, qualified ex-felons, etc.). This tax credit was scheduled to expire at the end of this year, but has now been extended through August 31, 2011. The Act also expands the definitions of the qualifying individuals.

Alternative minimum tax can be offset by WOTC and tip credit – Many tax credits can offset "regular tax", but not the AMT. The Act provides that the work opportunity tax credit and the FICA tip credit can now offset AMT.

Spouses may elect out of partnership rules – An unincorporated business carried on by two or more persons generally is treated for income tax purposes as a partnership. The Act provides that an unincorporated business carried on jointly by spouses is permitted to file as a sole proprietorship, with each spouse reporting their respective share of the business income.

ESBTs can deduct interest on S-corp stock acquisition debt –

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M. Nadine Swain

Member in the Spotlight — Nadine Swain

Nadine Swain joined Bridges & Dunn-Rankin 2 ½ years ago following completion of her Bachelor of Business Administration degree (with a major in Accounting) from Valdosta State University, where she graduated with the Magna Cum Laude distinction. She originally joined the firm as part of our Audit and Assurance practice, but has found that she enjoys tax work and so has begun to gravitate more to our tax practice where she has gained experience in the taxation of corporations, partnerships and individuals. She is currently working on her MBA and Masters of Accountancy degrees at Kennesaw State University

Nadine, a native and life-long resident of Smyrna, Georgia, is a member of Beta Gamma Sigma, and volunteers throughout her community with Habitat for Humanity, The Haven, and Festival of Trees. She enjoys running, bicycling, and spending time with her family.

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

The Small Business and Work Opportunity Tax Act of 2007- continued

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Electing small business trusts (ESBTs) will now be permitted a tax deduction for interest expense on debt incurred to purchase S corporation stock.

S corporation capital gains – An S corporation which was previously a C corporation and has "C-corp earnings and profits" can be subject to a corporate level tax if its "passive investment income" exceeds 25% of its gross receipts for the year. The Act removes capital gains from stock sales from the definition of passive investment income making it less likely that an S-corp will inadvertently trigger this very punitive tax.

Kiddie tax age increased (again) – Since the Tax Reform Act of 1986, children under the age of 14 have had their unearned income (e.g. interest and dividends) over a minimal amount ($1,700 for 2006) taxed at their parents' marginal tax rate. This provision was designed to prevent parents from shifting income to their children's typically lower tax rate bracket. 2006 tax legislation increased the age to children under 18, and now the 2007 legislation increases the age to include children who are 18 and full-time students up to the age of 23.

FICA tip credit enhanced – The Federal minimum wage level for purposes of calculating the tip credit is frozen, thereby allowing restaurants to continue claiming the full tip credit despite an increase in the Federal minimum wage.

S-Corp vs. C-Corp vs. LLC: Which is Right For Your Business?

One of the significant decisions you face when starting a company is deciding through which type of legal entity you will operate the business. And for existing businesses, an evaluation should be made annually as to whether the type of entity you are using is still the best choice for you.

What are Your Choices?

If the business will have only one owner, then you could operate it as an unincorporated sole proprietorship. In other words, you would own the business directly without any legal entity in place. However, because this format would offer you no legal liability protection, it will rarely be used unless the business is a one-person consulting operation; and even then the use of a legal entity may be very beneficial from a perception standpoint. For a one-owner business, the choices of entity are basically limited to a subchapter S corporation, a subchapter C corporation, or a single-member LLC (treated as a "disregarded entity" for income tax purposes). For a business with more than one owner, you can add to the list of choices a partnership. The general partnership format, like a sole proprietorship, offers no legal liability protection, so it will rarely be a good choice. However, it is discussed here because the tax rules that apply to LLCs are based on the tax rules that apply to partnerships.

What are Subchapter C and Subchapter S?

An incorporated entity is automatically a "Subchapter C" corporation unless it elects "Subchapter S" status. A "C" corporation is a separate taxable entity, subject to Federal and state income tax on its net profits. Any profits distributed to shareholders as dividends are subjected to a second level of tax at the shareholder level. If a corporation elects Subchapter S status, then the entity is largely ignored from an income tax perspective, and the shareholders are taxed directly on the profits of the corporation. The profits are <u>not</u> subject to a second level of tax when distributed as dividends. The S election has no effect on the corporation other than for income tax purposes.

Advantages of Subchapter S Election

The primary advantage of the S election is the ability to avoid the corporate level tax (i.e. double taxation). Prior to the Tax Reform Act of 1986, it was possible to let earnings accumulate inside a C corporation and bail the earnings out at a later date without a second level of tax by way of a liquidation of the entity. The Tax Reform Act of 1986, however, eliminated this loophole. Thus, the S election has been very popular since 1987 as a way to permanently avoid a second level of tax. The second level of tax is avoided either by virtue of distributions being tax free to the shareholders or upon sale of the company stock by virtue of the step up in basis of the S corporation stock for earnings retained in the corporation; neither of which is permitted for C corporations.

Owner-operated companies are frequently able to avoid the

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S-Corp vs. C-Corp vs. LLC: Which is Right For Your Business? - continued

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second level of tax by bailing all of the earnings out through payment of compensation to the employee/shareholder rather than payment of dividends. However, the IRS may seek to characterize a portion of the compensation as a constructive dividend. This has devastating consequences as the payment would still be taxable to the shareholder, but would be nondeductible for the C corporation.

Even if you are successful in bailing out the earnings of the corporation from operations each year through payment of compensation, the C corporation form may come back to haunt you upon a sale of the business. Buyers of a corporate enterprise generally wish to purchase assets rather than stock. There are two general reasons for this preference for assets over stock: (1) to avoid assumption of unknown liabilities of the selling corporation; and (2) to achieve a step-up in the tax basis of the assets. Even if your company does not have much in the way of tangible assets, it likely will have very valuable intangible assets such as customer list, favorable contracts in place, skilled work force in place, recognized name, technology, etc. Current tax law, enacted in 1993, makes all of these intangibles amortizable for income tax purposes, and thus a buyer of the business will want to be able to write the tax basis of the assets up to fair market value.

If a C corporation sells assets, it is taxed once upon the gain at the corporate level, then the proceeds are taxed again upon distribution to the shareholders. "Built-in gain" rules prevent the corporation from making an S election just prior to selling in order to avoid the corporate tax. In this scenario you might be able to insist upon a stock sale rather than an asset sale, but this may result in a reduction of the sales price.

Disadvantages of S Election

If there were no disadvantages to the S election, then obviously all qualifying corporations would make the election. Unfortunately, there are some disadvantages. The primary disadvantages of the S election are: (1) limitations on ownership structure; (2) loss of lower corporate marginal rates on taxable income of less than $75,000; and (3) restriction on allowable tax year (S corporations generally must have a calendar year).

The ownership restrictions basically require that all shareholders be individuals (US citizens or resident aliens) and that there not be more than 100 shareholders. S corporation stock cannot be owned by a corporation, partnership or other entity, other than certain qualified trusts and tax-exempt entities. The S corporation can only have one class of stock; and an S corporation cannot own more than 79% of the stock of another corporation, unless the entity is a Qualified Subchapter S Subsidiary. An S corporation can, however, be a partner in a partnership or a member of a limited liability company (LLC). The restrictions on type of shareholder and classes of stock generally prevent companies which are financed by venture capital firms from qualifying for Subchapter S treatment.

Consideration of Non-Corporate Entities

The above S vs C analysis assumes that you will utilize a corporation. However, you might instead conduct your business through either a partnership or a limited liability company (LLC).

Partnership

A partnership, much like an S corporation, is a transparent entity which is not subject to income tax. The income of a partnership is taxed on the personal returns of the partners, regardless of whether the income is distributed or retained within the entity. The partnership vehicle is much more flexible than an S corporation, in that there are (for the most part) no restrictions on ownership, and profits and losses may be allocated any way you choose, provided such allocations have substantial economic effect.

Distributions of cash from a partnership are generally not taxable to a partner unless they exceed the partner's tax basis in the partnership. Non-cash distributions are generally nontaxable even if in excess of the partner's basis. In this manner, the partnership form is more advantageous than the S corporation, in that distributions from an S corporation in excess of a shareholder's basis (which, unlike with a partnership, generally does not include the liabilities of the entity) are taxable, and distributions of non-cash assets by an S corporation can trigger taxable gain.

Partnerships fall into three categories: (1) general partnerships, (2) limited partnerships, and (3) limited liability partnerships.

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Client in the Spotlight — American Recycling Group, Inc.

American Recycling Group, Inc. is one of the largest independently owned collectors, processors and marketers of recovered paper in the Southeastern United States. Founded in 1982 by CEO Jack Lupas, the company operates recovered paper processing plants in Georgia, Alabama and South Carolina and a pulp and paper trading company with offices in those states and Wisconsin. The company, which recovers most of its paper from commercial printers, shredding companies, office complexes, manufacturing facilities and distribution centers, will handle over 270,000 tons of paper this year; much of which might otherwise end up in landfills.

Under the leadership of its executive team, Jack Lupas, Mark Zachocki, Adam Glasgow and Ron Moore, American Recycling has experienced dramatic growth while sticking to its core principles of integrity, quality and value.

Bridges & Dunn-Rankin is proud to be associated with American Recycling Group, Inc.

S-Corp vs. C-Corp vs. LLC: Which is Right For Your Business? - continued

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Partners in a general partnership can be held legally liable for any debts of the partnership. Limited partners in a limited partnership are not held liable for the debts of the partnership, but you must have a general partner in a limited partnership, which normally necessitates the formation of a corporate entity to serve this purpose. A limited liability partnership is a general partnership which has made an election to avail itself of some liability shield. This format is generally used by professional service firms such as accounting and law firms.

Limited Liability Company (LLC)

The LLC is a hybrid entity which combines the tax advantages of a partnership with the legal liability protection of a corporation. Effective March 1, 1994, Georgia enacted legislation permitting the formation of LLCs.

Many consider the LLC to be the best of all worlds, and it has become the entity of choice over the past decade. The LLC will not be the appropriate choice in all cases, however. For example:

- Self-employment tax may apply to each active individual member's share of the profits; whereas with an S-corp amounts that are reasonably classified as distributions (as opposed to salary) escape FICA tax.
- An LLC cannot engage in a tax-free merger with a corporation. It may be possible to achieve a tax-free incorporation prior to entering into a merger transaction, but this carries with it some risks and limitations.
- An LLC cannot issue "incentive stock options". It may be possible, however, to achieve a similar result by carefully structuring the allocation provisions of your LLC operating agreement.
- The hassle factor of having to issue K-1s to each owner.
- VCs generally prefer C-corps.
- Public companies generally must be C-corps, so conversion from LLC status to C-corp status would be necessary in order to do an IPO.

Conversion From One Type of Entity to Another

It is generally possible to convert from one type of entity to another, and frequently this can be accomplished tax free. However, because of the inherent risk that a taxable gain will unintentionally be triggered in the process, the specifics of your situation must be carefully analyzed before undertaking a conversion.

Summary

The choice as to the appropriate entity through which to operate your business is an important one, both from a tax and legal perspective, that can effect you for years to come. It should be addressed before starting the business, and on an annual basis thereafter.

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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 individuals.

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.

Opening for Tax Professional

Bridges & Dunn-Rankin currently has an opening for another tax professional. If you know of someone who might be a good fit for our firm, please have them send their resume to kent.bridges@bridgesdunnrankin.com.

Trivia

Last quarter's trivia question was "How much did Americans donate to charity in 2005?" The first person to respond with the correct answer of "$260 billion" was Steve Farley of Regions Bank.

Now, for this quarter's contest. Our lead article this quarter was on choice of legal entity. This quarter's trivia question is "Which state was the first to enact an LLC statute, and in what year did the IRS issue a ruling that LLCs created under its statute would be treated as partnerships for income tax purposes"?

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