

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

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Dear Clients and Friends,

October 15 marked the passing of our last major tax-filing deadline of the year. So we have had a few weeks now to catch up on some much needed rest, family time, and deferred projects, and to begin year-end planning for our clients.

With the traditional holiday season coming up, at the top of my Christmas wish list is finding a couple of outstanding tax professionals to fill openings we currently have. We get lots of resumes, but finding those candidates who are a perfect fit, and meet our high standards, is always a challenge. If you know of any candidates who you believe would be a good fit with our firm, please have them contact me.

Our extended family here continues to grow, with firm member Brock Bullard recently having his third son, Thatcher Morris Bullard.

There has been no new major tax legislation to report since the last issue of our newsletter, but there are proposals in Congress dealing with the

alternative minimum tax and the taxation of “carried interests”. In this issue we will discuss year-end tax planning strategies, taxation of “carried interests”, a recent IRS ruling dealing with vested stock becoming nonvested, 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

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 2% 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 2% 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 tax liability or 110% of your prior year tax liability. With

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Jennifer L. Curran, CPA

Member in the Spotlight – Jennifer L. Curran, CPA

Jen Curran joined Bridges & Dunn-Rankin earlier this year following a 2-year stint with Deloitte in Chicago and a brief stint at Emory working on her PhD. Jen, a native of Minnesota, holds a Bachelor of Business Administration degree (cum laude) in Accounting from the University of Notre Dame and a Master of Science in Accountancy, also from the University of Notre Dame. She remains an avid supporter of the Fighting Irish, in spite of the recent

dismal performance of their football team.

Jen and her husband T.J. (who is also a CPA, specializing in mergers & acquisitions taxation) enjoy running, golf and traveling (they seem to have friends getting married all over the country).

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

Year-end Tax Planning Strategies— continued

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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 not 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 \$500,000 in furniture and equipment for the year) can elect to immediately expense up to \$125,000 of the cost of furniture and equipment against otherwise taxable profit. If your capital expenditures for the year will be less than \$500,000 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 income tax rates on a portion of your withdrawals (the portion representing the income earned by the IRA account). The Taxpayer Relief

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Year-end Tax Planning Strategies— continued

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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.

Client in the Spotlight – Blue Ridge Mountain Water, Inc.

Visitors to our office know that they can expect to be served a cold glass of the best tasting water in Georgia. What they may not realize is that the water comes from one of our clients, Blue Ridge Mountain Water, Inc.

Blue Ridge Mountain Water was founded in 1989 by Diane Killen, with Diane, the company president, personally delivering bottles of water from the back of her Jeep. She was later joined in the business by husband Bill, and from that modest beginning the company has grown to become the second largest provider of bottled water service in Metro Atlanta. Blue Ridge specializes in delivering 5 gallon, 3 gallon, and ½ liter bottles of premium mountain spring water and providing water coolers for

homes and offices. The water is bottled at the source at their own spring on a pristine 150-acre protected reserve near Clarkesville, Georgia, and has a natural, crisp taste.

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.

As per the company's slogan, Blue Ridge is “on the way to another satisfied customer,”™ and Bridges & Dunn-Rankin is proud to be associated with Blue Ridge Mountain Water, Inc.



Proposed Legislation to Tax “Carried Interests” as Ordinary Income

There has been much in the media recently about proposed legislation to tax “carried interests” as ordinary income rather than at the more favorable long-term capital gains rate. So what is “carried interest” and what is the controversy about?

Venture capital funds, hedge funds, private equity funds and oil & gas and real estate deals are typically structured as partnerships or limited liability companies (which are taxed like partnerships), and increasingly operating companies are structured as LLCs as well. The managers of these partnerships often receive a share of the profits (or future appreciation of the entity) disproportionate to their share of the contributed capital. This so-called “carried interest” is designed to closely align their interests with that of the investors and motivate them to increase the value of the investments.

Under partnership tax law, a service provider receiving an interest in a partnership is generally only subject to tax on the receipt of the ownership interest to the extent it is a “capital interest”, meaning the amount that the partner would receive in excess of his investment if the partnership immediately sold all

of its assets for their fair market value and liquidated. “Future profits interests” on the other hand are generally not subject to tax until such profits or gains are actually realized, and then often at the more favorable long-term capital gains rate.

Following regular news reports of private equity fund and hedge fund managers reaping hundreds of millions of dollars in compensation taxed mostly as long-term capital gains, legislation was proposed in Congress to tax such “carried interests” as ordinary income. Those who support the legislation say that such is more equitable and a way to pay for relief from the alternative minimum tax for the middle class. The industries which would be primarily affected by such legislation are actively opposing it, saying it would make the U.S. less competitive and might even drive some of this activity offshore.

It's still too early to say whether such a rule change will be narrowly targeted to financial services firms, apply broadly to all service providers receiving an interest in a partnership or LLC, or pass at all, so stay tuned.

IRS Issues Ruling on Vested Stock Becoming Nonvested

Under the general rule of Internal Revenue Code Section 83, if an employee or other service provider receives stock in connection with the performance of services, such service provider has compensation income at the time the stock becomes vested in an amount equal to the excess of the value of the stock at that time over the amount paid for the stock. An exception to this general rule is that if the service provider files a "Section 83(b) election" within 30 days of receipt of the stock then the measurement and recognition of the compensation will occur at the time of receipt of the stock rather than at the time of vesting (which can be very advantageous if the stock increases dramatically in value before vesting).

Founders of start-up companies typically receive fully vested shares. However, in connection with a subsequent investment in the company an investor (typically a venture capital or private equity fund) may insist that the founders subject some portion or all of their shares to a vesting schedule in order to ensure their continued performance of services. So does this make the founders' shares which would have been taxed as long-term capital gain upon an eventual sale now potentially subject to tax at ordinary rates upon vesting?

Fortunately, a recent IRS revenue ruling says that since there has been no "transfer" of shares here, the imposition of vesting

restrictions does not cause the shares to become subject to potential taxation as compensation under Section 83.

In the case of an exchange of vested shares of one company for unvested shares of another company in a tax-free merger transaction, the IRS concluded that a favorable result could also be achieved, but only if the service provider filed a timely Section 83(b) election. In this case, the IRS concluded that a transfer had taken place for purposes of the Section 83 rules, but that the purchase price paid for the new shares was equal to their value on that date, such that no compensation income would result from the filing of a Section 83(b) election. In an identical situation involving a taxable merger transaction, the IRS reached the same conclusion, except that the service provider would have a taxable capital gain equal to the excess of value over basis on the date of the merger and get a basis step-up in the shares equal to such excess.

The gist of the above is that if you subject your vested shares to a vesting schedule in connection with a capital raise you should be okay tax-wise without further action on your part, but if you do so in connection with a merger transaction you will probably need to make a timely Section 83(b) election in order to avoid compensation income upon vesting.

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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.

Openings for Tax Professionals

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

Trivia

An article in this issue discusses proposed legislation to tax "carried interests" as ordinary income rather than long-term capital gain. This proposed legislation gained momentum earlier this year after a large and very successful private equity group announced plans to file for an initial public offering and it was disclosed that its top officers had earned hundreds of millions in compensation in 2006 and were expected to receive billions from the partnership's IPO. This quarter's trivia question is "What is the name of this private equity firm"?

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 brittany.lovvorn@bridgesdunrankin.com.