

# Tax Talk

*A quarterly publication of Bridges & Dunn-Rankin, LLP*

## Inside this issue:

|   |   |
|---|---|
| Tax Legislation on the Horizon (and the Expiring "Bush Tax Cuts") | 1 |
| Member in the Spotlight – Phil Poovey                             | 2 |
| The Small Business Jobs Act                                       | 2 |
| Year-end Tax Planning Strategies                                  | 2 |
| Client in the Spotlight – Clear Harbor, LLC                       | 3 |
| Quick Notes   | 4 |

Dear Clients and Friends,

Late November through year end is the time for year-end tax planning. Tax planning always involves some degree of uncertainty as to what the future holds, but this is especially true this year with the so-called "Bush tax cuts" scheduled to expire on December 31 and no clear indication yet as to which, if any, of these expiring tax breaks will be extended by Congress. Recent Republican gains in Congress have increased the likelihood that the lower rates may be extended for all taxpayers (and not just the low and middle income as favored by President Obama and the Democrats). We may get an answer to this during the lame duck session of Congress, or we may not know what the 2011 rates will be until sometime in 2011. Either way, we have to proceed with year-end tax planning using the best information we have and preparing for multiple possible scenarios.

In this issue we will review the potentially expiring tax provisions, summarize tax legislation enacted in late September, discuss year-end tax planning strategies, and, as always, highlight a member of our firm and one of our clients.

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

Sincerely,

*Kent Bridges*



Kent Bridges,  
Managing Partner

## Tax Legislation on the Horizon (and the Expiring "Bush Tax Cuts")

Legislation passed in 2001 reduced income tax rates on ordinary income, qualified dividends, and long-term capital gains, provided for a gradual increase in the estate tax exemption coupled with a gradual decrease in the rate, and provided for the eventual elimination of the estate tax. These so-called "Bush tax cuts" included a sunset provision, whereby, absent Congressional action to the contrary, they expire at December 31, 2010 and we revert to the pre-2001 Act tax rates and law. Here is a synopsis.

**Ordinary income tax rates** – The highest individual rate is currently 35%. Effective January 1, it is scheduled to revert to 39.6%. The rates for the lower income brackets would increase as well.

**Qualified dividend income** – Presently, the highest rate on "qualified dividends" (which includes most dividend income other than interest income equivalents like money market mutual fund dividends) is 15%. Effective January 1, the rate would revert to 39.6%.

**Long-term capital gains** – Currently, long-term capital gains enjoy a historically low Federal rate of 15%. Effective January 1, the rate would be 20%.

**Estate tax** – For persons dying in 2009, there was a \$3.5 million

exemption from the estate tax and a maximum rate of 45%. For those dying in 2010, there is no estate tax. Effective January 1, 2011, the exemption reverts to only \$1,000,000 and the top rate reverts to 55%.

**Extenders** – A number of favorable tax provisions already expired at the end of 2009, and await Congressional action for possible extension. Amongst them are the higher alternative minimum tax exemptions, research tax credit, deduction of sales tax in lieu of state income tax, charitable distributions from IRAs, and above-the-line deductions for college tuition and educator expenses. Also, absent Congressional action, the phaseouts of itemized deductions and personal exemptions for the higher income will return at pre-2006 levels.

**What is likely to happen?** While our crystal ball is far from perfect, it appears likely that the current tax rates on ordinary income, qualified dividends and long-term capital gains will be extended for at least another year for all taxpayers, that the higher alternative minimum tax exemptions, research tax credit, deduction of sales tax in lieu of state income tax, charitable distributions from IRAs, and above-the-line deductions for college tuition and educator expenses will be extended for at least another year, and that the estate tax exemption amount and rates will be temporarily set at the 2009 levels (i.e. exemption of \$3.5 million and top rate of 45%).



Phillip R. Poovey, CPA

### Member in the Spotlight – Phil Poovey

Phil Poovey joined Bridges & Dunn-Rankin three years ago as partner in charge of the firm's Accounting and Assurance Services practice. Phil, who holds a Bachelor of Accountancy with Distinction from George Washington University, started his accounting career in the audit department of KPMG in 1984. He left KPMG as an audit manager to join one of his clients, Ferro Union Southeast, as Controller and later Chief Financial Officer. His experience prior to

joining Bridges & Dunn-Rankin also includes 3 years at the CPA firm Tarpley & Underwood and 1 year operating his own CPA firm.

Phil, a native of the Atlanta area, and his wife Lauren (also a CPA) enjoy hiking and spending time outdoors with their daughters, Kendall and Rachel.

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

### The Small Business Jobs Act of 2010

While Congress has been in a long-term stalemate with respect to the expiring "Bush tax cuts", it did manage to pass in late September a \$12 billion tax incentives package titled *The Small Business Jobs Act of 2010*. Highlights of the tax provisions include:

**Bonus first-year depreciation** – For most new depreciable assets (other than buildings) placed in service during 2010, 50% of the cost can be expensed immediately, with the balance recovered under the regular depreciation rules. This special first-year deduction applies both for regular tax and alternative minimum tax. For autos and light trucks, for which first-year depreciation would otherwise be limited under the so-called "luxury automobile rules", bonus depreciation of \$8,000 may be taken (bringing the total deduction to approximately \$11,000).

**Increased section 179 expense amount** – The amount of furniture and equipment purchases that businesses can elect to immediately expense is increased to \$500,000 for purchases made during 2010 and 2011, and the level of purchases at which this benefit begins to be phased out is increased to \$2,000,000. This benefit is also now extended to cover the cost of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property.

### Year-end Tax Planning Strategies

Late November through year end 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.

**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. If you have a significant capital gain from earlier in the year (e.g. from the sale of a business), it is important to realize these losses for tax purposes before year end in order to be able to deduct them against the capital gain. You should be aware that under the "wash sale rules" if you buy the same stock within 30 days before or after you sell the stock at a loss, then your tax loss is disallowed. To the extent that you are concerned that the market may bounce back within the 30 day period and you do not

**Increased deduction for start-up expenses** – For tax years beginning in 2010, the amount of start-up expenses which can be immediately expensed is increased to \$10,000.

**Increase in exclusion for gain on sale of Qualified Small Business Stock** – For "qualified small business stock" which is purchased between September 23, 2010 and December 31, 2010 and held at least 5 years, gain from the sale of such will be free from Federal tax.

**More favorable treatment of small business tax credits** – "Eligible small businesses" (those with average annual revenue of less than \$50 million) will be able carry general business credits generated in 2010 back 5 years. Further, such credits will be able to offset both regular tax and alternative minimum tax.

**Shortening of the "built-in gains tax" period for S-corps** – C-corporations which make a Subchapter S election and then sell their assets within 10 years of electing S status are subject to a corporate level tax (the "built-in gains tax") on any unrealized gains that existed at the effective date of the S election. For asset sales which occur during 2009 or 2010, legislation enacted last year shortened this period to 7 years. For asset sales which occur during 2011, the new legislation further shortens the period to 5 years.

want to risk missing out on the recovery, you can generally buy a similar stock (or similar mutual fund) without violating the wash sale rules.

**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. 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.

(Continued on page 3)

## Year-end Tax Planning Strategies – continued

*(Continued from page 2)*

*Use of tax credits to minimize state income tax* – There are various tax credits which can be utilized to minimize or avoid state income tax. Some (e.g. the Georgia jobs credit, research credit and retraining credit) must be generated by a business entity, some can essentially be purchased (e.g. the Georgia 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). Some of these credits (e.g. the Georgia low-income housing credit) are generally priced in such a way that they really only make sense for individuals if they are in the alternative minimum tax posture.

*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 percentage 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.

*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 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.

*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.

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## Client in the Spotlight – Clear Harbor, LLC

In 2004, communications industry veterans Lee Waters and Tut Smith came together to form Clear Harbor, LLC, a company focused on providing nearshore solutions for customer care and business process outsourcing services.

Through its call centers located in the eastern Caribbean, Clear Harbor provides customer care solutions with respect to billing inquiries, account maintenance, tier 1 support, payment arrangements, order status, order entry, product troubleshooting, service call scheduling, customer welcome calls and upsell/cross selling and business process outsourcing with respect to revenue assurance, order provisioning, order compliance, warranty claims processing, account research, data verification, commission/royalty management, supply chain management, and reverse

logistics support.

Its locations in Dominica, Grenada and St. Kitts provide Clear Harbor’s clients a number of strategic advantages, including English as the primary language, local education systems based on a UK model, ties to North America which have resulted in cultural familiarity, local governments anxious to create employment opportunities for their residents, and a time zone similar to that of the U.S. The company was recently ranked 53<sup>rd</sup> on Inc. Magazine’s list of fastest-growing companies.

Bridges & Dunn-Rankin is proud to be associated with Clear Harbor, LLC.



## Year-end Tax Planning Strategies – continued

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*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 \$2,000,000 in furniture and equipment) can elect to immediately expense up to \$500,000 of the cost of furniture and equipment against otherwise taxable profit. If your capital expenditures for the year will be less than \$2,000,000 and you will be in a high rate bracket for the year, then accelerating the purchase of some equipment may be advantageous.

*Bonus first-year depreciation* – For most new depreciable assets (other than buildings) placed in service during 2010, 50% of the cost can be expensed immediately, with the balance recovered under the regular depreciation rules. This special first-year deduction applies both for regular tax and alternative minimum tax. For autos and light trucks, for which first-year depreciation would otherwise be limited under the so-called “luxury automobile rules”, bonus depreciation of \$8,000 may be taken (bringing the total deduction to approximately \$11,000).

*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.

*Net operating loss carryback claims* – Tax operating losses can generally be carried back to recover tax paid in previous years. Accordingly, if you will have a tax loss for the current year and

paid tax at a high rate in previous years, then maximizing your current year tax loss may be advantageous.

*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 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. Prior to 2010, you could only convert a traditional IRA to a Roth if your income for the year of conversion was less than \$100,000. This income limit does not apply for 2010. The conversion is a taxable event, so careful planning is necessary to determine if a conversion makes sense for you.

*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 \$13,000 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 \$26,000 per year per donee. For those with a significant number of potential heirs, this represents an opportunity to remove a significant 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 2010, 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.

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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.

### Quick Notes

- For 2010, companies with employees exercising ISOs or making ESPP purchases will be required to file new forms 3921 and 3922.
- 12/31/10 is the deadline for 409A corrections to deferred compensation plans.
- The social security wage base will remain at \$106,800 for 2011.

*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.*