Certified Public Accountants • Strategic Business Advisors

weber · obrien ltd.

WWW.WEBEROBRIEN.COM · 5580 MONROE ST., SYLVANIA, OH 43560 · 419-885-8338

2011 YEAR-END TAX PLANNING FOR BUSINESSES

THE TIME TO CONSIDER TAX-SAVING OPPORTUNITIES FOR YOUR BUSINESS IS BEFORE ITS TAX YEAR-END.

Some of these opportunities may apply regardless of whether your business is conducted as a sole proprietorship, partnership, limited liability company, S corporation, or regular corporation. Other opportunities may apply only to a particular type of business organization. This *Tax Letter* is organized into sections discussing year-end, and year-round, tax-saving opportunities for:

- All businesses
- Partnerships, limited liability companies, and S corporations
- Regular (C) corporations

Tax planning for businesses also requires consideration of the tax consequences to the individual owners. Accordingly, we suggest you also review our December *Tax Letter* titled *2011 Year-End Tax Planning for Individuals*.

This *Tax Letter* only discusses federal tax planning. However, state taxes also should be considered because the tax laws of many states do not follow the federal tax laws. Your BDO Seidman Alliance* firm client service professional may be consulted for guidance regarding individual state tax planning or multi-state tax planning opportunities when your business operates in more than one state.

This *Tax Letter* includes a discussion of a number of tax incentives that have been enacted or extended by various pieces of legislation over the last two years. The most significant was the two year extension of the current individual rate structure, including the current capital gains and qualified dividend rates to December 31, 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"). At this writing, Congress is considering additional tax legislation that would, if enacted, extend certain provisions that would expire at the end of this year. Although Congress routinely extends such expiring provisions, the outcome of this proposed legislation cannot be predicted with certainty, and it is possible that many of the provisions that would expire at the end of this year may not be extended until well into 2012, if at all.

TAX SAVING OPPORTUNITIES FOR ALL BUSINESSES

2011 VERSUS 2012 MARGINAL TAX RATES

Whether you choose to accelerate taxable income into 2011 or defer it until 2012 depends, in part, on the marginal tax rate for each year projected for your business. Generally, unless your 2011 marginal tax rate will be significantly lower than your 2012 marginal tax rate, you should defer taxable income to 2012.

The marginal tax rate is the rate applied to your next dollar of income or deduction. Projections of your business's 2011 and 2012 income and deductions are necessary to determine the marginal tax rate for each year.

* *The BDO Seidman Alliance is a nationwide association of independently owned local, regional and boutique firms.*

Your Alliance firm client service professional can be consulted to recommend how your business can shift income and deductions between these years to minimize your tax liability. (Also see our December 2011 *Tax Letter for Individuals*.)

Although the statutory tax rates for individuals and corporations are scheduled to remain unchanged between 2010 and 2011, the circumstances of an individual taxpayer may cause the marginal or effective tax rate to be higher in one year than in the other year. Moreover, inasmuch as the top tax rates in either year can be as high as 35% for individuals and corporations, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.

CAUTION: Individual tax rates are scheduled to remain the same for 2012 before increasing to rates as high as 39.6% in 2013. Congress is currently considering various proposals that may affect marginal tax rates in 2012 and beyond.

CASH VERSUS ACCRUAL ACCOUNTING

Except for farming businesses and certain qualified personal service corporations, taxable (C) corporations and partnerships that have a C corporation as a partner must use an accrual method of accounting if their average annual gross receipts for the three prior taxable years are more than $5 million, regardless of the type of business in which they are engaged. If their average annual gross receipts are $5 million or less, C corporations and partnerships that have a C corporation as a partner can use the cash method of accounting unless they have inventories, in which case they must use an accrual method of accounting.

All other taxpayers, including S corporations and C corporations that are qualified personal service corporations, can use the cash method of accounting regardless of their average annual gross receipts. However, if they have inventories, they must use an accrual method for purchases and sales, with the exception of certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million. Supplies consumed in the rendering of services are not inventory. In addition, some taxpayers in certain businesses have been successful in persuading courts that certain types of tangible property transferred to customers in connection with the provision of services are not inventory if the property is incidental to the performance of services.

The Internal Revenue Service has provided a *de minimis* exception with regard to the use of an accrual method of accounting. Under this exception, a taxpayer can use the cash method of accounting if it has average annual gross receipts of $1 million or less. If the taxpayer has inventories, it can deduct the cost of the inventory only when sold.

Planning Suggestion: A corporation that must change to an accrual method because its average annual gross receipts for the three prior taxable years exceed $5 million should consider an S corporation election if an accrual method is undesirable, assuming it is otherwise qualified to be an S corporation. An S corporation election, to be effective beginning with the current taxable year, must be made by filing Form 2553, Election by a Small Business Corporation, on or before the 15th day of the third month of the taxable year for which it is to take effect. (The Service has the authority to grant relief for a late or improperly filed Form 2553, even for a prior year.) Please consult your Alliance firm client service professional to determine whether an S corporation election is appropriate for your corporate business.

A business using an accrual method that qualifies to use the cash method may obtain permission from the Service to change to the cash method by filing an IRS advance consent Form 3115, Application for Change in Accounting Method, no later than the last day of the year of change. (An automatic consent procedure is available for certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million to change to the cash method.) On the other hand, a business currently using the cash method that wishes to voluntarily change to an accrual method may, in certain circumstances, do so automatically by filing a Form 3115 with its timely-filed income tax return (which, in most cases, will be the 2011 return). The accrual method may be desirable, for instance, if accrued expenses exceed accrued income.

Any change of accounting method must be made in compliance with IRS approval procedures. Your Alliance firm client service professional can be contacted for further information.

ADVANCE PAYMENTS

Cash-method taxpayers recognize revenue when cash is actually or constructively received. Accrual-method taxpayers

recognize revenue upon the earliest of when (1) payment is earned through performance, (2) payment is due, or (3) payment is received. However, under a May 2004 revenue procedure, payments received by an accrual-method taxpayer in advance of services being performed or goods being delivered can be deferred to the next succeeding taxable year if such payments are reported on the taxpayer's "applicable" financial statements as deferred revenue, or if earned in a later taxable year in the absence of applicable financial statements. Deferral is also available for advance payments received for the use of intellectual property, certain guaranty or warranty contracts, and the sale, lease, or license of computer software. If an accrual-method taxpayer wishes to change its present method of accounting for recognizing advance payments to a method consistent with the revenue procedure, generally such change can be made automatically by filing a Form 3115 with its timely-filed tax return.

In addition, under existing income tax regulations, advance payments received with respect to an agreement (*e.g.*, a gift card) for the sale of inventoriable goods may be deferred for two years unless required to be included in income earlier for financial statement purposes. Qualifying taxpayers wishing to change to this method of accounting are required to obtain the advance consent of the Service by filing Form 3115 with the Service no later than the last day of the year of change.

RELATED-PARTY TRANSACTIONS

Accrual-method taxpayers may not deduct salaries, bonuses, interest, rent, or other expenses owed to related cash-method parties until payments are made.

Related parties include:

- An individual and his or her more than 50%-owned corporation;
- Partnerships and their partners;
- S corporations and their shareholders;
- Two corporations having more than 50% common ownership; and
- A corporation and a partnership, if the same persons own more than 50% of each entity.

UNRELATED PARTY COMPENSATION

Accrued compensation, including vacation pay which is payable to unrelated employees, reduces an employer's taxable income. However, these deductions are also subject to restrictions. Economic performance must have occurred to generate a deduction for compensation that is otherwise fixed and determinable by the employer's year end. The Service issued additional guidance in 2011 on the application of these requirements to bonus plans. Please consult with your Alliance firm client service professional before year-end to determine if your bonus plan or plans meet these requirements.

In addition to the foregoing requirements, for the accrual-method employer to obtain a current deduction for compensation, the 2011 accrued compensation must be paid to unrelated employees (and cash-method independent contractors) within 2½ months after the end of the taxable year. Otherwise, this compensation is treated as deferred compensation and is deductible only when paid.

Note: Vested deferred compensation, although not currently deductible, is considered "wages" for FICA and FUTA tax purposes. Note also that under the section 409A deferred compensation rules discussed below and in our 2011 year-end *Tax Letter for Individuals*, certain items with deferred payment dates will now be currently taxed to the employee (with a corresponding deduction to the employer).

Planning Suggestion: Employers with taxable years that end in October, November, or December 2011 should pay accrued compensation to unrelated employees in early 2012 (within 2½ months of the employer's year-end) in order to obtain the following advantages:

- 2011 deduction for employers; and
- 2012 income for employees.

CAUTION: Individual tax rates are scheduled to remain the same in 2012 as they are in 2011. Congress is currently considering certain proposals which may increase the highest marginal rates in 2012.

DEFERRED COMPENSATION

The American Jobs Creation Act of 2004 created section 409A which imposes restrictions on the timing of distributions from, and contributions to, deferred compensation plans. While employers should have modified their existing deferred compensation plans by December 31, 2008, to conform to the section 409A rules, provisions for new plans must be in full operational compliance for all years. Companies should review plans and arrangements, especially those created during 2011, to ensure compliance with section 409A.

Companies that are noncompliant with these new rules will not incur penalties directly; however, the participants in the plans will be subject to immediate taxation of plan balances plus an additional 20% tax penalty and interest. Companies also

have a reporting requirement with respect to amounts either contributed to a plan or distributed from a plan during the taxable year. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options, stock appreciation rights, phantom stock plans, and restricted stock unit plans.

The Service issued guidance that provides businesses with a correction program if problems are discovered during the year the deferral starts or in later years. In 2010 the Service issued additional guidance that allows taxpayers to correct certain plan-document failures by December 31, 2011, with no penalties in certain instances. Corrective action for plans implemented during 2011 should be completed by December 31, 2011.

DEDUCTIBLE VERSUS CAPITALIZED COSTS

In an effort to provide more certainty as to whether various costs, especially costs that provide a benefit beyond the current taxable year, can be expensed or are required to be capitalized, the Service issued comprehensive final regulations in December 2003, regarding the treatment of costs to acquire or create intangible assets. For example, under these regulations:

- Employee compensation is deductible even if the employee's functions relate to acquiring or creating intangible assets, such as contract rights; and
- Prepaid costs to obtain a right or benefit not extending beyond the earlier of 12 months or the end of the following taxable year may be deductible.

Your Alliance firm client service professional can be consulted for information about how to change your tax method of accounting to comply with these regulations.

START-UP AND ORGANIZATIONAL EXPENDITURES

A business may elect to deduct start-up expenditures, and a partnership or corporation may elect to deduct organizational expenditures, in the taxable year in which the business begins, of an amount equal to the lesser of (1) the amount of such expenditures, or (2) $5,000, reduced by the amount by which such expenditures exceed $50,000. The remainder may be amortized over a 180-month period. If an election is not made, no amount of start-up or organizational expenditures may be deducted or amortized.

In prior years, it was necessary for a taxpayer to attach a separate election statement to its timely filed return in order to make the election. Recently finalized regulations (as well as the temporary regulations that preceded them) provide that a taxpayer is no longer required to file a separate election statement. Instead, the taxpayer is deemed to have made the election unless it chooses to forgo the deemed election by clearly electing to capitalize its organizational expenditures on a timely-filed return.

DEPRECIATION DEDUCTIONS

The timing of asset acquisitions is critical to obtain maximum depreciation deductions. Using other depreciation rules to your advantage will also reduce your taxes.

> ***Planning Suggestion:*** If you expect to buy property in 2012, you may benefit by accelerating the purchase so that you place the property in service in 2011.

Subject to the application of the bonus depreciation rules described below, the time when you place assets in service during the year establishes the amount of depreciation. Generally, all personal property is subject to a half-year depreciation convention. In other words, one half-year's depreciation is allowable for the year in which the property is placed in service. A mid-month convention must be used for real estate.

If the total basis of personal property placed in service during the last three months of a taxable year exceeds 40% of the total basis of personal property placed in service during the entire year, then a mid-quarter convention must be used instead of the half-year convention for all personal property placed in service during the taxable year.

> ***Example:*** T, a calendar year taxpayer, placed a machine in service on October 1, 2011. No other property will be placed in service during 2011. Therefore, the mid-quarter convention applies, and T's 2011 depreciation must be computed as though the machine was placed in service on November 15, 2011, instead of July 1, 2011. However, as discussed below, if the property qualifies for bonus depreciation, the entire cost of the property may be deducted regardless of the date on which the property was acquired during the year.

CAUTION: Generally, no depreciation is allowable if the property is placed in service and disposed of in the same taxable year.

AMT DEPRECIATION

The alternative minimum tax ("AMT") is imposed on corporations and individuals and is added to the regular tax if and to the extent the AMT exceeds the regular tax. AMT is based on alternative minimum taxable income ("AMTI"), which consists of a taxpayer's regular taxable income increased by various adjustments to items that for regular tax purposes result in the deferral of income (*e.g.*, accelerated depreciation) and by various tax preference items.

"Small corporations," corporations with average gross receipts of less than $7.5 million for the prior three taxable years (less than $5 million for the corporation's first three-taxable-year period), are exempt from AMT. S corporations are not directly subject to the AMT, but must report their AMT adjustments and preference items to their shareholders so that they, in turn, can determine their own liability for the AMT.

Planning Suggestion: If AMT is anticipated, and you are not able to claim the 100% bonus depreciation deduction (discussed below), you may wish to consider leasing instead of purchasing depreciable property, because depreciation computed for regular tax purposes may have to be adjusted for AMT purposes. Your Alliance firm client service professional can discuss with you the advantages and disadvantages of this and other possible measures to avoid the AMT.

ASSET EXPENSE ELECTION

Generally, if you purchase depreciable tangible personal property (including off-the-shelf computer software), you may elect to treat up to $500,000 as a deduction for property placed in service in taxable years beginning in 2011. However, the benefits of this election begin to phase out if more than $2,000,000 of qualifying property is placed in service. (The maximum amount that can be expensed ($500,000) is reduced on a dollar-for-dollar basis for eligible property placed in service in excess of $2,000,000). This asset expense election is further increased for qualifying property placed in service by a qualifying "enterprise zone business." For 2012, the maximum deduction will decrease to $139,000, with the benefits phased out for property purchases over $500,000. The asset expense election for sport utility vehicles is limited to $25,000. For property placed in service in 2011, this election is useful only in the case of property that does not qualify for 100% bonus depreciation, including used property and certain classes of real property.

BONUS DEPRECIATION

From time to time, Congress has enacted "bonus" depreciation provisions to give businesses additional first-year depreciation deductions, and thus to provide significant incentives for making new investments in depreciable tangible property. However, in an unprecedented move, the 2010 Tax Relief Act provided an unlimited deduction for the full cost of all eligible depreciable tangible personal property placed in service between September 8, 2010, and December 31, 2011. In order to qualify the property must be new; used property will not qualify.

For property placed in service in 2012, for both regular tax and the AMT, the depreciation deduction allowed on qualified tangible personal property is increased by 50% of the cost of such property.

The aggregate deduction provided by the asset expense election and bonus depreciation for 2011 and 2012 is illustrated by the following example:

Corporation X purchases and places in service new machinery (five-year property) in its calendar 2011 taxable year having a cost of $500,000. Corporation X will be entitled to a depreciation deduction in 2011 for the entire $500,000 purchase cost. If Corporation X purchases the same asset in 2012, assuming the property is subject to the half-year convention, Corporation X can elect to expense $139,000, leaving the machinery with a remaining depreciable basis of $361,000. Applying the bonus depreciation, Corporation X is entitled to a further deduction in 2011 of $180,500 (50% of $361,000), leaving the machinery with a remaining depreciable basis of $180,500. Standard first-year depreciation for five-year property under the half-year convention is 20%, providing Corporation X with further depreciation on the machinery of $36,100. Accordingly, Corporation X is entitled to a total expense and depreciation deduction of $355,600 in 2012 on its $500,000 machinery purchase.

Please consult your Alliance firm client service professional for further information.

Planning Suggestion: Plan purchases of eligible property to assure maximum use of this annual asset expense election

and bonus depreciation.

LEASEHOLD IMPROVEMENTS

Tax consequences should be considered when negotiating a lease. Generally, the cost of leasehold improvements must be depreciated over 39 years rather than over the lease term. However, when the lease terminates, the tenant may deduct any unrecovered cost Qualified leasehold, restaurant, and retail improvement property is depreciated over 15 years using the straight-line method, rather than over 39 years, for property placed in service before January 1, 2012. Qualified leasehold improvement property is any improvement to the interior portion of nonresidential real property made under or pursuant to a lease by the lessee, sublessee, or lessor. The improvement must be part of the interior of the building that is used exclusively by the lessee or sublessee and must be placed in service more than three years after the date the building was first placed in service.

PERSONAL PROPERTY VERSUS REAL PROPERTY

For regular tax purposes, real property depreciation deductions are available over 27½ years for residential rental property and 39 years for nonresidential property. However, depreciation deductions may be accelerated for real property components that are essential to manufacturing or other special business functions.

Example: Taxpayer constructed a $10 million manufacturing facility, which was placed in service during 2010. The design required an overhead crane, a special reinforced foundation to support equipment, and other specific features to accommodate the manufacturing process. A cost segregation study revealed that approximately $5 million of the facility's cost can be recovered over seven years instead of 39 years for regular tax purposes.

Planning Suggestion: Arrange for a cost segregation study to identify personal property and determine optimum depreciable lives for both new and prior acquisitions and construction. The position of the Service is that the present depreciation method for property previously misclassified can be changed, and the full amount of any prior depreciation understatement can be deducted in the current year. Your Alliance firm client service professional can be consulted for further information and assistance.

DEDUCTIBLE REPAIR AND MAINTENANCE COSTS VERSUS CAPITAL COSTS

For regular tax purposes, costs must be capitalized that add to the value of property, substantially prolong the useful life, or adapt the property to a new or different use. Costs not meeting those criteria are potentially eligible for current deduction as a repair and maintenance deduction. These criteria can lead to a more generous repair and maintenance deduction for tax purposes compared to the book treatment, capitalizing such costs.

Example: Taxpayer incurred $500,000 in costs for a $10 million facility to repair walls, replace broken light fixtures, apply new paint inside and out, repair damaged floor, and reseal the floor. Such costs are potentially deducible as repair and maintenance expenses for tax purposes.

Planning Suggestion: Deductible costs capitalized in current and prior taxable years can be deducted in the current year, net of any prior depreciation claimed. Arrange for a fixed asset review to identify deductible

repair and maintenance costs. Your Alliance firm client service professional can be consulted for further information and assistance.

RESEARCH TAX CREDIT

The Research & Development Tax Credit ("R&D Tax Credit") is available for taxpayers that make investments to try to develop or improve their products, manufacturing processes, and software. In 2008 corporations in almost every industry reported over $8.3 billion in R&D Tax Credits.

Many sizeable R&D opportunities, however, go unnoticed or unclaimed:

- Many taxpayers believe they must be doing basic or revolutionary research to qualify, even though most of the $8.3 billion relates to the kind of general product, process and software development and improvement activities most manufacturers and many companies in other industries perform.
- Many taxpayers miscalculate their credits – sometimes by a factor of thousands – because the rules for calculating the credit are complicated and not fully accounted for in the software used by even the largest of companies and accounting firms to prepare tax returns.
- Many taxpayers continue to believe that old and higher standards for qualification and documentation still apply, even though they have been abandoned, *e.g.*, the "discovery test" and pre-filing documentation requirements the Treasury Department promulgated in 2001 but abandoned in 2004.

If your business attempts to develop or improve products, manufacturing or other processes, software, techniques, formulae, or the like – even if only incrementally – now is the time to assess whether your business is taking full advantage of this valuable incentive.

The R&D Tax Credit is based on three types of payments: (1) qualified research expenditures ("QREs", *i.e.*, certain expenses paid or incurred, generally, for product, process, and software development and improvement activities); (2) payments to qualified organizations for basic research; and (3) payments to energy research consortia for energy research. Credits based on QREs and basic research payments are incremental; those based on energy research payments are not.

With respect to 2011 year-end planning, taxpayers need to be aware that the 2010 Tax Relief Act extended the R&D Tax Credit through December 31, 2011. Congress has routinely extended the R&D Tax Credit in the past, but there is no guarantee Congress will continue to do so.

For more information about the R&D Tax Credit (including reporting on financial statements and the availability of any state tax benefits—most states provide benefits for R&D, and more than ten of them provide *refundable* benefits), please contact your Alliance client service professional.

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

The American Jobs Creation Act of 2004 included a tax deduction with respect to income from certain domestic production activities (section 199). For taxable years beginning in 2010 and beyond, the deduction has been fully phased in at nine percent of "qualified production activities income" subject to certain limitations. Qualifying domestic production activities may include:

- Manufacture, production, growth, or extraction of tangible personal property;
- Film production;
- Electricity, natural gas, or water production;
- Construction or renovation of real property; and
- Engineering and architectural services.

COMPUTER SOFTWARE COSTS

The tax treatment of costs to develop, purchase, or lease computer software is as follows:

- Software development costs, including the costs of customizing and implementing purchased software, may be treated as either current expenses and deducted in full or as capital expenditures and amortized ratably over 60 months from the completion of the development or 36 months from the date the software is placed in service.
- The cost of purchased software that is separately stated from the cost of computer hardware may be amortized ratably over 36 months beginning with the month the software is placed in service.
- The cost of leased software may be deducted as paid or incurred.

If you have treated software costs differently in a prior year, a change of accounting method can be made. Your Alliance firm client service professional can be consulted for further information.

EMPLOYMENT-RELATED CREDITS

The work opportunity credit is available (even against the AMT) to employers that pay wages to an individual who is a member of a "target group." An individual who fits into one of the following target groups qualifies for the credit: (1)

qualified Temporary Assistance to Needy Families ("TANF") recipient; (2) qualified veteran; (3) qualified ex-felon; (4) designated community resident; (5) vocational rehabilitation referral; (6) qualified summer youth employee; (7) qualified food stamp recipient; (8) qualified SSI recipient; (9) Hurricane Katrina employee.

If the worker works at least 400 hours in the first year, the credit is 40% of the first $6,000 of wages paid. If the worker works at least 120 hours and less than 400, the credit is 25%. Therefore, once the employee works the requisite 120 hours, he qualifies the previous 120 hours for the 25% credit. Once the employee works the requisite 400 hours, he or she qualifies the previous 400 hours for the 40% credit. In some cases, the employer may want to extend the tax return to qualify some workers for the 40% credit.

A welfare-to-work credit is available to employers of long-term family assistance recipients. A "long-term family assistance recipient" is a member of a family receiving assistance under TANF or successor program for specified time periods.

The amount of the credit is equal to 35% of the "qualified first-year wages" and 50% of the "qualified second-year wages." The amount of qualified wages with respect to an individual cannot exceed $10,000 per year. Thus, the maximum credit is $8,500 per qualified employee.

If a welfare-to-work credit is allowed to an employer with respect to an individual for any taxable year, the employer cannot also take a work opportunity credit with respect to that individual for that taxable year.

Employers are also eligible to receive a tax credit equal to 25% of qualified expenses for employee child care facilities and ten percent of qualified expenses for employee child resource and referral services, up to $150,000 per taxable year.

The Hiring Incentives to Restore Employment Act of 2010 created a credit in 2011 for certain employees that qualified for exemption of the employer's share of the OASDI tax in 2010. The credit is the lesser of $1,000 or 6.2% of the wages paid during the 52-week period.

PASSIVE LOSSES

Generally, passive losses currently offset only passive income. Unused passive losses are carried to future years. An unused (suspended) loss generally is deductible when a taxpayer disposes of his interest in the passive activity. Regulations define "activity" broadly.

Personal service corporations ("PSCs") are subject to the passive loss restrictions. "Closely-held C corporations" (other than PSCs) can use passive losses to offset active income except for interest, dividends, or other portfolio income. A closely-held C corporation is defined as a C corporation in which more than 50% of the value of its outstanding stock is owned by five or fewer individuals.

Planning Suggestion: Your Alliance firm client service professional can assist you in determining whether it would be advisable for you to transfer personally owned passive loss activities to your closely-held corporation (if it is not a PSC). Also, if you anticipate having unusable passive losses this year, those losses may be available to offset gains from partnership or S corporation distributions in excess of your basis.

Passive losses of S corporations and partnerships are passed through to their owners. Special rules apply to publicly-traded partnerships.

RENTAL REAL ESTATE

For real estate professionals, rental real estate activities are not subject to the passive loss rules if, during a taxable year:

- More than 50% of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. However, in determining material participation, a spouse's participation is taken into account. Services performed as an employee are ignored unless the employee owns more than five percent of the employer.

In determining whether a taxpayer materially participates in any of his real estate activities for purposes of applying this test, each interest of the taxpayer in rental real estate must generally be treated as if it were a separate activity. However, the taxpayer may alternatively elect to treat all of his interests in rental real estate as a single activity. The election is irrevocable but is often necessary to qualify.

A closely-held C corporation will satisfy these tests if more than 50% of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

INVENTORIES

For taxable years beginning after 1986, specified overhead costs, which previously were deductible, had to be capitalized by being added to inventory. This accounting method change increases taxable income to the extent that inventory is on hand at year-end. Special rules apply to LIFO inventories.

> ***Planning Suggestion:*** Some taxpayers either have not complied with these uniform capitalization rules, or have either included too little or too much overhead into their inventory cost. Your Alliance firm client service professional can help you review whether changes should be made to your inventory costing method. The Service provides incentives for voluntarily making corrective changes to accounting methods.

INVENTORY SHRINKAGE

Businesses that do not take a physical inventory count at the end of their taxable year may accrue a deduction for estimated inventory "shrinkage" at year-end. Inventory shrinkage is a catch-all amount attributable to items such as undetected theft, breakage, and bookkeeping errors, which cause a taxpayer's actual inventory to be less than the amount recorded on its books. In estimating shrinkage at year-end, businesses may take into account their experience in prior years, sometimes adjusted for special circumstances and other factors that management considers appropriate.

The adoption of a method of estimating inventory shrinkage is a change of accounting method, which requires conformity with IRS procedures. Your Alliance firm client service professional can be consulted for further information.

LIFO INVENTORIES

Use of the LIFO method, in inflationary times, allows a taxpayer the ability to increase deductions and lower taxable income. This is accomplished by removing the impact of inflation from ending inventory.

> ***Planning Suggestion:*** Taxpayers using LIFO should monitor their inventory levels to avoid invading LIFO inventory layers and a resulting increase in taxable income.

The Service issued generally favorable LIFO rules in 2002 to allow taxpayers to elect a revised inventory price index computation ("IPIC") method. Contact your Alliance firm client service professional to discuss whether this election would benefit your business.

CAUTION: If a corporation using the LIFO method elects to be an S corporation, it must include in income for its last taxable year as a regular corporation its "LIFO recapture amount," computed as follows:

Example:	
Inventory's value at FIFO	$2,000,000
Less inventory's value at LIFO	1,600,000
LIFO recapture amount	$ 400,000

Any resulting tax is payable in four equal installments without interest. The first installment must be paid on the due date, without extensions, of the return for the last taxable year as a C corporation. The next three installments must be paid by the due date, without extensions, of the S corporation's tax return for the succeeding taxable years.

RESCINDING A TRANSACTION

Because tax consequences are based on an annual accounting concept that uses the facts as they exist at the end of a taxable year, transactions occurring during the year may be disregarded if properly rescinded before year-end.

Example (1): A calendar-year taxpayer sells property at a gain on July 1, 2011. If the buyer and seller properly rescind the sale by December 31, 2011, the sale is disregarded for tax purposes.

Example (2): A regular corporation and its shareholders are calendar-year taxpayers. The shareholders make capital contributions to the corporation during 2011 for an expansion project which is later abandoned. If the capital contributions are properly rescinded and returned to the shareholders by December 31, 2011, the contributions will be treated as though they were never made and thus will have no tax effect. However, if they are returned after 2011, they may be treated as dividends or other taxable distributions.

CAUTION: State-law considerations should be taken into account in determining whether a transaction may be rescinded. Your Alliance firm client service professional and your attorney should be consulted if you wish to rescind a transaction and achieve tax consequences as if the transaction and rescission had not occurred.

TAX SAVING OPPORTUNITIES FOR PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND S CORPORATIONS

PARTNERSHIPS

Regulations governing the allocation of partnership income and loss can sometimes lead to unanticipated results. The allocation of losses may be particularly sensitive to routine changes in partnership liabilities. Even if these changes do not affect allocations, they may trigger income to the partners in certain circumstances. Contributions, distributions, and interest transfers can also present income recognition issues. Many of these issues depend on the position of the partnership at the end of its taxable year. Therefore, unforeseen tax consequences can often be mitigated with year-end planning. For example, the implementation of loan guarantees or indemnification agreements can sometimes prevent tax problems related to partnership liabilities.

A partnership must generally file its federal income tax return by the 15th day of the fourth month following the end of its taxable year, but an automatic extension is available upon request. In past years, the due date for a partnership return could be automatically extended for six months, so that a calendar-year partnership could file its return as late as October 15. For tax returns due after December 31, 2008, the Service will automatically grant partnerships an extension of only five months. As a result, the due date of a partnership return for the year ending December 31, 2011, can now be extended only until September 15, 2012. These changes also affect the due dates for the returns of estates and trusts.

The reason for the change is to ensure that partners will receive their Schedules K-1 in time to accurately report their share of partnership income by the extended due dates of their returns. Thus, while the change imposes a burden on partnerships that will have less time for gathering and processing year-end accounting information, it may also make it easier for partners to file complete and accurate returns on a timely basis.

LIMITED LIABILITY COMPANIES

Generally, the same federal tax rules that apply to a partnership also apply to a two-or-more member limited liability company ("LLC") that is properly classified as a partnership, rather than a corporation, under applicable income tax regulations. Under these same regulations, a single-member LLC owned by an individual can choose to be classified either as a disregarded entity, *i.e.*, sole proprietorship (Schedule C business), or as a corporation, and a single-member LLC owned by a corporation can choose to be classified as a disregarded entity, *i.e.*, part of its corporate owner or a division, or as a separate corporate subsidiary.

S CORPORATIONS

With individual income tax rates equal to or close to corporate tax rates, now may be the time to consider making an S corporation election for your regular corporate business, if eligible. Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation in order to take advantage of anticipated losses.

Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.

- If the corporation has earnings and profits ("E&P") on hand which were accumulated during the time it was a regular corporation, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Because loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a written document to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (15%) capital gains tax rate.
- Distributions to shareholders which exceed the corporation's accumulated adjustments account ("AAA") may result in inadvertent dividends if the corporation has E&P accumulated from the time it was a C corporation. Therefore, distributions should be delayed if the amount of the AAA balance at year-end is uncertain.
- Until December 31, 2012, dividends received by non-corporate shareholders from domestic and qualified foreign corporations are taxed at a maximum 15% rate. Accordingly, S corporations with C corporation E&P may wish to consider making an actual or a deemed dividend distribution of this E&P, which would be taxed to its shareholders at the present maximum 15% dividend rate. Congress is expected to consider legislation that will extend the 15% dividend rate beyond 2012, but the outcome of that process cannot be predicted.
- Consider making gifts of S corporation stock to shift income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation). A built-in gain is determined as follows:

Example:	
Total gain on asset's sale	$1,000,000
Less appreciation accruing while an S corporation	300,000
Built-in gain	$ 700,000

If an S corporation has sold property and recognized built-in gains, it should consider offsetting these gains by recognizing built-in losses. Alternatively, the built-in gains tax may be deferred or, in some circumstances, eliminated if the corporation's taxable income can be eliminated.

CAUTION: Estimated taxes must be paid on net recognized built-in gains. (These estimates cannot be based on the preceding year's tax, if any.)

Recent changes have temporarily suspended the application of the built-in gains tax for certain S corporations that converted from C corporation status several years ago. For taxable years that began in 2009 or 2010, the tax was not imposed if the S corporation had completed seven taxable years of its "recognition period" before the year of the sale or other disposition of the built-in gain asset. For the first taxable year that began in 2011, the tax will not be imposed if the S corporation has completed five years in the recognition period. For taxable years beginning in 2012 or later, the temporary suspension will no longer apply, and the full ten-year built-in gains tax recognition period will apply.

Other changes have made more corporations eligible to become S corporations. For instance, financial institutions not using the reserve method of accounting can become S corporations; S corporations can have up to 100 shareholders and in determining the number of shareholders, extended family groups can be treated as a single shareholder; certain tax-exempt organizations can be shareholders; S corporations can hold controlling interests in other corporations; and wholly-owned domestic subsidiaries of S corporations can be disregarded as entities separate from their parent S corporations if an election is made by the S corporation.

In addition, income allocable to an employee stock ownership plan ("ESOP") as a shareholder of an S corporation is not currently taxed, but rather is taxed to the ESOP beneficiary at the time of distribution.

Note: The American Jobs Creation Act of 2004 and the Small Business and Work Opportunity Tax Act of 2007 made several liberalizing changes with respect to S corporations.

TAX SAVING OPPORTUNITIES FOR C CORPORATIONS

RETENTION OF CORPORATE EARNINGS

The present 35% top rate for individuals may exceed the marginal tax rate of your corporation. In this case, it may be desirable to retain corporate income by deferring compensation to employee-shareholders.

CAUTION: A corporation that accumulates E&P beyond its reasonable business needs may be subject to an additional 15% tax on its accumulated taxable income. However, up to $250,000 in E&P may generally be accumulated before this tax applies. Special rules pertain to holding, investment, and personal service corporations.

PERSONAL SERVICE CORPORATIONS

PSCs are denied the benefit of the lower corporate tax brackets and are taxed at a flat 35% rate. A PSC is a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and also meets certain stock ownership tests.

PSCs and certain small businesses on an accrual method of accounting are permitted to eliminate from accrued service income an amount that, based upon experience, will not be collected.

CAUTION: A PSC that elected a fiscal year is subject to a "minimum distribution" requirement. Such a PSC must monitor the level of payments (compensation, rent, etc.) to employee-shareholders to avoid postponing part or all of the deduction for these payments. Therefore, if your top individual tax rate exceeds the top rate of tax applicable to your corporation, it may be advisable to terminate a fiscal-year election, if you have not done so already.

CORPORATE STOCK AND STOCK OPTIONS

A corporation may obtain a deduction by the issuance of its stock or stock options to pay otherwise deductible expenses. For example, stock issued to employees or independent contractors constitutes deductible compensation to the issuer at the time the stock is unconditionally vested. In the case of nonqualified stock options, the deduction is generally available when the option is exercised.

CAUTION: The issuer is only allowed a deduction if the employee or independent contractor includes the same amount of the deduction in income. This requirement is deemed satisfied if the issuer timely files a Form W–2, in the case of an employee, or a Form 1099, in the case of an independent contractor.

New reporting requirements also went into effect in 2010 for certain transfers of incentive stock options ("ISOs") and options granted under a qualifying employee stock purchase plan ("ESPP"). Forms 3931, Exercise of an Incentive Stock Option Under Section 422(b) and 3922, Transfer of Stock Acquired Through An Employee Stock Purchase Plan must be filed not later than January 31, 2012, for 2011 ISO exercises and ESPP purchases.

Planning Suggestion: For stock vested upon transfer (including transfer via the exercise of an option), fiscal-year corporations may take the deduction in the taxable year such stock is transferred to the employee or independent contractor, rather than waiting until the next taxable year in which the employee's or independent contractor's taxable year ends. If this is a change in method of accounting, a Form 3115 will be required no later than the last day of the year of change.

Disqualifying dispositions of incentive stock options ("ISOs") by employees during the year will also result in compensation deductions for the employer. Companies that have issued ISOs to their employees should determine whether there have been any disqualifying dispositions of the underlying stock during the year.

Stock or stock options (warrants) issued to a lender could also result in deductible "original issue discount" as the result of allocating a portion of the issue price away from the debt instrument.

Your Alliance firm client service professional can be consulted for further information regarding ISOs and nonqualified stock options. Also see our discussion of stock options in our 2011 *Tax Letter for Individuals.*

ESTIMATED TAXES

Corporate estimated tax payments may significantly affect your business's cash flow. Accordingly, planning for the lowest required payment is essential. The requirements differ for small and large corporations.

A small corporation is one that had taxable income of less than $1 million for each of the three preceding taxable years. Conversely, a large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable

years. Taxable income, for this purpose, is computed without net operating and capital loss carryovers and carrybacks.

A small corporation may base its estimated tax payments on the preceding year's tax liability. However, a large corporation may base only its first estimated tax payment on the preceding year's tax liability. For either type of corporation, an estimate may be based on the preceding year's tax only if the preceding taxable year consisted of 12 months and the preceding year's return showed a tax liability.

Estimated tax payments that cannot be based on the prior year's tax can be based on 100% of the expected tax for the current year or tax calculated on the current year's annualized income. The annualized income method provides a safe harbor from estimated tax penalties if the expected tax for the entire year is difficult to determine. If the annualized income method is used, payments are made as follows:

Installment Number	Annualization Period	% of Tax to Be Paid
1	1st 3 months of taxable year	25
2	1st 3 months of taxable year	50
3	1st 6 months of taxable year	75
4	1st 9 months of taxable year	100

Alternatively, a corporation may annually elect one of the following annualization periods:

Installment Number	Optional Annualization Periods		
	I	or	II
1	1st 2 months of taxable year		1st 3 months of taxable year
2	1st 4 months of taxable year		1st 5 months of taxable year
3	1st 7 months of taxable year		1st 8 months of taxable year
4	1st 10 months of taxable year		1st 11 months of taxable year

Option I or II must be elected by the due date of the first quarterly installment for each year. Form 8842, Election to Use Different Annualization Periods for Corporation Estimated Tax, can be used to make the election.
In some cases, lower payments may be made under the adjusted seasonal installment method. No estimated taxes are required for a particular year if the tax shown on the return for that year is less than $500.

Estimated taxes also are required if there is an AMT liability for the current year.

Final regulations for corporate estimated tax payments, issued in August 2007, apply to taxable years beginning after September 6, 2007. These regulations provide a general rule that taxpayers using the annualized income method must annualize items incurred during the quarter, as well as special rules for specific deductions and extraordinary items.

Planning Suggestion: A corporation anticipating no 2011 tax should consider taking action to produce a small tax by reporting low taxable income so that estimated 2012 tax payments can be based on 2011 tax.

Examples:
- X Corporation will have a $100 net operating loss and no tax for 2011. X must pay 2011 estimated taxes based on its 2012 regular or AMT income to avoid penalties.
- Y is a small corporation. Its 2011 return will show a $500 tax liability. Y will be able to pay only $500 as 2012 estimated taxes and avoid penalties, even though its actual 2012 tax may be much higher. If Y's 2012 tax is $100,500, it would pay the $100,000 balance on March 15, 2013.

"QUICK REFUND" FOR EXCESS ESTIMATED TAX

If estimated taxes paid exceed the expected annual tax, a corporation may apply for a "quick refund" (on Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax) of the excess tax before the tax return is filed, but only if this excess tax is at least $500 and ten percent of the expected annual tax. This quick refund may be requested after the close of the corporation's taxable year, but no later than the 15th day of the third month following the end of the taxable year (the original due date of the corporation's income tax return). The Service must act on this refund application within 45 days after it is filed.

Example: Z, a calendar-year corporation, paid $50,000 in estimated taxes for the first three quarters of 2011. In the fourth quarter of 2011, Z incurs a large loss so that the tax due for the year is expected to be only $10,000. Z may request a $40,000 refund after December 31, 2011, and by March 15, 2012. The Service must act on Z's refund application within 45 days after it is filed.

POSTPONING TAX PAYMENTS IF NET OPERATING LOSS EXPECTED

Generally, a taxpayer cannot obtain an extension of time for paying a tax. However, if a corporation expects an NOL for the current year, it may extend the time for paying the tax for the immediately preceding taxable year. The postponement is available only for tax payments due after this extension is filed and applies to the extent that the NOL can be carried back to preceding taxable years. Although the tax payment is postponed, interest is still charged from the original due date of the tax payment until the original due date of the current year's return.

Example: Q, a fiscal year corporation, determines that it will have an additional $30,000 tax to pay on December 15, 2011, for its taxable year ended September 30, 2011. Q also expects to have a $100,000 NOL for its year ending September 30, 2012, which may be carried back to one or more of its preceding taxable years. Q files Form 1138, Extension of Time For Payment of Taxes By a Corporation Expecting a Net Operating Loss Carryback, before December 15, 2011, to extend the time for paying the $30,000 tax otherwise due on December 15, 2011. Interest on the postponed tax payment will be charged from December 15, 2011, until December 15, 2012.

EXPEDITED REFUND CLAIM IN HARDSHIP CASES

If a corporation incurs an NOL in the current year, it may request a "quick refund" from a carryback of that NOL by filing Form 1139, Corporation Application for Tentative Refund, on or after the date of filing the tax return for the NOL year-but not later than one year after the end of the NOL year. Generally, the Service must act on this refund request within 90 days of its filing. If Form 1139 is not timely filed, the corporation must file an amended tax return (Form 1120X) for the prior year to carry back the NOL.

In extreme cases, where a corporation can demonstrate hardship if it has to wait even 90 days for the refund, the taxpayer also should file Form 911, Application for Taxpayer Assistance Order to Relieve Hardship. We have been successful in obtaining refunds within a week or two where a desperate need for the refund was demonstrated, such as the need to meet payroll.

PLANNING FOR NET OPERATING LOSSES

NOLs are a valuable corporate attribute. Even net operating losses that were not fully reported on a prior year return can be carried forward. However, the ability to use an NOL carryforward may be limited where a loss corporation has experienced a change of stock ownership–for example, as a result of a merger or acquisition, the issuance of new stock, or the acquisition of outstanding stock by a five-percent shareholder. Your Alliance firm client service professional can assist you with the appropriate planning needed to preserve and maximize the use of NOLs by your corporate business.

SUCCESSION AND FAMILY BUSINESS PLANNING

Year-end is the traditional gift-giving season. This should also be a time to plan for your company's succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes. We urge you to consult with your Alliance firm client service professional for ideas to preserve your family wealth.

CONCLUSION

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely-held entities requires a delicate balance between planning for the business and planning for its owners.

This 2011 year-end *Tax Letter for Businesses* and our 2011 year-end *Tax Letter for Individuals* cannot cover every tax-saving opportunity that may be available to you and your business. Inasmuch as taxes are among your largest expenses, we urge you to meet with your Alliance firm client service professional. We can provide a comprehensive review of the tax-saving opportunities appropriate to your particular situation.