

# Formation and Start-Up Tax Info Sheet (2008)

## ENTITY COMPARISON

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• Easy to form.</li> <li>• Simple to operate.</li> <li>• Easy to sell the assets of the business.</li> <li>• Few administrative burdens.</li> <li>• No separate tax filings.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited sources of capital.</li> <li>• No limited liability.</li> <li>• No continuity beyond the proprietor.</li> <li>• All business net income is subject to self-employment tax.</li> </ul>
<b>Partnerships</b>	
<ul style="list-style-type: none"> <li>• More sources of initial capital than proprietorships.</li> <li>• More management resources.</li> <li>• Less administrative burdens than corporations.</li> <li>• Income is generally taxed only at partner level.</li> <li>• Income and loss allocations can be flexible.</li> <li>• Termination can be tax-free.</li> </ul>	<ul style="list-style-type: none"> <li>• Transferring interests difficult.</li> <li>• No liability limitation unless a limited partner or a limited liability partnership.</li> <li>• Generally, all business net income is subject to self-employment tax.</li> <li>• Income tax and basis adjustment rules are complex.</li> <li>• Partners are entitled to few of the tax deductible employee fringe benefits.</li> </ul>
<b>Limited Liability Partnerships (LLPs)</b>	
<ul style="list-style-type: none"> <li>• Favorable pass-through taxation status.</li> <li>• Flexibility to structure ownership interests.</li> </ul>	<ul style="list-style-type: none"> <li>• Partners may be personally liable for entity obligations, their own acts and those of persons they supervise.</li> </ul>
<b>Limited Liability Companies (LLCs)</b>	
<ul style="list-style-type: none"> <li>• Members have limited liability.</li> <li>• Number of members unlimited.</li> <li>• Members may be individuals and all types of entities.</li> <li>• Double taxation is avoided.</li> <li>• Members can participate in management.</li> <li>• Members generally not personally liable for LLC debt (but personal guarantees often required of owners).</li> <li>• Distributions do not have to be proportional to owners.</li> <li>• Different ownership classes.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited life, often terminates on the death or bankruptcy of a member.</li> <li>• Transferring interests is difficult.</li> <li>• Not all industries or professions can use LLCs.</li> <li>• LLC laws vary by state.</li> <li>• The various LLC laws are relatively new and untested in nontax matters.</li> <li>• For tax purposes, the complex partnership rules apply.</li> <li>• Members will often be subject to self-employment tax.</li> </ul>
<b>Corporations</b>	
<ul style="list-style-type: none"> <li>• Can raise capital through the sale of capital stock.</li> <li>• Owners have limited liability.</li> <li>• Unlimited corporate life.</li> <li>• Relatively easy to transfer ownership interests.</li> <li>• Generally have more management resources.</li> <li>• S corporation income taxed to owners.</li> <li>• For C corporations, most dividends taxed at a favorable 15% (or lower) federal rate at the individual level.</li> <li>• C corporation owner-employees may receive the full array of employer-provided tax free fringe benefits.</li> <li>• Distributions from S corporations usually payroll tax free.</li> </ul>	<ul style="list-style-type: none"> <li>• C corporation income is taxed and dividends are taxed to owners.</li> <li>• Administrative burdens.</li> <li>• Difficult to form.</li> <li>• Dissolution can trigger tax.</li> <li>• Borrowing may be hard unless stockholders guarantee debt.</li> <li>• S corporations limited to 100 shareholders.</li> <li>• S corporations can have only one class of stock.</li> <li>• S corporations can't have corporate, partnership or nonresident alien shareholders.</li> <li>• S corporations generally must choose a calendar year.</li> <li>• More-than-2% S shareholders pay taxes on fringe benefits.</li> <li>• Tax rate on S corporation income may be higher than for C corporation.</li> </ul>

## BUSINESS PLAN USES

- Obtain financing (whether from loans or equity investments).
- Provide a yardstick against which future performance will be measured (especially by lenders and investors).
- Keep management and employees focused when the inevitable problems and distractions arise (by identifying critical goals and implementation tasks—thereby providing a framework for decision making and activity coordination).
- Define the business culture that will be communicated to employees, customers, suppliers, etc.



## LEASING VS. BUYING

Item	Leasing	Buying
<b>100% financing</b>	Leases provide 100% financing, but a security deposit may be required.	Loans generally require a down payment.
<b>Cash flow</b>	Lower initial cash requirements and lower periodic payments.	Larger initial cash requirements and periodic payments.
<b>Cancellation option</b>	May grant the lessee the option to cancel, passing the risk of obsolescence of the asset to lessor.	Purchases can only be cancelled by selling the asset.
<b>Fixed payments</b>	Lease payments typically are fixed.	Loans may have variable interest rate.
<b>Maintenance costs</b>	Lessee can often obtain a maintenance contract as part of an equipment lease—the lessor assumes responsibility for maintenance.	Purchasers may be able to obtain maintenance contracts, but they usually pay an additional fee.
<b>Operating restrictions</b>	Leases typically do not have restrictive covenants.	Loans may contain covenants that impose operating restrictions.
<b>Access to funds</b>	Leasing companies often evaluate a lessee's credit history on shorter terms than banks.	Banks may require several years of financial information and operating history before granting a loan.
<b>Borrowing capacity</b>	Operating leases are an off-balance-sheet financing technique. They do not affect the lessee's working capital or debt to equity ratios.	Loans usually affect financial ratios and borrowing capacity.
<b>Residual value benefits</b>	Residual values usually accrue to benefit the lessor. If residual value is conservatively estimated, lessor can profit from selling the asset at a price above the residual value.	All benefits from residual values (that is, salvage value) are acquired by the purchaser.
<b>Residual value risk</b>	In open-end leases, the lessee incurs the risk of a decline in value.	There are no residual value guarantees with purchases.
<b>Interest rates</b>	The implicit interest rates usually are higher than comparable loan rates because lease payments include a profit component.	Loans usually have lower interest rates.

# Personnel and Compensation Tax Info Sheet (2008)

## EMPLOYMENT LAWS

Any new employer will need to become familiar with a multitude of labor laws and regulations, including:

- Immigration Reform and Control Act of 1986.
- Civil Rights Act (Title VII on employment discrimination).
- Equal Employment Opportunity Act.
- National Labor Relations Act.
- Fair Labor Standards Act.
- Employee Retirement Income Security Act (ERISA), Pension Reform Act of 1974.
- Consolidated Omnibus Budget Reconciliation Act (COBRA).
- Occupational Health and Safety Act.
- Right-to-Know Chemical Act.
- Federal Rehabilitation Act of 1973.
- Age Discrimination in Employment Act.
- Drug Free Workplace Act of 1988.
- Vietnam Era Veterans Readjustment Assistance Act of 1974.
- Worker Adjustment and Retraining Notification Act of 1988.
- Americans with Disabilities Act of 1990.
- Family Medical Leave Act of 1993.
- Equal Pay Act.
- Fair Minimum Wage Act of 2007.



The Department of Labor website ([www.dol.gov](http://www.dol.gov)) includes a wealth of information for employers. It also includes information on various state labor laws.

New business owners should consider conferring with an employment lawyer for advice on the many labor laws and regulations.

## EMPLOYING FAMILY MEMBERS

### Advantages of Hiring Children in the Family Business

**Income Shifting.** The business owner deducts reasonable compensation paid to the child and the child receives and reports earned income from compensation, which is often taxed at a lower rate than the business income would have been. A child claimed as a dependent is entitled to a standard deduction equal to the greater of \$900 or earned income plus \$300, up to a maximum of \$5,450 for 2008.

**Fringe Benefits.** The child-employee may be eligible to participate in employer-sponsored fringe benefit arrangements (that is, health and disability insurance, employer-provided vehicle for business travel).

**Payroll Tax Exemption.** Wages and compensation paid by a sole proprietorship (or partnership, if the parents of the child are the only partners) to the proprietor's (or partner's) child who is under age 18 are exempt from Social Security payroll taxes. Similarly, this compensation is exempt from federal unemployment tax if the child of the proprietor (or partner) is under age 21. However, federal income tax withholding will apply unless the child can claim an exemption from withholding.

**Individual Retirement Account (IRA) Opportunity.** Earned income paid to the child enables the child to fund an IRA contribution [up to the lesser of \$5,000 (for 2008) or 100% of earned income]. Usually, the child will qualify to make a deductible contribution to a traditional IRA since he is either not covered by an employer retirement plan or his income is beneath a certain level. A Roth IRA, which potentially allows all earnings to be tax-free, may be another attractive option for a child, due to the child's long horizon for saving. The ability to compound income either tax-deferred or tax-free for many years is a powerful way to build wealth.

## ADVANTAGES OF INDEPENDENT CONTRACTOR STATUS

By hiring independent contractors, rather than employees, a business:

- Would not have to withhold federal, state or local income taxes;
- Would not have to withhold and pay matching payroll taxes;
- Would not have to pay federal and state unemployment or disability taxes;
- Would not have to meet federal and state overtime or minimum wage laws;
- May exclude the workers from retirement plans and fringe benefits; and
- May exclude the workers from workers' compensation coverage.

## EMPLOYER STOCK OPTIONS

A stock option is a contractual right granted an employee to purchase shares of the company's stock under a formal plan. The plan normally specifies how many options may be granted, who may participate, the option price, the form of payment, the periods for exercising options and making payment, and other matters.

### Stock Option Terminology

<b>Grant Date</b>	The date on which an employee receives an option.
<b>Exercise Date</b>	The date when the employee exercises the option to buy stock.
<b>Strike Price</b>	The price at which the stock can be purchased under the terms of the option.
<b>Bargain Element</b>	The difference between the fair market value (FMV) of the stock and the strike price.
<b>Even-Money</b>	When the strike price equals the FMV of the stock.
<b>In-the-Money</b>	When the strike price is less than the FMV of the stock.
<b>Under Water</b>	When the strike price is greater than the FMV of the stock.
<b>Vested</b>	No restrictions on transferability.
<b>Vesting</b>	Attaining the right to exercise options because service or other requirements have been met.
<b>Incentive Stock Options (ISOs)</b>	Also called qualified stock options, they must meet certain statutory requirements. Generally, an ISO benefits the employee by allowing for capital gains taxation on the future appreciation of the underlying stock.
<b>Nonqualified Stock Options (NQSOs)</b>	Not subject to any specific statutory rules. They generally create compensation income for the employee and an offsetting deduction for the employer upon exercise.

### Tax Implications of Incentive Stock Options (ISOs)


- Neither the grant nor the exercise of an ISO creates compensation income to the employee, but the employee may have an alternative minimum tax adjustment upon exercise.
- The exercise price becomes the purchase price and the employee's basis in the acquired stock.
- The employee recognizes taxable income or loss when the stock acquired through the option's exercise is disposed of.
- The character of the income (ordinary versus capital gain) from the sale of the ISO shares depends on whether the sale is a qualifying or disqualifying disposition.



# Financing Tax Info Sheet (2008)


## PRIVATE SOURCES

*The easiest to obtain and usually the lowest cost*

<b>Personal Resources</b>	Loans or equity contributions from the owner's personal resources. <i>Advantage:</i> obtain more quickly than other sources. <i>Disadvantage:</i> lose availability of funds for future personal emergencies.
<b>Friends or Relatives</b>	May take the form of debt, equity or a hybrid debt with an option to convert to equity. <i>Advantage:</i> often available at a lower cost of capital due to the relationship between the parties. <i>Disadvantages:</i> may result in inadequate financing or financing at terms that inhibit the ability of the business to operate or grow; may lead to later friction between the parties. 
<b>Vendor Credit</b>	Vendors tend to relax their credit constraints as the company begins operation.
<b>Customer Deposits</b>	Customer prepayment funds the working capital needed to manufacture or provide the product or service the customer will ultimately receive.

## SHORT-TERM FINANCING

*Demand notes and funds due in one year or less*

<b>Maintenance Contracts</b>	Contract with a customer in which the company guarantees service for a specified period in return for a set fee paid in advance. <i>Advantage:</i> advance payment is not recognized as income until the service is performed, but business has the money in the bank to fund operations. <i>Disadvantage:</i> business is committed to providing maintenance and repair services that may cost more than the revenue generated from any one contract. 
<b>Lines of Credit</b>	Agreement with a bank to borrow up to a specified amount whenever needed, with interest paid only on amount actually borrowed. To obtain a line of credit, business ordinarily must pledge certain assets as collateral, generally including accounts receivable, inventory and any other short-term assets.
<b>Demand Notes</b>	Note has no fixed term; is callable by lender. May be unsecured or secured by owner's personal assets.
<b>Accounts Receivable Financing</b>	Provides an acceleration of collections by receiving today what would have been collected in the future. May take the form of (1) advances against accounts receivable, (2) factoring or (3) credit cards.
<b>Inventory Financing</b>	Loans collateralized by specific items or total inventory. Lenders usually provide less money for a given value of inventory than for an equal value of receivables.
<b>Construction Loans</b>	Loan funds are drawn as construction of commercial property progresses, and repaid from proceeds of permanent financing (normally a long-term mortgage loan) obtained when project is completed.
<b>Asset-Based Lending</b>	Asset-based lenders will make loans to companies that are highly leveraged or lack strong cash flow, and may accept collateral that is not attractive to banks. <i>Advantage:</i> typically no compensating balance requirements or extensive loan covenants. <i>Disadvantage:</i> lender charges higher interest rates, maintains tighter controls over collateral and often values collateral very conservatively.


## MEDIUM-TERM FINANCING

*One to five years; may be secured or unsecured*

<b>Equipment Financing</b>	Manufacturers and suppliers of machinery, equipment and vehicles often provide financing.
<b>Leasing Arrangements</b>	A popular way to obtain business equipment. <i>Advantages:</i> conserves cash because of the small down payment, generally is less restrictive than a debt agreement and provides some protection against obsolescence because the business may return the equipment at the end of the lease term. <i>Disadvantage:</i> the business does not own the asset at the end of the lease term, although the equipment can often be purchased for a nominal amount.
<b>Term Loans</b>	Loans of 1 – 10 years secured by specific machinery and equipment with fixed or variable interest rates, depending on the bank. Most banks will normally advance 70% to 95% of the FMV of new machinery or equipment and 50% to 80% of the quick sale value of used machinery or equipment.
<b>Government Loan Programs</b>	U.S. Small Business Administration ( <a href="http://www.sba.gov">www.sba.gov</a> ), National Science Foundation ( <a href="http://www.nsf.gov">www.nsf.gov</a> ) and Departments of Energy ( <a href="http://www.doe.gov">www.doe.gov</a> ), Housing and Urban Development ( <a href="http://www.hud.gov">www.hud.gov</a> ), Interior ( <a href="http://www.doi.gov">www.doi.gov</a> ), Commerce ( <a href="http://www.commerce.gov">www.commerce.gov</a> ) and Agriculture ( <a href="http://www.usda.gov">www.usda.gov</a> ). In addition, some state and local agencies provide financing.

## LONG-TERM FINANCING

*Difficult to obtain except for mortgage loans*

<b>Equity Financing</b>	Potential sources include private investors, other companies and early employees of the business who want to participate in its growth. <i>Advantages:</i> generally cheaper than debt because there is no interest cost; does not have to be repaid. <i>Disadvantages:</i> issuing equity to new shareholders dilutes the owner's holdings; the additional owners may insist on participating in management, which could cause conflicts.
<b>Venture Capital</b>	Venture capitalists typically invest \$1,000,000 or more in a company expecting that in three to five years it will be worth considerably more. 
<b>Angel Investors</b>	Venture capitalists who typically invest between \$50,000 and \$500,000 in business start-ups; may demand a lower return on their investment and be willing to invest for longer periods.
<b>Mortgage Loans</b>	If the business owner has significant equity in his personal residence, the proceeds of a home equity loan can be used to fund initial start-up costs; loan terms can range up to 20 years.
<b>Layered Financing</b>	Uses several financing sources at one time; should be considered if a single source fails to meet the business's needs. May be attractive to potential financing sources because it allows them to share financing risks. However, it can be time-consuming and complex since the business is pursuing multiple financing sources with differing requirements at the same time.

# Fringe Benefits Tax Info Sheet (2008)

## VALUING PERSONAL USE OF COMPANY OWNED AUTOS

An employer can value an employee's use of a company car (for income tax withholding, payroll taxes and W-2 reporting) based on what it would cost the employee to lease a comparable car. Since this is usually impractical, three special valuation methods are available to employees.

### Availability of Special Valuation Methods

	Annual Lease Value	Commuting Value	Cents per Mile
Car provided to control employee	OK	Can't Use	OK
Car's FMV over \$15,000 (\$15,900 for light trucks and vans) in 2008	OK	OK	Can't Use
Non- <i>de minimis</i> personal use other than commuting	OK	Can't Use	OK
Car (1) not regularly used for business and (2) driven <10,000 miles/year	OK	OK	Can't Use

Annual lease value (ALV) is based on an auto's fair market value (FMV) on the day made available to an employee for personal use. The personal-use percentage (based on miles driven in the year) of the ALV is taxable income to the employee.

### Annual Lease Value Table

Automobile FMV	Annual Lease Value
\$ 20,000 to 20,999	\$ 5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

If FMV > \$59,999, ALV equals  $(.25 \times \text{FMV}) + \$500$ .

Employer-provided fuel must be added at FMV or at 5.5¢ per mile.

## HEALTH SAVINGS ACCOUNTS

Individuals whose only health insurance is a high deductible health plan can make HSA contributions.

### High Deductible Health Plans (2008)

Coverage	Minimum Annual Deductible	Out-of-Pocket Expense Limit*
Individual	\$ 1,100	\$ 5,600
Family	\$ 2,200	\$ 11,200

\* Policy premiums don't count as out-of-pocket expenses.

### 2008 HSA Contribution Limits

Individual has Self-Only Coverage	\$ 2,900
Individual has Family Coverage	\$ 5,800
Additional deductible contribution for taxpayers age 55 – 65	\$ 900

## FRINGE BENEFITS

### Permitted Cafeteria Plan Benefits

Tax-Free Benefits	Taxable Benefits
<ul style="list-style-type: none"> <li>Accident and health insurance premiums including for accidental death or dismemberment insurance and dental insurance.</li> <li>Premiums for COBRA coverage.</li> <li>Contributions to Health Savings Accounts.</li> <li>Contributions to a 401(k) plan.</li> <li>Group-term life insurance coverage (up to \$50,000).</li> <li>Disability insurance coverage.</li> <li>Dependent care assistance (up to \$5,000).</li> <li>Flexible spending account (FSA) arrangements for medical expenses, adoption expenses or dependent care assistance.</li> </ul>	<ul style="list-style-type: none"> <li>Premiums for group-term life insurance over the \$50,000 tax-free coverage limit.</li> <li>Medical coverage, group-term life insurance coverage and benefits under a dependent care assistance program that are taxable income to the recipient employee because applicable nondiscrimination requirements for these benefits are not met.</li> </ul>



### Monthly Imputed Income per \$1,000 of Group-Term Life Insurance Coverage

Employee's Age	Imputed Cost
Under 25	\$ .05
25 through 29	.06
30 through 34	.08
35 through 39	.09
40 through 44	.10
45 through 49	.15
50 through 54	.23
55 through 59	.43
60 through 64	.66
65 through 69	1.27
70 and older	2.06

**Note:** Table cost is pro-rated if less than a full month of coverage.



# Retirement Plans Tax Info Sheet (2008)

## QUALIFIED RETIREMENT PLANS

### Retirement Plan Advantages

- Contributions to the plan are deductible by the employer when made, but not taxed to the employee until distributed.
- Funds accumulate tax-deferred for retirement.
- Attracts qualified employees and retains existing employees.
- Encourages loyalty among existing employees by requiring a specified number of years of service before an employee is entitled to employer contributions (known as vesting).
- Offers a benefit competitive with other companies that offer qualified plans.
- Usually very favorable for self-employed individuals.
- Funds accumulated in a plan are not subject to the claims of either the employee's or employer's creditors.
- Certain plans allow employees to make plan contributions on a pre-tax basis.

### Retirement Plan Disadvantages

- Some plans must meet complex requirements to keep the plan's tax favored status.
- Some plans are expensive and time-consuming to operate.
- Some plans are subject to special top-heavy rules that require minimum contributions for lower-paid employees and more rapid vesting of benefits.
- Some plans must file Form 5500.
- Plan fiduciaries, including the plan administrator, must act in the best interest of participants and beneficiaries. Fiduciaries are not only subject to significant penalties if they breach this responsibility, they may also be personally liable for any losses to the plan resulting from the breach.
- Depending on the type of plan, an annual contribution may be required.



### Qualified Plan Special Rules

<b>Eligibility</b>	Employees who are age 21 or older and who have completed a year of service must generally be allowed to participate in the plan.
<b>Coverage</b>	The plan must cover a broad range of employees and cannot discriminate in favor of owners or key employees.
<b>Vesting</b>	Participants generally must be entitled to 100% of their plan benefits after five years of service (seven years of service if graded vesting begins after two years of service).
<b>Nondiscrimination</b>	Plan contributions and benefits cannot discriminate in favor of owners or key employees.

## QUALIFIED RETIREMENT PLAN TYPES

**Defined benefit plans** promise specific benefits at retirement. For example, the plan might promise to pay an employee at retirement 80% of his average salary for the last five years of employment. The employer is required to make annual contributions to fund this benefit. This amount must be determined by an actuary.

**Defined contribution plans** provide benefits based on the amount contributed to an employee's individual account plus any earnings or forfeitures of other employees that are allocated to the account. The amount available at retirement equals whatever is in the employee's account at that time.

Defined contribution plans include:

- Profit-sharing plans.
- Money purchase pension plans.
- 401(k) plans.



For 2008, contributions plus plan forfeitures allocated to a participant's account cannot exceed \$46,000 or, if less, 100% of the participant's compensation.

### Employer Deduction Limits

<b>Defined Benefit Pension Plan</b>	Amount necessary to satisfy annual minimum funding standard. Must be actuarially determined.
<b>Profit-Sharing Plans and SEPs</b>	Up to 25% of total compensation paid to all plan participants.
<b>SIMPLE IRA Plans</b>	The employer matching or nonelective contribution, whichever is required.

## PAYROLL DEDUCTION IRAs

- Payroll deduction IRAs are an economical way to encourage employees to save for retirement. In effect, the employer collects employee IRA contributions and transmits them to the custodian or trustee.
- Contributions cannot exceed the lesser of the employee's compensation or \$5,000 for 2008 (\$6,000 if age 50 or older).

## SIMPLIFIED EMPLOYEE PENSIONS (SEPs)

- An SEP allows an employer to make contributions to employees' IRAs. Although designed for small businesses, any employer, regardless of its size or number of employees, may establish an SEP. Subject to limitations, contributions paid to an SEP are deductible by the employer and excluded from the employees' income until withdrawn.
- Employees who are age 21 or over, performed services for the employer for at least three of the immediately preceding five years and received at least \$500 from the employer must be allowed to participate.
- For 2008, contributions are generally limited to \$46,000 or, if less, 25% of the participant's compensation. Contributions must be made under a nondiscriminatory written allocation formula.


## SIMPLE IRA PLANS

- SIMPLE IRA plan is a salary reduction arrangement under which employees can elect to have part of their paychecks contributed to an IRA.
- SIMPLE IRAs must cover all employees who received at least \$5,000 in compensation from the employer during any two prior years, and who are reasonably expected to receive that much or more in the current year.
- A SIMPLE IRA can only be established by an employer that had 100 or fewer employees earning at least \$5,000 during the preceding calendar year.
- Employee elective deferrals are limited to \$10,500 (\$13,000 if age 50 or older) for 2008. Employers must generally make either 3% matching or 2% nonelective contributions.

# Travel, Meals and Entertainment Tax Info Sheet (2008)

## 50% LIMIT ON MEALS AND ENTERTAINMENT

With some exceptions (see below) the deduction for meals and entertainment expenses is limited to 50% of the amount that otherwise qualifies for deduction.

Meals and Entertainment Costs Not Subject to the 50% Limit		
Expense	Description	Example
Advertising	Meals or entertainment provided to the general public to advertise or create goodwill.	Distributing free food and beverages to the public; sponsoring a TV or radio show.
Meals/entertainment sold to customers	The taxpayer is in the business of furnishing meals and entertainment.	Restaurants deduct the full cost of meals served to customers; night clubs deduct performer costs.
Charitable sports event	A ticket to a charitable sports event (including a meal) if: <ul style="list-style-type: none"> <li>The event's main purpose is to benefit a qualified charitable organization,</li> <li>The entire net proceeds go to the charity and</li> <li>The event uses volunteers to perform substantially all the work.</li> </ul>	The cost of a charity golf tournament package, including dinner after the golf. <div style="text-align: center;">  </div>
Nonemployee prizes and awards	Meals and entertainment costs reported to a non-employee recipient on Form 1099.	As a sales promotion, a business holds a drawing and awards a customer a dinner cruise.
Meals and entertainment for the benefit of employees	Costs for recreational, social or entertainment gatherings that primarily benefit rank and file (rather than highly compensated) employees.	Company outings (such as a summer picnic) and banquets or other gatherings (such as the annual Christmas party) for employees and their guests.
De minimis fringe benefits	Costs of benefits that are tax-free <i>de minimis</i> fringe benefits.	Employers provide their employees with free coffee and soft drinks or subsidized meals (on a nondiscriminatory basis) in a cafeteria on or near the employer's business premises.
Meals furnished on the employer's premises for the employer's convenience	The cost of such meals are fully deductible, even though they are excluded from the employee's income.	Paramedics are furnished meals in a hospital cafeteria so that they will be available to respond to emergency calls.



## RECORDKEEPING FOR T&E

Expenses for travel and entertainment (T&E) cannot be estimated. The taxpayer must be able to prove (1) that he or she incurred a deductible expense and (2) the amount. Usually, entries on an expense report or log, along with canceled checks or bills to support claimed expenses are adequate to support a deduction.

Requirements for Documentary Evidence	
Type of Document	Requirements
Hotel Receipt	<ul style="list-style-type: none"> <li>Hotel's name and location.</li> <li>Dates taxpayer stayed there.</li> <li>Separate amounts for charges such as lodging, meals and telephone calls.</li> <li>A credit card statement alone is not sufficient evidence for a lodging expense.</li> </ul>
Restaurant Receipt	<ul style="list-style-type: none"> <li>Restaurant's name and location.</li> <li>Number of people served.</li> <li>The date and amount of the expense.</li> <li>If a charge is made for items other than food and beverages, the receipt must show that this is the case.</li> </ul>
"Ticketless" Airfare	<ul style="list-style-type: none"> <li>Copy of an email or fax of the airline itinerary/receipt.</li> </ul>
Cancelled Check	<ul style="list-style-type: none"> <li>A cancelled check along with a bill from the payee or other evidence that there was a business purpose.</li> <li>A cancelled check by itself does not prove a business expense.</li> </ul>
Situations where documentary evidence is <i>not</i> needed	<ul style="list-style-type: none"> <li>Expenses, other than lodging, that are less than \$75.</li> <li>Transportation expense for which a receipt is not readily available.</li> </ul>

## PER DIEM REIMBURSEMENTS

Instead of reimbursing actual expenses, employers can use a *per diem* allowance to reimburse employees for business travel expenses away from home.

If the employee substantiates the time, place and business purpose of the travel, the amount will be deemed substantiated, up to the lesser of:

- 1) The *per diem* allowance paid or
- 2) The amount based on the federal *per diem* rate for the locality of travel.

If an employer's *per diem* rate exceeds the federal *per diem* rate, the excess is taxed to the employee and subject to payroll and withholding tax.

Employees who are not reimbursed by their employers and self-employed individuals can also use the *per diem* method to compute their deductions for meals and incidental expenses (M&IE) when traveling on business. However, they can't deduct a *per diem* amount for lodging—they must deduct actual expenses.

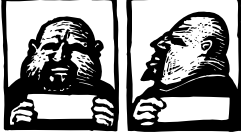
Who Can Use Per Diem Rates?			
Taxpayer	M&IE and Lodging	M&IE Only	IE Only
Self-employed taxpayer	No	Yes	Yes
Employer reimburses unrelated employee	Yes	Yes	Yes
Employer reimburses more than 10% owner	No	Yes	Yes
Unreimbursed employee	No	Yes	Yes

# Dealings With Owner


## Tax Info Sheet (2008)

### RENTALS WITH OWNERS

#### Advantages of C Corporation Shareholders Receiving Rents and Royalties From Their Business

<b>Avoiding Payroll Taxes</b>	<p>Rental income from real estate is exempt from the self-employment (SE) tax. Rental income from personal property may be exempt from SE tax. Royalties are not subject to SE tax unless earned in an activity that is a trade or business.</p> 
<b>Avoiding Corporate-Level Gain</b>	Retaining ownership of real estate and other tangible or intangible assets with high probability of appreciating outside the corporation avoids the potential for triggering corporate-level gain when those assets are sold or distributed.
<b>Retirement Cash Flow</b>	Retaining valuable assets outside a closely held corporation allows the shareholder-lessor to continue to receive cash flow from the corporation in the form of rents or royalties, even though the shareholder sells or is no longer actively employed by the corporation.
<b>Business Transition</b>	Retaining assets outside the corporation allows ownership of the business entity and the ownership of business assets to be segregated. For example, a controlling shareholder-lessor may want to dispose of some or all of the corporate stock but retain a significant portion of the business assets for lease to the entity. This can help transfer ownership and control to the successor generation by minimizing the corporation's value (that is, the corporation contains only operating assets such as receivables and inventory, with fixed assets owned individually by a passive or investor shareholder).

#### Potential Traps When Paying Rents to C Corporation Shareholders

<b>Reasonableness of Rent</b>	<p>Rental payments that are too high in relation to the property's fair rental value face possible reclassification as constructive dividends or compensation. Rents that are too low face the possibility of IRS imposing constructive receipt of rental income (creating income that wasn't actually received).</p> 
<b>SE Tax Risks of Equipment Rental</b>	Real estate rentals and personal property that is leased with real estate is exempt from SE tax. However, SE tax applies to personal property leased to a corporation if the leasing activity is considered a trade or business of the lessor.
<b>Passive Income Recharacterization</b>	Net rental income (gross income net of expenses) is recharacterized from passive to nonpassive. Therefore, other passive losses cannot be used to offset this income.
<b>Timing Rule</b>	An accrual basis closely held corporation cannot deduct lease payments payable to a cash basis individual owner until the amount is includable in income of the owner.

### OWNER DEBT

#### Advantages of C Corporation Debt Owed to Owners

Advantage	Description
<b>Interest Deduction</b>	The interest payments to the owner from the corporation are deductible by the corporation, allowing cash payments to the owner without the double taxation burden of dividends or the payroll tax burden of compensation. However, the interest is not deductible until includable in the shareholder's income.
<b>AET Avoidance</b>	The requirement for a corporation to make debt payments can be used as a legitimate reason for the corporation to retain earnings without being exposed to the accumulated earnings tax (AET). The AET prevents C corporations (other than personal holding companies) from accumulating taxable income indefinitely and without economic need.
<b>Cash Extraction</b>	Loan principal payments are recovered tax-free by the owner.
<b>State Tax Savings</b>	Owner debt may reduce the corporation's franchise tax liability because in many states, the franchise tax is based on the net asset value of the company (unless the particular state requires owner-provided debt to be added back to equity for franchise tax purposes).

#### Advantages of Owner Debt Issued to Pass-Through Entities

- Owners can fund the business capital needs without altering their ownership percentages.
- Potential franchise tax savings in states that tax the entity on its equity.
- Owners obtain an increase in the tax basis of their ownership interest to allow deductions for pass-through losses.

### PARTNER HEALTH INSURANCE PREMIUMS PAID BY PARTNERSHIP

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as distributions to the partner, the partnership cannot deduct the premiums.

**Note:** A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income on Form 1040. However, the partner cannot deduct the premiums for any calendar month or part of a month in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner or the partner's spouse.

### PAYING PARTNERSHIP EXPENSES

Individual partners are often required to incur business expenses that will not be reimbursed by the partnership (travel, entertainment, etc.). Partners are generally not entitled to deduct partnership expenses on their individual income tax returns. However, if the partnership's agreement or practice requires a partner to pay certain partnership expenses from his own funds, with no right to reimbursement from the partnership, the partner is entitled to deduct (above the line, in arriving at AGI) these as trade or business expenses on his personal return.

**✂ Strategy:** Partners should make explicit the "requirement" that partners incur partnership expenses without right of reimbursement, either as a provision of their partnership agreement or through a written policy of the partnership.

# Business Dispositions

## Tax Info Sheet (2008)

### CLASSIFYING GAINS AND LOSSES

The sale of business assets results in taxable gains and losses to the seller. Gain or loss must be determined for each asset sold—this requires allocating part of the total sales price to each asset when multiple assets or an entire business are sold.

Whether a sale yields capital (lower tax rate) or ordinary (higher tax rate) gains or losses depends on the classification of the assets sold. Assets fall into three categories:

Capital Assets	Tax Code Section 1231 Assets	Other (Ordinary Income) Assets*
Property <i>other than</i> : <ul style="list-style-type: none"> <li>• Inventory.</li> <li>• Trade receivables.</li> <li>• Real and depreciable trade or business property.</li> <li>• Certain copyrights; musical, literary and artistic compositions; letters; memoranda; and U.S. government publications.</li> </ul>	<ul style="list-style-type: none"> <li>• Real and depreciable trade or business property held more than one year.</li> <li>• Intangible personal property amortizable under Code Section 197.</li> <li>• Certain livestock; certain timber, coal and domestic iron ore.</li> <li>• Certain unharvested crops.</li> </ul>	<ul style="list-style-type: none"> <li>• Inventory.</li> <li>• Trade notes and accounts receivable.</li> <li>• Real or depreciable trade or business property that would be Code Section 1231 property if held long enough.</li> </ul>
<p>* <b>Note:</b> The sale of these other assets generates ordinary gains and losses that do not receive any special tax treatment.</p>		

### CAPITAL GAINS AND LOSSES

**Holding period.** Capital gains and losses must be separated according to how long the property was held.

**Short-term.** Capital asset is held for one year or less.

**Long-term.** Capital asset is held for more than one year.

**Individuals.** For individual taxpayers (including business sole proprietors), net capital gains receive preferential tax treatment.

- The maximum rate on an individual's net long-term capital gains is generally 15%.
- The capital gains rate falls to 0% if the taxpayer is otherwise in the 10% or 15% tax bracket beginning after 2007.
- A 28% maximum rate applies to gains from the sale of collectibles held over 12 months.
- Short-term capital gains are taxed at ordinary rates.



**Partnerships, LLCs and S corporations.** Capital gains and losses are passed through to partners (LLC members) and shareholders, and the capital gain rules then apply to the owners based on their type of entity.

**C corporations.** Net capital gains are taxed at the same rates as ordinary income. Net capital losses can't be deducted in the current tax year. However, a net capital loss can be carried back three years or forward five years to offset capital gains.

### TAX CODE SECTION 1231 GAINS AND LOSSES

**Section 1231 gains and losses receive special tax treatment:**

- A net Section 1231 gain for the year is treated as a capital gain.
- A net Section 1231 loss for the year is treated as an ordinary loss.
- Section 1231 gains and losses from partnerships, LLCs and S corporations are passed through to the owners, and these rules are applied at the owner level.

**Applicable rates—individuals:**

- A 25% rate applies to gain up to the amount of depreciation not already treated as ordinary income recapture (see following).
- Gains over and above the ordinary income and unrecaptured amounts qualify for the 15%/0% maximum rate.

**Applicable rates—corporations:**

- There is no difference in the corporate tax rate on capital gain income versus ordinary income.
- The distinction between ordinary income and capital gain income becomes significant when a corporation has capital losses that can only be offset against capital gains.

### ORDINARY INCOME RECAPTURE

- Gains from selling certain depreciable real estate, personal property and other assets are taxed as ordinary income for some or all of the taxable gain (Code Section 1245 and 1250 recapture).
- Includes gains from amortizable intangible personal property.
- Gain in excess of ordinary income recapture is Section 1231 gain.
- No recapture when a business asset is sold at a loss.
- C corporations are subject to additional recapture rules for depreciable real estate.
- The Tax Code contains other recapture provisions, such as those for oil, gas and other mineral properties.

#### C Corporation Stock Sales

Pros	
	<ul style="list-style-type: none"> <li>• Usually the simplest transaction.</li> <li>• Assuming the stock is not registered with the SEC, a transaction can be closed quickly.</li> <li>• Favorable tax consequences to the owner because it generates capital gain.</li> <li>• Deferred payments usually qualify for installment reporting, which defers the owner's tax liability to the year payments are received.</li> </ul>
Cons	
	<ul style="list-style-type: none"> <li>• Purchasers are generally willing to pay less for stock than for the business assets, since all of the corporation's known and unknown liabilities remain with the stock.</li> <li>• Potential liabilities or unwanted assets may make it difficult to find a purchaser willing to acquire stock at a price at which seller is willing to sell.</li> <li>• Commercial lenders often will not lend funds necessary to purchase a closely held business, forcing sellers to finance the sale and significantly defer their cash proceeds.</li> <li>• A seller financing the sale retains risk since repayment depends on the success of the purchaser running the business.</li> </ul>

### INSTALLMENT SALES

- An installment sale is any property sale where at least one payment is received after the close of the tax year of the sale.
- Under the installment method, the seller recognizes a portion of each payment as taxable gain when payment is received. Each payment will usually consist of three parts: (1) interest, (2) gain on sale and (3) recovery of basis.
- Losses are not eligible for installment reporting.
- The installment sale reporting rules are mandatory unless the seller elects out of them.

**What is the benefit to the seller?**

The benefit of reporting gain using the installment method is that it enables the seller to report the gain over several years. Thus, the seller's tax on the sale is normally paid as cash is received.

**Caution:** All gain subject to ordinary income recapture is taxed in the year of sale, even with an installment sale.

# Valuation Tax Info Sheet (2008)

## BUSINESS VALUATION PURPOSES

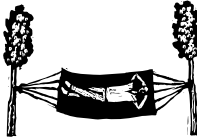
- The purchase or sale of part or all of a business.
- Buy/sell agreement purposes.
- Noncompete agreements.
- Valuation of an interest for estate or gift tax purposes.
- Divorce proceedings.
- Financial reporting.
- Valuation for personal financial statements or to obtain financing.
- Mergers, recapitalizations and dissolutions.
- Valuation for condemnation, business interruption or other damage or loss.
- Property tax valuation protests.



## BUSINESS VALUATION TERMS

<b>Appraisal</b>	The act or process of determining value, an appraisal is an opinion of the value of an asset or an ownership interest of a business enterprise. However, a business's value can depend on the circumstances.
<b>Book Value</b>	This accounting term refers to a specific asset's historical cost less any allowances for depreciation, amortization or unrealized losses. For a business, book value is its owners' equity (the excess of total assets over total liabilities on the balance sheet).
<b>Fair Market Value (FMV)</b>	The most widely recognized and accepted standard of value. Many provisions in the Tax Code refer to FMV, which is the price of property as it changes hands between a willing buyer and a willing seller when the former is under no compulsion to buy and the latter is under no compulsion to sell and both parties have reasonable knowledge of the relevant facts. This definition is commonly used by the IRS, the courts and valuation consultants. It assumes a hypothetical arm's length sale without regard to a specific buyer or seller.
<b>Fair Value</b>	In valuations, the term is not the same as in accounting literature. Rather, it stands for the statutory (or court-determined) standard that generally applies in dissenting-shareholder suits and in corporate dissolutions under some states' laws. Almost all interests valued under this standard are minority interests. In some states, if a business agrees to a merger, sale, etc., and the minority owners believe they will not get adequate consideration, they may have their interests appraised and receive fair value in cash. In these cases, the valuation consultant considers the factors established by relevant statutes and case law, which may include market values, individual asset values, methods commonly used in the financial community and other factors. It is important to obtain legal advice in connection with a fair value valuation.
<b>Going-Concern Value</b>	Based on the business being valued as a viable operating entity. It may also refer to the intangible elements of a business arising from such factors as having in place a trained, qualified work force; an operating plant; and the required licenses, systems and procedures.
<b>Intrinsic Value</b>	Some valuation consultants use this term interchangeably with investment value. Others consider intrinsic value to be based on the analysis and judgment of an independent security analyst, investment banker or financial manager. In court cases, it often is not defined clearly and may refer to FMV, fair value or some other type of value. Valuations based on this term need a clear definition of the meaning.
<b>Investment Value</b>	The value of an asset or business to a specific owner or a prospective owner. Accordingly, this considers the owner's or prospective owner's knowledge, abilities, related business interests, expectations of risks and earning potential and other factors. The key point is that investment value is an owner-specific concept.
<b>Liquidation Value</b>	Sometimes called breakup value, it assumes a company's operations will cease and its individual assets will be sold (or otherwise disposed). It usually is determined by a liquidation. An orderly liquidation means selling the assets over a reasonable period to maximize sales proceeds. A forced liquidation (auction value) means selling the assets as quickly as possible, such as at an auction. Liquidation value (orderly or forced) considers not only the proceeds from selling the assets, but also the selling costs, the costs to hold the assets until their sale and other expenses. Typically, this represents the lower limit of value.

## VALUATION APPROACHES AND METHODS

Approach	Method
<b>Income</b> —value is determined by estimating future ownership benefits and discounting them to present value.	<b>Capitalized returns:</b> Capitalization of earnings Capitalization of net cash flow
	<b>Discounted future returns:</b> Discounted net cash flow Discounted future earnings
<b>Market</b> —value is determined by analyzing recent sales of comparable companies.	<b>Value multiples using guideline company data or transactions:</b> Price/earnings (P/E) Price/dividends Price/gross cash flow Price/book value Price/revenues Price/net asset value
	
<b>Asset-Based</b> —value is based on the values of its individual assets.	<b>Underlying assets:</b> Net asset value Liquidation value
<b>Other</b>	Excess earnings Rules of thumb Multiple of discretionary earnings Business specific methods

## VALUATION REPORT CHARACTERISTICS

<b>Thorough</b>	It includes all relevant data and analyses that affect the determination of value.
<b>Balanced</b>	It discusses both positive and negative factors affecting value. Although the client may have a vested interest in the value being relatively high or low, the consultant should remain unbiased. Accordingly, the consultant's report should be an impartial discussion of all relevant factors.
<b>Readable</b>	All the report's readers should be able to follow the work done and the conclusion reached. That means the report should be clear and concise. Technical jargon should be defined. Any data presented in the report should be adequately described. Most readers will not be financial analysts or accountants.
<b>Coherent</b>	The report should flow logically from the data presented to the final conclusion. Also, the report's conclusions and analyses should be internally consistent.
<b>Well-Supported</b>	The report normally should present enough detail that a reader can reconstruct the consultant's valuation process and reach the same conclusion. That means presenting detailed calculations and identifying the data sources.

# Buy/Sell Agreements Tax Info Sheet (2008)

## WHAT ARE THEY?

A *buy/sell agreement* is a contract that restricts the ability of corporate shareholders, partners or limited liability company (LLC) members to freely transfer their ownership interests. It provides that an owner's interest in the business will be sold (or at least offered for sale) at a specified price to the other owners and/or to the entity upon the occurrence of specified events. This prevents unwanted individuals from joining the owner group and ensures a ready market for closely held interests.



### Who Needs One?



<b>Liquidity of Ownership Interests Is Desired</b>	<ul style="list-style-type: none"> <li>• Owners want to ensure a ready market for their ownership interests (in the event of death, disability, retirement, etc.).</li> <li>• Can be particularly important for heirs or retiring owners with noncontrolling interests.</li> </ul>
<b>Owners Want to Eliminate Uncertainty About Ownership Transfers</b>	<ul style="list-style-type: none"> <li>• Co-owners are comfortable with an owner's plans to transfer ownership to a child in the event of death or disability.</li> <li>• An agreement between the parent and child (with an option on the part of the remaining owners to buy the interest if the child doesn't) removes the uncertainty that exists if a will or other document is being relied upon to effectuate the transfer.</li> <li>• Wills can be changed at the last minute or challenged by heirs or potential heirs. A binding buy/sell agreement can nail down the rights and obligations of the parties.</li> </ul>
<b>Future Ownership Conflicts Can Be Foreseen</b>	<ul style="list-style-type: none"> <li>• It is anticipated that the remaining owner(s) would have difficulties coexisting with the family of a deceased or withdrawing co-owner who would inherit an interest.</li> <li>• A former spouse could obtain an ownership interest in a divorce settlement.</li> <li>• A buy/sell agreement can ensure that the remaining owners control the interest.</li> </ul>
<b>Ownership By Outsiders Is Undesirable</b>	<ul style="list-style-type: none"> <li>• Applies when owners are a tight knit group.</li> <li>• A creditor could become a member of the owner group if an owner is insolvent.</li> <li>• A buy/sell agreement ensures that interests can't leave the existing ownership group without its approval.</li> </ul>
<b>Owners' Heirs Not Interested</b>	<ul style="list-style-type: none"> <li>• The heirs feel the business is too risky for their tastes or they simply have no desire to participate.</li> </ul>
<b>Estate Tax Valuation is Desired</b>	<ul style="list-style-type: none"> <li>• Owners are interested in establishing the estate tax value of their ownership interests.</li> <li>• A buy/sell agreement can be used if certain requirements are met.</li> </ul>

## HOW ARE THEY FUNDED?

A buy/sell agreement is of little benefit without a funding mechanism to provide the cash needed to fund the purchase upon the occurrence of a triggering event. Life insurance is the most common method of funding buy/sell agreements because it assures that a large lump sum will be available upon the death of the insured while requiring only modest annual premiums. Some prospective purchasers may choose to accumulate earnings over time to fund a buyout obligation (a sinking fund). Disability buyout insurance is commonly used to fund the purchase of a disabled owner's business interest. An installment sale can enable funding in the absence of adequate cash reserves or insurance.

## HOW DO THEY WORK?

### Types of Buy/Sell Agreements

Type	Description
<b>Redemption Agreement</b>	<ul style="list-style-type: none"> <li>• The owner of a business entity and the entity itself (whether a corporation, partnership or LLC) enter into a contract. The owner agrees to sell his ownership interest to the entity according to the specified price, terms and circumstances.</li> <li>• Typically amounts to giving entity the right of first refusal when an owner wishes to sell the interest to a party outside the current ownership group. If entity chooses not to exercise its right, the owner is typically free to sell to the third party. May obligate entity to purchase if no outside buyer.</li> <li>• If there is no third-party buyer, entity must buy owner's interest upon certain circumstances (for example, death, disability or retirement). Agreement can require deceased owner's estate to offer the interest to entity at specified price and terms.</li> <li>• Sometimes referred to as entity plans. For partnerships, often called a liquidation agreement.</li> </ul>
<b>Cross-Purchase Agreement</b>	<ul style="list-style-type: none"> <li>• A contract between the owners of a corporation, partnership or LLC (sometimes referred to as a "criss-cross" agreement) under which the owners agree to offer their ownership interests for sale to each other at the specified price and terms.</li> <li>• Upon an owner's death, the estate normally must offer ownership interest for sale to other owners at a specified price and terms. If there is no third-party buyer, other owners are generally obligated to buy interest in the event of certain circumstances (for example, death, disability or retirement). A cross-purchase agreement is essentially a right of first refusal combined with a purchase obligation (or option).</li> <li>• Work best when business only has two or three owners. As number of owners increases, the mechanics of a cross-purchase become complex.</li> </ul> 
<b>Hybrid Agreement</b>	<ul style="list-style-type: none"> <li>• The business owners contract both with the entity and the other owners. Upon certain events, the owners agree to offer their ownership interests for sale to the entity and/or other owners at a price and terms specified in the contract. The same is true for the estate of a deceased owner.</li> <li>• Sometimes provide that ownership interest will be offered first to entity and then to other owners if entity doesn't buy interest. In other agreements, owners may have option to purchase interest with entity required to buy if other owners decline.</li> <li>• May provide that part of ownership interest first be offered to entity and remainder to other owners.</li> <li>• A right of first refusal if there is a third-party buyer or a purchase obligation (or option) if not.</li> <li>•  <b>Practice Tip:</b> Hybrid agreements generally aren't used when insurance is necessary for the buyout, because of the uncertainty as to who might actually be the buyer (the entity or the remaining owners). Thus, hybrid agreements typically tend to be used when the buyout will be seller financed.</li> </ul>
<b>Third-Party Agreement</b>	<ul style="list-style-type: none"> <li>• Involves a contract between the owners and one or more parties outside the current owner group.</li> </ul>

# C Corporations Tax Info Sheet (2008)

## REASONS TO INCORPORATE

### Non-tax Reasons

- Asset protection.
- Continuity of life for business entity.
- Transferability of ownership interests.



### Tax Reasons

- Income splitting and tax rates.
- Fringe benefit rules.
- Employment tax reduction.
- Tax year rules.
- Tax-free reorganizations.
- Tax benefits of employee stock ownership plans (ESOPs).
- Qualified small business corporation (QSBC) tax rate and gain rollover rules.
- Passive activity loss rules.
- Dividends received deduction.
- Multiple corporation benefits.

## SEGREGATING ACTIVITIES IN MULTIPLE CORPORATIONS

<b>Limiting Liability</b>	Critical in businesses with a high risk of lawsuits (oil and gas drilling, transportation of hazardous material) or requiring substantial financing (real estate development).
<b>Insulating Low-Risk Assets From High-Risk Assets</b>	If multiple activities are owned by one corporation, it may be advisable to form separate corporations to insulate the assets of one operation from potential lawsuits or loss by the high-risk activity of another. (Also, a creditor or major supplier occasionally prefers that different operations be separately incorporated.) For example, a corporation owns \$500,000 of securities, an operating business and land. The securities are exposed to the debts arising from the business and land.
<b>Hollowing Out an Operating Company Using Multiple Entities</b>	A thin (undercapitalized) corporation is subject to being pierced as a mere shell. Accordingly, it is important that any limited liability entity be sufficiently capitalized to carry out its operations. State law and the corporation's facts and circumstances (for example, the type of business it operates) are key factors to determine the minimum capital required. Owners should consult a local attorney for advice on the appropriate capitalization in their state.

**✂ Strategy:** To protect business assets, consider hollowing out the business by dividing it into two separate entities: an operating one and an asset-owning one. The operating entity provides products/services to the public and has contractual dealings with suppliers, purchasers, employees, etc. These activities create significant liability exposure, particularly for professional practices and high-risk businesses. There is little risk in owning equipment and leasing it to a sister company. Given the choice, it is beneficial to place all valuable assets in the asset-owning corporation and retain minimal capital in the operating one. The operating entity can lease necessary equipment from the asset-owning one without exposing the equipment to its own creditors.

## CORPORATE DISTRIBUTIONS

- 1) **Amount of Distribution.** Equals the cash plus the value of any property (reduced by attached liabilities) included in the distribution.
- 2) **E&P and Basis.** Shareholder has a taxable dividend to the extent the distribution is paid out of current or accumulated earnings and profits (E&P). If it exceeds E&P, the excess reduces the shareholder's stock basis. Any amount in excess of basis is capital gain.
- 3) **Stock Redemptions.** Treated as either a nonliquidating corporate distribution (potentially a dividend) or proceeds from selling the shares back to the corporation (capital gain or loss).



## COMPENSATION PLANNING TIPS

To increase likelihood that employee/shareholder pay is deductible:

- 1) **Consistently Apply Formal Compensation Policies.** Formalize in writing and apply consistently from year to year.
- 2) **Use Objective Third Parties to Determine Compensation.** Using professional advisors or outside directors to design shareholder/employee compensation packages shows objectivity and reasonableness. Ensure the advice is well documented.
- 3) **Document the Rationale Behind Compensation Decisions in the Corporate Minutes.** The corporate minutes should reflect compensation for each shareholder/employee and the rationale supporting the compensation.
- 4) **Use Reliable Data for Comparable Companies.** Favorable data on comparable salaries should be collected for documentation. Compensation decisions should be in line with appropriate industry averages unless there are factors justifying the difference (in which case the factors should be set forth in writing, preferably in the corporate minutes).
- 5) **Anticipate Steady (Not Explosive) Growth in Compensation.** When possible, plan for steady growth of compensation. It is more difficult to defend explosive growth in compensation from one year to the next (unless the employee was clearly undercompensated in earlier years, which should be documented in the corporate minutes).
- 6) **Do Not Use Compensation as a Tool to Erase Corporate Earnings.** Salary and bonuses of shareholder/employees should not be blatantly designed to wipe out corporate earnings each year. This violates the concept that a company's return on equity should be at a level an outside investor would accept. (The company's retained earnings generally should grow). But for professional service firms where all income comes from the shareholders' work, zeroing out earnings may be acceptable.
- 7) **Pay at Least Nominal Dividends.** Compensation payments are often easier to defend if at least some dividends were paid.
- 8) **Avoid Compensation Payments Proportionate to Stock Ownership.** Compensating shareholder/employees based on their stock ownership indicates that at least part of the compensation package is disguised dividends.
- 9) **Use Fringe Benefits and Deferred Compensation.** Establishing fringe benefit and deferred compensation plans can compensate shareholder/employees with less "visibility" than salaries and bonuses. While relevant to determining reasonableness, they may reduce the likelihood of an IRS challenge.
- 10) **Pay Shareholder/Employees in Relation to Their Contributions to Company Success.** Compensation is not the place to equalize active and inactive family members. (Gifts, including stock gifts, are better suited.) Paying productive shareholder/employees more is easier to defend than claiming compensation deductions for payments to nonproductive family members.



## DIVIDEND PLANNING IDEAS

**Paying dividends to low-bracket shareholders.** High-bracket shareholders should consider giving stock to family members in the 10% or 15% tax brackets, who will pay no federal income tax on the dividends in 2008 – 2010.

**Distributing appreciating assets to shareholders.** While this can trigger double tax, the current 15% maximum rate on qualified dividends reduces the tax burden. Consider distributing appreciated corporate assets, especially when the corporation has losses to offset its gain triggered by the distribution. Also consider distributing assets that haven't yet appreciated much, but that are likely to. Getting assets out of the corporation now can prevent a large future tax bill on the appreciation.

**Reducing E&P.** Many C corporations have built up substantial E&P balances because paying dividends would have resulted in double tax. Consider reducing E&P by paying dividends currently taxed at no more than 15%. This strategy reduces the risk of paying tax at higher rates on dividends in future years.

# S Corporations Tax Info Sheet (2008)

## CONSIDERING S STATUS

An S election means that a corporation has chosen a special set of tax rules. It has no effect on the corporation for any other purposes (for example, liability protection under state law). Thus, S status lets business owners combine the legal and economic benefits of a corporation with favorable taxation as a pass-through entity. However, there are potential drawbacks to S status and situations where not electing S status (that is, remaining a C corporation) is more beneficial.



**Observation:** To be an S corporation, the taxpayer must make an affirmative S election. Also, it may help to note that the terms “S corporation” and “S election” come from the fact that the rules for S corporations are found in Chapter 1, Subchapter S of the Internal Revenue Code—thus, the use of “S” when referring to this type of corporation.

### S Election Considerations

When an S election can be advantageous:	Situations where S election may not be advantageous:
<ul style="list-style-type: none"> <li>New business expected to incur start-up losses, which will be passed through to the shareholders.</li> <li>A profitable, cash-rich corporation that can distribute enough cash to shareholders to pay the income tax on the pass-through income.</li> <li>Personal service corporation that pays out all income as compensation each year. Making the S election eliminates the need to pay out all the corporation's earnings by year-end.</li> </ul>	<ul style="list-style-type: none"> <li>Rapidly growing corporation in a competitive market that will use cash to fund growth. Then, the corporation may be unable to distribute enough cash to shareholders to pay their tax on the S corporation income.</li> <li>Most of the corporation's shareholders are employees. Common fringe benefits provided to owner/employees that are otherwise tax-free will be taxable if the corporation elects S status.</li> <li>One class of stock rule limits corporation's ability to raise capital.</li> <li>Corporate income is expected to be less than \$100,000. Here, taxing the income at the graduated corporate rates may result in less tax than taxing it at the shareholder's rates, especially if the corporation doesn't intend to make significant shareholder distributions.</li> </ul>

## DISTRIBUTIONS

### How S Corporation Distributions Are Taxed

Corporation Has No E&P**	Corporation Has E&P
<ul style="list-style-type: none"> <li>Distributions up to the shareholder's stock basis = nontaxable return of basis.</li> <li>Distributions in excess of basis = capital gain.</li> </ul>	<ul style="list-style-type: none"> <li>Distributions come first from AAA*                             <ul style="list-style-type: none"> <li>Tax-free up to the shareholder's stock basis.</li> <li>Distributions from AAA over the stock basis = capital gain.</li> </ul> </li> <li>Next, distributions from accumulated E&amp;P = taxable dividend.</li> <li>After AAA and E&amp;P are gone, distributions are tax-free up to remaining stock basis, then capital gain.</li> </ul>
<p>* AAA = undistributed S corporation income that has been taxed to the shareholders.</p> <p>** E&amp;P = earnings and profits.</p>	

## QUALIFICATION

### Qualifying for S Status

<b>No more than 100 shareholders at a time</b>	<ul style="list-style-type: none"> <li>Husband and wife counted as one.</li> <li>Certain family members are treated as one shareholder.</li> <li>Tenants in common or joint tenants counted separately.</li> <li>Trust beneficiaries counted as shareholders if trust owns the stock.</li> </ul>
<b>Only one class of stock permitted</b>	<ul style="list-style-type: none"> <li>Differences in voting rights only are OK.</li> <li>No preferential rights allowed for distributions or liquidation proceeds.</li> <li>Holders of restricted stock generally not considered unless shareholder has elected to include value of stock in income.</li> <li>Buy/sell agreements don't create a second class of stock unless the sales price is substantially different than stock's fair market value (FMV) at creation date AND a principal purpose of the agreement is avoiding the one-class-of-stock rule. However, agreements to buy stock at a shareholder's death, disability, divorce or termination never create a second class of stock.</li> <li>Debt must be real debt, not disguised equity.</li> </ul>
<b>Eligible shareholders</b>	<ul style="list-style-type: none"> <li>Individuals who are U.S. citizens or resident aliens.</li> <li>Estates (but estate held open for over two years without good reason can be reclassified as trusts).</li> <li>Certain types of trusts.</li> </ul>

## FAMILY MEMBER SHAREHOLDERS

All family members (and their estates) are treated as one shareholder for purposes of determining the number of shareholders in an S corporation.

### Family members include:

- A common ancestor (whether or not alive) and that ancestor's lineal descendants (up to six generations), as well as the ancestor's and descendants' spouses and former spouses.
  - Observation:** The six-generation limit does not provide much hindrance to counting family members as one shareholder because the first generation to be excluded would be a great-great-great-great grandparent of a shareholder in the youngest generation.
- A husband and wife. A divorce will not increase the number of shareholders for purposes of the 100-shareholder limit.
- The estate of a deceased family member when the estate or a testamentary trust holds stock in the S corporation.
- Beneficiaries of certain trusts owning the S corporation stock when the beneficiaries are family members.
- The owner of a disregarded entity, such as a single-member LLC, if the owner is a family member.

**Caution:** Treating separate shareholders as one applies only when determining if the corporation has exceeded the allowable number of shareholders. Shareholders are treated separately for other purposes, such as the pass-through of the S corporation's items of income, gain, loss or deduction. Furthermore, if a corporation is making the S election, each person holding shares must separately consent to the S election.

**Observation:** The family member rule greatly expands the number of actual shareholders an S corporation is permitted to have. For example, if 20 members of 50 different families held stock in an S corporation, the actual number of shareholders would be 1,000, but for purposes of the number of shareholders test, there would be only 50 shareholders.

# LLCs and Partnerships Tax Info Sheet (2008)

## FEDERAL INCOME TAX

In this Tax Info Sheet, except where otherwise indicated, "LLC" can be substituted for "partnership," and "member" can be substituted for "partner." (An LLC's owners are known as members.) This is so because, unless they elect to be taxed as corporations, multi-member LLCs are treated as partnerships for federal income tax purposes. Single-member LLCs are generally ignored as an entity separate from their owner for federal income tax purposes (that is, their income is taxed directly to the owner).

### What Is a Partnership?

<b>Definition</b>	A business or investment venture conducted jointly by two or more participants (partners) with the intent to divide the income and profits from the undertaking.
<b>Joint Ventures</b>	Partnerships with limited business purposes (for example, to develop and sell a specific parcel of real estate or drill and operate an oil well) are commonly termed "joint ventures."
<b>Legal Aspects</b>	These are governed by state partnership statutes, most of which are in conformity with the Uniform Partnership Act (UPA) and the Revised Uniform Limited Partnership Act (RULPA).
<b>Liability Limitation</b>	Using a limited partnership and/or liability insurance can often offer the partners virtually the same level of liability protection as enjoyed by corporate shareholders and LLC members.
<b>Tax Advantages</b>	From a federal income tax perspective, partnerships offer the advantage of freedom from double taxation ("pass-through taxation") without the need to worry about meeting the strict S corporation eligibility rules.

### Classic Case for a Partnership

A partnership can be formed under state law to pursue any lawful business or investment opportunity. The "classic" situation calling for the use of a partnership to operate a proposed venture is one in which:

- 1) Achieving pass-through taxation is a critical goal.
- 2) Some or all owners are prohibited from being S corporation shareholders.
- 3) The S corporation single-class-of-stock rule prevents the owners from holding the types of ownership interests they want.

## PARTNERSHIP AGREEMENT CONTENTS

**Purpose:** The partnership agreement is a written record describing the partners' intentions regarding how the partnership will be formed and operated. Use this list to determine if a partnership agreement is adequate. In general, the items listed below should be addressed by the agreement.

- 1) Name of partnership, names of initial partners and date of agreement.
- 2) Date partnership intends to commence its legal existence.
- 3) Description of partnership's business or investment purpose or activities.
- 4) Duration of the partnership.
- 5) Description of partnership's principal place of business.
- 6) Required initial capital contributions, and provisions regarding anticipated and unanticipated future contributions of capital (including what happens to partners who fail to make their contributions).
- 7) Dates of partnership distributions and rights of partners to take draws in advance of formal distribution dates.



- 8) Descriptions of how distributions are calculated (for example, if certain partners are to receive "preferred returns" with respect to their capital accounts).
- 9) Provisions regarding partner salaries (treated as guaranteed payments for federal tax purposes).
- 10) Specific authority for partnership to borrow or incur debts.
- 11) Specific authority for partners to lend to partnership and/or for partnership to lend to partners.
- 12) Indemnification provisions (covering rights of partners to recover from partnership if they pay "more than their share" of partnership liabilities, and rights of partnership to demand contributions from those partners who paid "less than their share").
- 13) Place where partnership's legal and financial records will be kept, and rights of partners to demand an accounting from the partnership.
- 14) Rights of partners to obtain access to partnership's books and records.
- 15) Restrictions on any partner's authority to legally bind the partnership.
- 16) Assignments of management authority to partners (including any restrictions on management authority).
- 17) Voting provisions regarding what is a quorum, how partners' votes are counted (per capita or based on percentage interest in the partnership), what majority is needed to conclude on certain issues, etc.
- 18) Provisions regarding periodic meetings of the partners.
- 19) Procedures for admission of new partners.
- 20) Provisions for voluntary withdrawal, retirement or expulsion of partners (including what rights these partners have to payment for their partnership interests, payment terms and how the interests will be valued).
- 21) Provisions regarding whether the partnership will take a partner's share of partnership goodwill into account for purposes of Item 20), and how the goodwill will be valued.
- 22) Provisions regarding rights of partners to sell, assign or otherwise transfer their partnership interests to third parties (including rights of first refusal for partnership or other partners to purchase the interests and how valuation of the interests will be determined).
- 23) Provisions regarding buyouts of partners' interests upon retirement, disability, insanity, death, etc. (including how the interests will be valued and payment terms).
- 24) Noncompete provisions after partner withdrawals.
- 25) Provisions regarding continuing (or not continuing) the partnership after the withdrawal, death, etc., of a partner.
- 26) Provisions regarding the partners agreeing to terminate the partnership, and how the partnership will be terminated in other circumstances.
- 27) Provisions regarding how property will be valued if the partnership is terminated and all assets distributed in liquidation.
- 28) Financial accounting and tax provisions regarding how profits, losses and liabilities will be shared, how "book" capital accounts will be maintained (including how they will be adjusted when noncash property is contributed or distributed), how tax items will be allocated among the partners, how capital accounts will be maintained for tax accounting purposes, when an election will be made by the partnership and so forth.



**Caution:** Because a partnership agreement has serious legal implications, competent legal counsel should be engaged to draft the agreement.

# Sole Proprietors Tax Info Sheet (2008)

## TAX PLANNING

Sole proprietors are subject to both income and self-employment (SE) tax. Several techniques are available to reduce their tax liability.

### Tax Saving Strategies

Description	How it works	When this works best
Employ your children in the business	Children's wages are not subject to FICA or FUTA if they are under age 18. However, they do reduce the business owner's income subject to SE tax. Also, wages aren't taxed at parent's rate under the kiddie tax rules.	Because the wages must be reasonable for the work done, this works best for children who are older and able to perform more skilled (that is, higher paid) tasks.
Rent property from your spouse	The rent deducted by the proprietor reduces self-employment (SE) income. However, the rent income the lessor spouse recognizes is not subject to SE tax. So, even though the couple's income tax is unchanged, the rents paid escape SE tax.	The proprietor's spouse owns property that can be used in the business. If the spouses own property jointly, half the rent paid will be deductible by the proprietor.
Employ your spouse in the business	The spouse can receive tax-free reimbursement of medical expenses from the business, even though the business deducts the reimbursements. The reimbursement plan can cover the entire family, so the family's out-of-pocket medical expenses are paid with pre-tax dollars.	The business must provide the medical benefit to all qualifying employees. Thus, the cost may be prohibitive unless there are few other employees that would have to be covered.

## EVALUATING OPTIONS

Although sole proprietorships are often appropriate, as the business grows, using a business entity (for example, to limit liabilities) may make sense.

### Comparison of Single-Owner Businesses

	Sole Proprietorship	C Corporation	S Corporation	Single-Member LLC
Simple to form and operate?	Yes.	No.	No.	Relatively.
Can interests in the business be transferred to new owners?	No—the owner can only transfer the business assets.	Yes.	Yes.	Yes—the entity becomes a multi-member LLC.
Can additional equity capital be raised?	No—the business's equity is limited to the owner's capital and ability to borrow.	Yes—the corporation can admit an unlimited number of new shareholders. No restrictions on who can be a shareholder.	Yes—the corporation can admit up to 100 shareholders. However, some restrictions on who can own S stock.	Yes—the LLC can admit an unlimited number of new members (thus becoming a multi-member LLC). No restriction on who can be a member.
Can the owner shelter income from income tax?	No—all income is taxed at owner's marginal rate.	Some—the first \$100,000 of income retained by the corporation is taxed at the corporate graduated rates. (However, owner generally taxed at 15% when income is eventually distributed.)	No—all income taxed at owner's marginal rate.	No—all income taxed at owner's marginal rate.
Can the owner shelter income from self-employment/payroll tax?	No—all income subject to self-employment tax.	Some—only income distributed as salary subject to payroll tax. IRS generally hasn't reclassified dividends as salary.	Some—only income distributed as salary subject to payroll tax, but IRS may reclassify distributions as salary if salary unreasonably low.	No—all income subject to self-employment tax. This may differ in a multi-member LLC.
Is the owner shielded from the business liabilities?	No.	Yes—exposure generally limited to capital invested.	Yes—exposure generally limited to capital invested.	Yes—exposure generally limited to capital invested.

#### Sole Proprietorship May Be Appropriate When:

- Business has no non-family employees—only workers are contractors or family members.
- There is a relatively low level of risk associated with the business or adequate insurance is available.
- Lenders would require the owner to personally guarantee business debts if business entity was used.
- Business is in early stages and profits are relatively low.



#### Sole Proprietorship May Not Be Appropriate When:

- Business results in exposure to product, environmental, etc. liabilities.
- The business will incur substantial debts to creditors, vendors and suppliers.
- Business has employees whose actions can create liabilities (for example, delivery drivers). Just having employees may make liability protection important.
- The business provides advice or acts as an agent (for example, attorney or psychologist).
- The business's nature is hazardous (for example, toxic chemicals are handled or heavy equipment is used).

# IRS

## Tax Info Sheet (2008)

### Business Publications

Following is a list of IRS tax publications for businesses and their owners. The publications are available online at [www.irs.gov](http://www.irs.gov).

Publication #	Title
1	<i>Your Rights As a Taxpayer</i>
15	<i>Circular E, Employer's Tax Guide</i>
15A	<i>Employer's Supplemental Tax Guide</i>
15B	<i>Employer's Tax Guide to Fringe Benefits</i>
51	<i>Circular A, Agricultural Employer's Tax Guide</i>
80	<i>Circular SS—Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands</i>
225	<i>Farmer's Tax Guide</i>
334	<i>Tax Guide for Small Business</i>
393	<i>Federal Employment Tax Forms</i>
463	<i>Travel, Entertainment, Gift, and Car Expenses</i>
505	<i>Tax Withholding and Estimated Tax</i>
509	<i>Tax Calendars</i>
510	<i>Excise Taxes</i>
515	<i>Withholding of Tax on Nonresident Aliens and Foreign Corporations</i>
527	<i>Residential Rental Property (Including Rental of Vacation Homes)</i>
535	<i>Business Expenses</i>
536	<i>Net Operating Losses</i>
537	<i>Installment Sales</i>
538	<i>Accounting Periods and Methods</i>
541	<i>Partnerships</i>
542	<i>Corporations</i>
544	<i>Sales and other Dispositions of Assets</i>
547	<i>Casualties, Disasters, and Thefts</i>
550	<i>Investment Income and Expenses</i>
551	<i>Basis of Assets</i>
553	<i>Highlights of Tax Changes</i>
560	<i>Retirement Plans for Small Business</i>
583	<i>Starting a Business and Keeping Records</i>
587	<i>Business Use of Your Home (Including Use by Day-Care Providers)</i>
594	<i>The IRS Collection Process</i>
595	<i>Capital Construction Fund for Commercial Fishermen</i>
597	<i>Information on the United States—Canada Income Tax Treaty</i>
901	<i>U.S. Tax Treaties</i>
925	<i>Passive Activity and At-Risk Rules</i>
946	<i>How to Depreciate Property</i>
954	<i>Tax Incentives for Distressed Communities</i>
957	<i>Reporting Back Pay and Special Wage Payments to the Social Security Administration</i>
966	<i>Electronic Choices to Pay All Your Federal Taxes</i>
969	<i>Health Savings Accounts and Other Tax-Favored Health Plans</i>
1542	<i>Per Diem Rates</i>
1544	<i>Reporting Cash Payments of Over \$10,000</i>
1635	<i>Understanding Your EIN—Employer Identification Numbers</i>
1779	<i>Independent Contractor or Employee</i>
4132	<i>EFTPS Online Fact Sheet</i>



### Small Business Resources

Following is a list of sites that have specific information dealing with small businesses. This list, along with internet hyperlinks to these sites is available online by accessing the small business resources link at [www.irs.gov/businesses/small](http://www.irs.gov/businesses/small).

**Business.gov.** [Business.gov](http://www.business.gov) guides you through the maze of government rules and regulations and provides access to services and resources to help you start, grow, and succeed in business.

**Court Rulings.** This page provides links to various federal, state and private sites that provide legal information for the small business owner.

**Department of Commerce.** The Department's mission is to create the conditions for economic growth and opportunity by promoting innovation, entrepreneurship, competitiveness and stewardship.

**Department of Education.** The Education Department's mission is to ensure equal access to education and to promote educational excellence throughout the nation.

**Department of Labor: Occupational Safety & Health Administration (OSHA).** OSHA's mission is to assure the safety and health of America's workers by setting and enforcing standards; providing training, outreach and education; establishing partnerships; and encouraging continual improvement in workplace safety and health.

**Department of the Treasury.** The mission of the Department of the Treasury is to promote the conditions for prosperity and stability in the United States and encourage prosperity and stability in the rest of the world.

**Environmental Protection Agency.** The mission of the U.S. Environmental Protection Agency is to protect human health and to safeguard the natural environment—air, water and land.

**GobiernoUSA.gov.** The government's official Spanish language web portal.

**Small Business Administration (SBA).** The mission of the SBA is to maintain and to strengthen the Nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters.

**Social Security Administration (SSA).** The SSA is the Nation's primary income security Agency. It pays retirement, disability and survivors benefits to workers and their families; administers the Supplemental Security Income Program; and issues Social Security numbers.

**State and Local Contacts.** The State and Local Government on the Net Directory provides one-stop access to the websites of thousands of state agencies and city and county governments.

**State Links.** A collection of links to State government websites with useful information for businesses.

**U.S. Customs and Border Protection.** U.S. Customs and Border Protection (CBP) is the unified border agency within the Department of Homeland Security (DHS).

**U.S. Department of Labor (DOL).** The DOL administers a variety of Federal labor laws including those that guarantee workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, unemployment insurance and other income support.

**U.S. Equal Employment Opportunity Commission.** The mission of the EEOC is to eradicate employment discrimination at the workplace.

# Hybrid Vehicle Credit and Cost Recovery

## Tax Info Sheet (2008)

### HYBRID VEHICLE CREDIT

**Hybrid vehicles.** Qualified vehicles combine an internal combustion engine with another propulsion system that uses an onboard rechargeable energy source such as electric batteries.

**Certification.** The IRS certifies the credit amount for particular cars based on information provided by auto manufacturers. The IRS is continually updating the list of vehicles that have been certified, which can be found by searching for "hybrid vehicle credit" at [www.irs.gov](http://www.irs.gov).

Hybrid Vehicle Credit—2008 Models <sup>1,2</sup>			
Make	Model	Credit	
Chevrolet	Malibu Hybrid	\$1,300	
Chevrolet	Tahoe Hybrid 2WD and 4WD	2,200	
Ford	Escape Hybrid 2WD	3,000	
Ford	Escape Hybrid 4WD	2,200	
GMC	Yukon Hybrid	2,200	
Honda	Civic CVT	<b>Purchase Date</b>	
		Before 2008	2,100
		1/1/08 – 6/30/08	1,050
		7/1/08 – 12/31/08	525
		After 2008	0
Mazda	Tribute 2WD	3,000	
Mazda	Tribute 4WD	2,200	
Mercury	Mariner Hybrid 2WD	3,000	
Mercury	Mariner Hybrid 4WD	2,200	
Nissan	Altima Hybrid	2,350	
Saturn	Aura Hybrid	1,300	
Saturn	Vue Green Line	1,550	

<sup>1</sup> As of May 16, 2008. Check the IRS website for updates. Lists of pre-2008 models that qualify for the credit are also available at the IRS website.

<sup>2</sup> No credit is available for Toyota or Lexus vehicles purchased after 9/30/07.

**Credit phaseout.** The credit for a specific manufacturer's hybrid vehicles is reduced once that manufacturer has sold 60,000 qualifying vehicles. The phase-out period begins the second calendar quarter following the quarter the 60,000th car is sold. Toyota (which also manufactures Lexus) sold its 60,000th car in 2006, so a credit for a Toyota or Lexus is not available for cars purchased after September 30, 2007. Honda sold its 60,000th vehicle in the third quarter of 2007, so the credit for Honda vehicles is reduced for purchases after December 31, 2007.

### COST RECOVERY

**Identifying capital vs. deductible expenses.** It is not always clear whether an expenditure to repair or refurbish property is a capital item or a currently deductible repair. Capital expenditures must be added to the property's tax basis and recovered through depreciation. For property not subject to depreciation, amortization or depletion, capitalized costs are only recovered when the property is disposed. Incidental repairs are not capital expenditures and thus can be deducted in the current year.

**Capital expenditures.** These include (1) costs for new buildings or permanent improvements or betterments to increase the value of the property or (2) amounts expended in restoring property or making good the exhaustion from depreciation.

**Capital expenditures include amounts paid or incurred that:**

- 1) Prolong an asset's life,
- 2) Substantially increase its value or
- 3) Make it suitable for a different use.

Examples of capital expenditures include the cost of defending or perfecting title to property, architects' fees, purchase commissions

paid to a broker and goodwill connected to acquiring the assets of a going concern.

**Incidental repairs.** These are a current deduction as ordinary and necessary business expenses, provided the repair does not materially add to the value of property or appreciably prolong its life. Rather, repairs keep the property in an ordinarily efficient operating condition.

**Examples of deductible repairs include:**

- Reconditioning floors (but not replacement),
- Repainting interior and exterior walls,
- Cleaning and repairing roofs and gutters and
- Fixing plumbing leaks (but not replacement of fixtures).

Costs of acquiring property are generally capitalized as part of the property's basis. However, expenses for repairs immediately after the property is acquired do not have to be capitalized if the expense would ordinarily qualify for deduction as a repair. If the repairs are required as a condition of the purchase, the cost is capitalized.

**Caution:** Repairs that are part of a general plan of rehabilitation, improvement, alteration or modernization must be capitalized even though, taken separately, they would be deductible.

**Depreciating property over the correct life.** Depreciable property placed in service after 1986 is generally subject to MACRS depreciation. All MACRS property falls into one of the following recovery periods:

MACRS Recovery Period	
Recovery Period	Examples of Assets Included in the Class
3 year	Race horses over two years old, other horses over 12 years old, qualified rent-to-own property and tractor units for over-the-road use.
5 year	Automobiles, most computers, high technology medical equipment, office machinery, breeding and dairy cattle.
7 year	Furniture and office equipment that is not in the five-year class (such as desks, files and safes); horses and tangible personal property not in other classes.
10 year	Single-purpose agricultural or horticultural structures, any tree or vine bearing fruit or nuts.
15 year	Land improvements and retail motor fuels outlets.
20 year	Certain farm buildings, municipal sewers and electric utility land improvements.
25 year	Certain water utility property.
27.5 year	Residential rental property.
39 year	Nonresidential real property.

**Segregate assets for tax.** For financial reporting, assets are often grouped together as "equipment" or "furniture and fixtures." For tax purposes, a seven-year recovery period would be assigned. However, "equipment" could include computers or high technology medical equipment that should be assigned a five-year recovery period.

**Bonus depreciation.** Under the bonus depreciation provision, taxpayers can claim a first-year depreciation deduction equal to 50% of a qualified asset's cost. To qualify, assets generally must be placed in service during 2008, but an extended deadline of December 31, 2009 applies to certain longer-lived assets.

**Section 179 deduction.** For tax years beginning in 2008, taxpayers can claim a Section 179 deduction (immediately expense) up to \$250,000. If investment in Section 179 property exceeds \$800,000 for 2008, the maximum deduction of \$250,000 is reduced dollar-for-dollar by the excess. Therefore, for 2008, the allowable deduction is completely phased out if investment in Section 179 property reaches \$1,050,000 or more.

