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SMALL BUSINESS TAX UPDATE

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Dear Client:

Tax planning for year-end 2008 presents unique opportunities and challenges for small business taxpayers to reduce or defer federal income tax liability. While traditional planning techniques remain fundamentally important considerations this year, new opportunities and pitfalls born from recent legislation and changes in the tax laws in response to our current financial crisis provide planning variables unique to this year end. This letter discusses important year-end tax planning strategies -- from the tried and true techniques to new considerations for our economic situation -- that can operate to reduce the tax burden for your small business.

BUSINESS STRUCTURE

The structure of your business determines how business income will be taxed. While C corporations are subject to two levels of tax, income, losses, deductions, and credits of S-corps, partnerships and limited liability companies (LLCs) are passed through to the owners and reported on their individual income tax returns. Plain-vanilla sole proprietorships, too, have their place in tax planning, with a traditional Schedule C attached to Individual Form 1040 for a business enterprise engaged in either full or part time sometimes the best choice.

Not only is the structure of the business important, but with sole-proprietorships and pass through entities, the individual tax situation of their owners is a particularly significant factor in year-end tax planning. In regular C corporations, year-end planning can mean deferring some of the profits by deferring dividends into the next year.

ACCOUNTING METHODS

The accounting method used by your business is a factor that impacts year-end tax planning strategies. Your accounting method is important to tax planning because it affects your ability to time and shift income and deductions between 2008 and 2009. Whether your business operates on a cash or accrual basis will determine when income must be recognized for tax purposes and when expenses are deductible.

Cash-basis business that anticipate being in the same or lower tax bracket in 2009 than 2008 because of the economy can smooth out their taxable income by deferring income to 2009 and accelerating deductions this year. To push income into 2009, cash-basis businesses can delay billing clients or customers (for example, wait until mid-January) for services and products so that payment is not received until 2009. Alternatively, if you anticipate your business's taxable income to be lower in 2008, you may want to accelerate income in 2008 and defer deductions until next year.

For accrual basis taxpayers, the right to receive income, rather than actual receipt, determines the year of inclusion in income. Expenses are deductible in the year in which all events have occurred to establish the liability of an amount certain. Accrual method businesses might consider deferring income by delaying the shipment of products or provision of services until the beginning of the 2009 tax year.

DEDUCTIONS

Deduction planning is an integral aspect of year-end business tax planning. There are many important deductions beyond the Code Sec. 162 deduction for ordinary and necessary business expenses that may benefit many small businesses by lowering their tax liability.

Bonus depreciation. The Economic Stimulus Act of 2008 provided 50 percent bonus depreciation of the adjusted basis of qualifying property. This accelerates an additional 50 percent of depreciation that would be allowed on business property into the first year in which it is acquired. However, the property generally must be purchased and placed in service during calendar year 2008 to qualify. In 2009, the tax law reverts to its regular depreciation allowances.

Enhanced expensing. Most small businesses are eligible for the Code Section 179 deduction, a generous and lucrative tax break that enables businesses (especially those that are capital intensive) to immediately deduct equipment purchases that otherwise would have to be depreciated over a number of years. There are limits to this deduction, however. Looking at the tax law as it now exists, the limits for 2008 are far more generous than for 2009.

The Economic Stimulus Act of 2008 almost doubled the amount of deductible Code Sec. 179 expensing for tax years beginning in 2008 to $250,000 and increased the threshold for reducing the deduction to $800,000. After 2008, the expensing limits revert to prior inflation-adjusted caps, anticipated for 2009 to be $133,000 for the deduction limit and $530,000 for the start of the phase-out. Of course, another economic stimulus package may be passed in 2009 to keep these amounts higher, but businesses likely to make purchases of qualifying property soon should consider at least maximizing amounts for 2008.

Domestic production deduction. The Code Sec. 199 deduction for qualifying domestic production activities benefits a broad array of businesses, including construction, engineering, architecture, and farming. For 2008 and again for 2009, the deduction generally equals six percent of the lesser of (1) qualified production activities income for the tax year, or (2) taxable income that does not take the deduction into account for the tax year. However, the deduction cannot exceed 50 percent of W-2 wages allocable to domestic gross receipts. The deduction applies for both regular and alternative minimum tax (AMT) liability. Starting in 2010, the deduction jumps to nine percent. Maximizing this deduction over all three years of the 2008-2010 period first requires a run-through on various computations and allocations.

Compensation and bonus deductions. If your business operates a qualified retirement plan, consider maximizing 2008 contributions to qualified retirement plans since the contributions are tax deductible in the year that they are made to plan participants. For employees with 401(k) balances especially hard hit by the recent downturn in the markets, these contributions will take on an added luster this year.

Year-end bonuses also require care. Paying year-end bonuses in December or January can create a significant compensation-based business deduction. For example, businesses can deduct in 2008 a bonus paid in 2009, as long as the obligation is paid within two and one-half months of the close of 2008. Accrual businesses can take a deduction in 2008 for bonuses not actually paid to employees until 2009 as long as (1) the employee does not own more than 50 percent in value of the business's stock, (2) the bonus is properly accrued on the company's books before the end of 2008, and the bonus is paid within two and one-half months of 2009.

LOSS DEDUCTIONS

Business losses sustained during the tax year generally can be deducted. For pass through entities such as S corps, LLCs and partnerships, losses will be passed through and deducted on the owners' personal income tax returns. Loss deductions can be taken for:

- Bad debts;
- Casualty and theft losses;
- Capital losses;
- Losses on the sale of business assets; and
- Net operating losses.

Net operating losses, in particular, will be something that many more businesses unfortunately will need to become familiar with during the present economic downturn. A trade or business has a net operating loss
(NOL) when its allowable deductions exceed its gross income for the tax year. Generally, an NOL can be carried back 2 years and carried forward 20 years--the carryover period (businesses in specially designated disaster zones may be entitled to a 5 year carryback).

The first year of the carryover period is the year after the NOL arises; thus, it becomes important to determine the correct year in which gross income is recognized and deductions are taken. The carryback period is especially valuable since the carryback can immediately reduce any taxable income for those prior two years, entitling the business to an immediate cash tax refund upon filing an amended return.

EXTENDED INCENTIVES

Thanks to the Emergency Economic Rehabilitation Act of 2008, businesses no longer need to guess whether certain tax breaks would be extended to apply for 2008 and beyond. They were extended, leaving businesses with the pleasant decision --in connection with these incentives-- of how to plan to maximize their use over 2008 and 2009.

Among the most significant changes made by the new law are a revised research tax credit, extension of accelerated depreciation for leasehold and restaurant improvements, and enhanced deductions for certain charitable contributions of food, books and computer equipment. Especially notable for small businesses, an "alternative simplified credit" has not only been extended but raised to a level at which smaller businesses have a greater tax incentive to spend money on research. Also good for both the environment and a lower bottom line tax, the new law has extended the energy deduction for energy efficient commercial buildings through 2013. Planning to take full advantage of these changes should start now.

AMT PLANNING

The alternative minimum tax (AMT) is not a challenge reserved solely for individual taxpayers; it may affect your small business as well. While Congress again enacted another round of temporary AMT relief for individual taxpayers, retroactive to the start of 2008, in the Emergency Economic Stabilization Act, more comprehensive reform must wait until 2009.

The 2008 AMT exemption amount for corporations is $40,000, subject to an income-based phase-out starting at $150,000. The AMT income tax rate for businesses is a flat 20 percent rate. Small corporations that meet an annual average gross receipts test (GRT) under Code Sec. 55(e) are exempt from the AMT. To qualify under the GRT, a corporation's average annual gross receipts for all three tax year periods beginning after 1993 and ending before the current year can not exceed $7.5 million. Computing the AMT is complicated and time-consuming, both for the business or for the business owner.

SUMMARY

With the complexity of the tax law, understanding what tax planning provisions to incorporate into your year-end tax planning strategy can be a daunting task. This letter hopefully gives you a heads up on several strategies that you might like to utilize before year end. Should you have any questions concerning items in this letter or other matters please don't hesitate to give this office a call.

Sincerely yours,

REILLY, CREPPAGE & CO., INC., CPAs

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