Halcolm Bard
Certified Public Accountant & Consultants

TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

September 2007

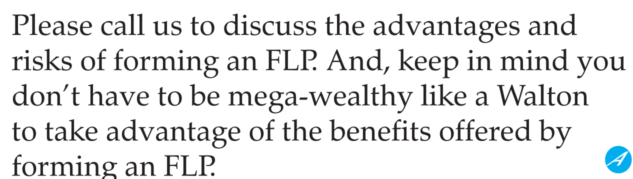
Family Limited Partnerships

In the last few years, family partnerships have received a tremendous amount of attention from both professional commentators and the financial press. Family partnerships are not a new phenomena, however. Perhaps the latest wave of interest in family partnerships can be traced to their exposure in Sam Walton's autobiography, *Made In America*. The Walton family formed a family partnership, Walton Enterprises, early on, prior to accumulating their wealth. By doing so, the Walton family probably saved billions in estate tax, kept family members together in a common endeavor, and avoided splitting up the estate in a manner that could have led to loss of control over the family business.

While they carry some risk as a planning strategy, family limited partnerships (FLPs) have been used successfully by taxpayers to achieve business and wealth transfer goals. Listed below are some of the benefits of structuring your financial affairs to take advantage of this planning opportunity.

Properly structured, an FLP allows you to (1) protect your assets from potential creditors; (2) begin the orderly transfer of assets to your children, with a minimum of transfer taxes; and (3) maintain as much control over the assets as possible without adverse tax effects. An FLP also provides flexibility to react to changing circumstances.

As the general partner of a family limited partnership, you maintain some control over the management and investment of the partnership's assets, yet you can give away or sell limited partner interests to your children or other heirs. Depending on the specific rights and powers associated with the partnership interests they receive, the value of the limited partnership interests may also be discounted, leading to significant transfer tax savings. In addition, limited partnerships are an excellent way to protect assets from creditors.



Please call us to discuss the advantages and risks of forming an FLP. And, keep in mind you don't have to be mega-wealthy like a Walton to take advantage of the benefits offered by forming an FLP.

The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

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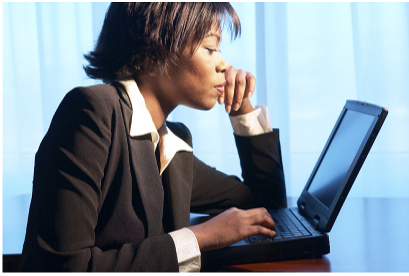
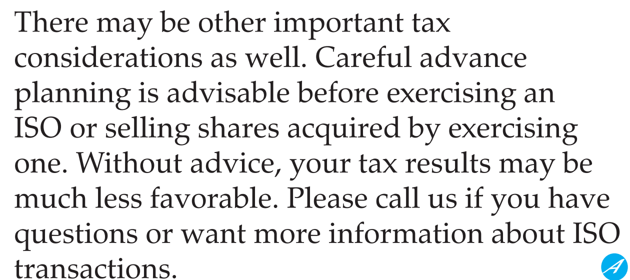
Incentive Stock Options

Incentive stock options (ISOs) received from your employer are an attractive form of compensation. When you sell the stock resulting from the exercise of your options at a gain, your entire profit from selling ISO shares can generally be taxed at lower capital gains rates, assuming you play all your cards right.



However there are some negative aspects with ISOs. Exercising an ISO when the market value of the company stock is above your exercise price could cause you to owe the alternative minimum tax (AMT) on the gain for the year of exercise. In addition, you will lose favorable capital gain treatment for your profit if you sell the option shares within two years of the option grant date or within one year of the option exercise date.

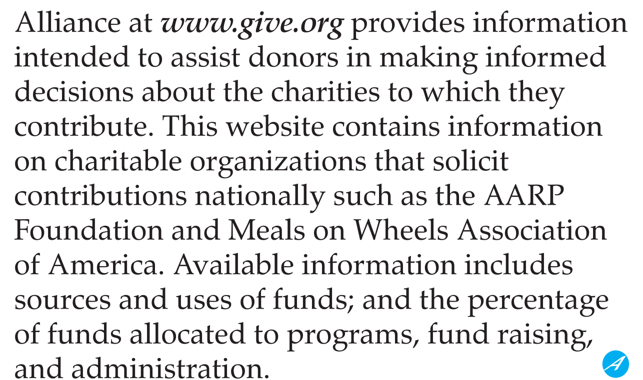


There may be other important tax considerations as well. Careful advance planning is advisable before exercising an ISO or selling shares acquired by exercising one. Without advice, your tax results may be much less favorable. Please call us if you have questions or want more information about ISO transactions.

Find National Charity Data Online

Have you ever wondered what percentage of the funds your charity collects pays for operating expenses or how the money you donate to a charity is spent?

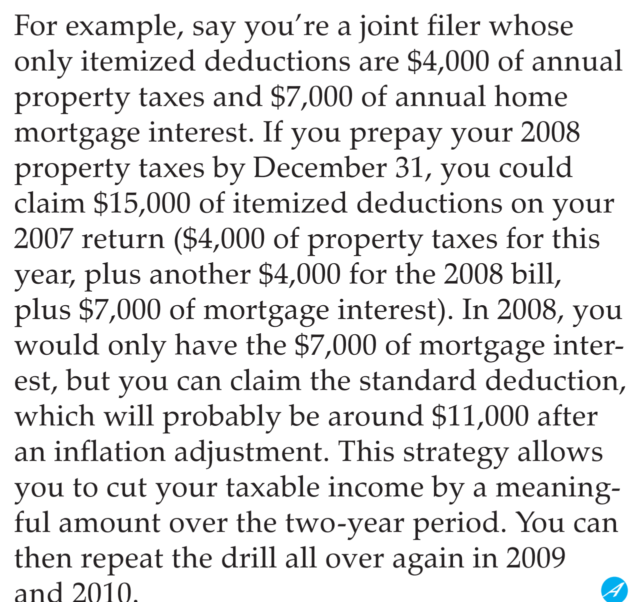
The Better Business Bureau's Wise Giving



Alliance at *www.give.org* provides information intended to assist donors in making informed decisions about the charities to which they contribute. This website contains information on charitable organizations that solicit contributions nationally such as the AARP Foundation and Meals on Wheels Association of America. Available information includes sources and uses of funds; and the percentage of funds allocated to programs, fund raising, and administration.

Bunching Deductible Expenditures

This year, the standard deduction for married joint filers is $10,700. The magic number for single filers is $5,350, while the figure for heads of households is $7,850. If your 2007 itemized deductions are likely to be just under or over this amount, it may pay to adopt the strategy of bunching together expenditures for itemized deductions every other year, while claiming the standard deduction in the intervening years. Examples of items that often work well for this strategy include the interest on your January home mortgage payment, charitable contributions, property taxes, and state income tax payments.



For example, say you're a joint filer whose only itemized deductions are $4,000 of annual property taxes and $7,000 of annual home mortgage interest. If you prepay your 2008 property taxes by December 31, you could claim $15,000 of itemized deductions on your 2007 return ($4,000 of property taxes for this year, plus another $4,000 for the 2008 bill, plus $7,000 of mortgage interest). In 2008, you would only have the $7,000 of mortgage interest, but you can claim the standard deduction, which will probably be around $11,000 after an inflation adjustment. This strategy allows you to cut your taxable income by a meaningful amount over the two-year period. You can then repeat the drill all over again in 2009 and 2010.

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Maximizing Deductions for Start-up and Organizational Expenses

Start-up Costs. As the name implies, start-up costs (often called preopening expenses) are expenses incurred before the business actually begins. Most start-up expenditures can be segregated into two broad categories: (1) investigatory expenses and (2) business preopening costs.

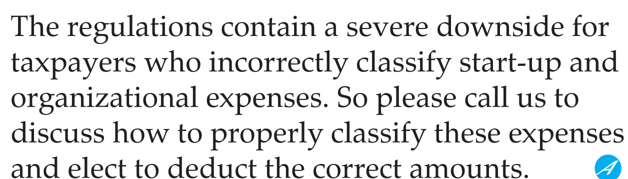
Investigatory expenses are costs incurred before reaching a decision to acquire or create a specific business. They include, but are not limited to, expenses for the analysis or survey of potential markets, products, labor supply, and transportation facilities. If incurred in investigating the acquisition of an existing business, investigatory expenses qualify as start-up expenses only if the taxpayer actually acquires an equity interest in the business and then actively participates in managing that business.

Business preopening costs are expenses incurred after the taxpayer decides to establish or acquire a specific business, but before the active conduct of that business actually begins. Such costs can include, but are not limited to, advertising; salaries and wages paid to employees being trained and their instructors; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries or fees paid or incurred for executives, consultants, and similar professional services.

Taxpayers can generally elect to claim up to $5,000 in start-up expenses as a current deduction. Start-up costs in excess of $5,000 are not currently deductible, but can be amortized over 180 months starting with the month in which the active trade or business begins or is acquired. However, the $5,000 instant deduction allowance is reduced dollar for dollar by cumulative start-up expenses in excess of $50,000 for the business in question. In many cases, start-up expenses for small businesses will be modest enough to qualify for immediate deduction under the $5,000 instant deduction allowance in the year when active conduct of business commences.

Example: Claiming the deduction for start-up expenses. Suzie (a calendar-year taxpayer) incurs $52,000 of start-up expenses in 2007 before opening her new car wash that began business in August of 2007. Suzie's 2007 deduction is projected to be $4,360 [$5,000 immediate write-off – $2,000 (start-up costs over $50,000) plus amortization of $1,360 (based on capitalized amount of $49,000 ÷ 180 months × 5 months)]. The remaining capitalized cost of $47,640 is amortized on a straight-line basis over the subsequent 175 months ($272 per month).

Organizational Costs. The costs of creating a corporation must be capitalized. Similar to procedures for deducting start-up costs, it is possible to elect to deduct up to $5,000 of common organizational costs including attorney's fees for drafting articles of incorporation, filing fees for registering the corporation with state and local authorities, preformation accounting fees, temporary director's fees, and organizational meetings of shareholders and directors. The $5,000 allowance is reduced by the amount of cumulative organizational costs in excess of $50,000. Taxpayers must capitalize and amortize any remaining costs that are not deducted over 180 months.



The regulations contain a severe downside for taxpayers who incorrectly classify start-up and organizational expenses. So please call us to discuss how to properly classify these expenses and elect to deduct the correct amounts.

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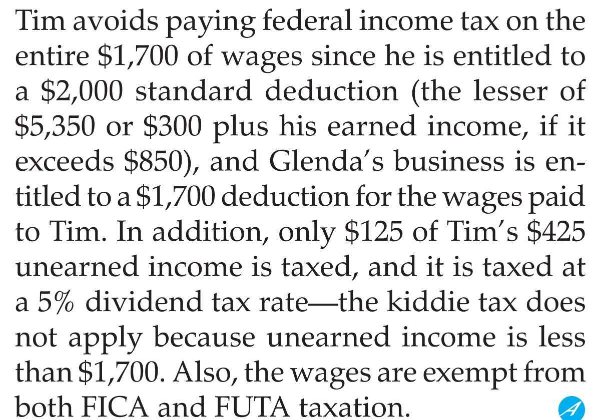
Employing Your Child in the Family Business

The Small Business and Work Opportunity Tax Act of 2007 recently expanded the kiddie tax rules which can now apply to children as old as 23. The expansion of the kiddie tax rules diminishes somewhat the value of shifting income-producing assets to children to take advantage of their lower tax bracket since the income generated will, in many cases, be taxed at the parent's higher tax rate. However, the kiddie tax only applies to *unearned* income (e.g., dividends and interest) and does not reach *earned* income (e.g., wages).

A technique for shifting income to children that avoids the kiddie tax is for parents to employ their child in a family business. Provided the compensation is reasonable relative to the work performed, the child has *earned* income and the business is entitled to a deduction for the expense. A child's earned income is not subject to the kiddie tax, so wages are taxed at the child's lower tax rate. In addition, wages paid to a child under age 18 from a parent's sole proprietorship are exempt from FICA taxes. A FUTA exemption exists as well.

In addition to the earned income being taxed at the child's rate, a child may shelter all or a portion of the earned income with the standard deduction. An individual claimed as a dependent (e.g., child) is entitled to a standard deduction equal to the greater of $850 or $300 plus actual earned income up to a maximum of $5,350 for 2007. However, the child may not claim a personal exemption if he or she is eligible to be claimed as a dependent.



Example: Saving taxes by employing your child. Glenda hires her 12-year-old son, Tim, to work in the stockroom of her clothing boutique which operates as a sole proprietorship. The boutique employees earn $10 per hour; Tim is paid $6 per hour based on the types of services he is able to perform. In 2007, Tim earned $1,700 in wages from the boutique. His only other income is $425 of dividends.

Tim avoids paying federal income tax on the entire $1,700 of wages since he is entitled to a $2,000 standard deduction (the lesser of $5,350 or $300 plus his earned income, if it exceeds $850), and Glenda's business is entitled to a $1,700 deduction for the wages paid to Tim. In addition, only $125 of Tim's $425 unearned income is taxed, and it is taxed at a 5% dividend tax rate—the kiddie tax does not apply because unearned income is less than $1,700. Also, the wages are exempt from both FICA and FUTA taxation.

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