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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

July 2009

Excluding Tax on Small Business Stock Gains

Owners of qualified small business stock can take advantage of special rules that apply when the stock is sold at a gain. [Incidentally, the term *qualified small business stock* (QSBS) means stock of a domestic C corporation with aggregate gross assets not exceeding $50 million either before or after issuance of the stock.] Traditionally, 50% of the capital gain on the sale of QSBS could be excluded from income if certain conditions were met. However, the American Recovery and Reinvestment Act of 2009 (Stimulus Act) increased the gain exclusion to 75% for QSBS acquired after February 17, 2009, and before January 1, 2011. Alternatively, taxpayers can roll over their gain from the sale of QSBS to a new QSBS stock position and indefinitely defer any tax due.

So, noncorporate taxpayers, primarily individuals, can exclude from gross income 75% (versus 50%) of any gain from the sale or exchange of QSBS acquired after February 17, 2009, and before January 1, 2011, if that stock is held for more than five years. The 75% capital gain exclusion removes some of the double taxation tax cost that applies to C corporation stock. If the corporation needs to retain income (rather than distribute it as dividends), the lower corporate tax rates on the first $75,000 of taxable income, combined with the 75% capital gain exclusion, may make the use of this strategy quite attractive.

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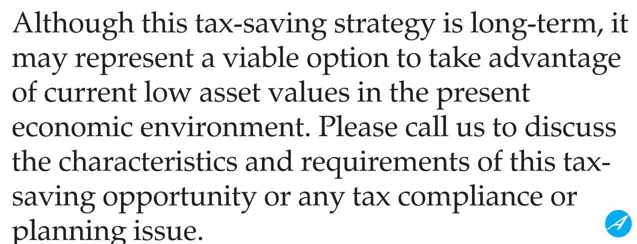
Status as a qualified small business corporation is not a matter of choice (i.e., no election is required), but it's an opportunity to save taxes if the fairly restrictive qualification requirements can be met. The major obstacles to qualification are the limits on the size of the business, types of eligible businesses, and types of assets a corporation can own and still meet the definition of a qualified small business. In addition, S corporation shareholders do not qualify for the gain exclusion tax break.



Although this tax-saving strategy is long-term, it may represent a viable option to take advantage of current low asset values in the present economic environment. Please call us to discuss the characteristics and requirements of this tax-saving opportunity or any tax compliance or planning issue.

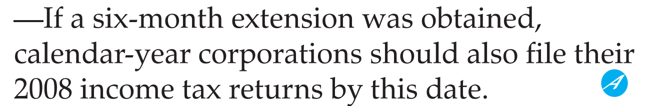
The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Tax Calendar

July 31—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds $500.

—The second quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

September 15—Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.



—If a six-month extension was obtained, calendar-year corporations should also file their 2008 income tax returns by this date.

Child Tax Credit

Taxpayers with qualifying children under age 17 are entitled to a child tax credit of $1,000 per child. The credit phases out at a rate of $50 for every $1,000 of modified adjusted gross income (MAGI), or fraction thereof, exceeding $110,000 for joint filers, $55,000 for married filing separately, or $75,000 for single and head of household filers. MAGI is adjusted gross income determined without regard to the exclusions from gross income for foreign earned income and foreign housing costs, and the income exclusion for residents of Guam, American Samoa, Northern Mariana Islands, and Puerto Rico.

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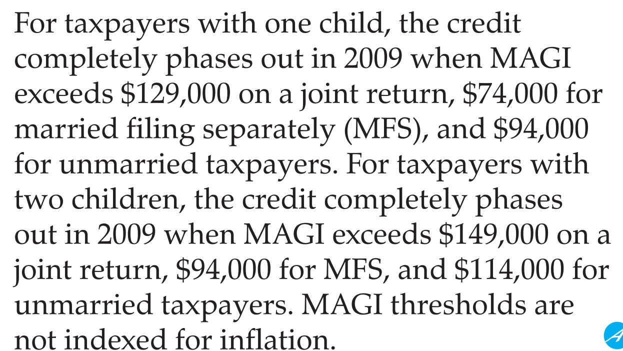
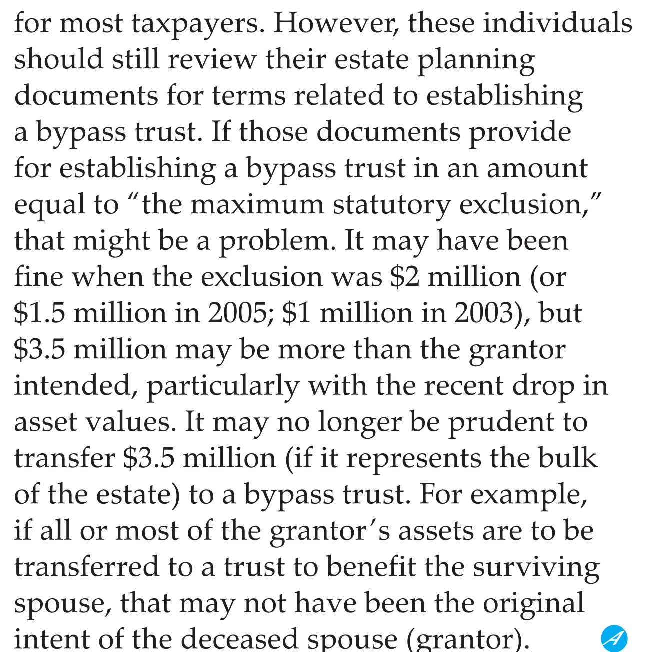


For taxpayers with one child, the credit completely phases out in 2009 when MAGI exceeds $129,000 on a joint return, $74,000 for married filing separately (MFS), and $94,000 for unmarried taxpayers. For taxpayers with two children, the credit completely phases out in 2009 when MAGI exceeds $149,000 on a joint return, $94,000 for MFS, and $114,000 for unmarried taxpayers. MAGI thresholds are not indexed for inflation.

Review Your Estate Planning Documents

This year is a good time to review your estate planning documents, particularly those related to a bypass trust. The federal estate tax exclusion amount for 2009 is $3.5 million per individual. That's an increase of $1.5 million over the $2 million available in 2008. With adequate planning, the increased exclusion should allow a married couple to leave up to $7 million to their heirs without paying any federal estate tax.

The increased exemption level will likely provide adequate protection from the estate tax for most taxpayers. However, these individuals should still review their estate planning documents for terms related to establishing a bypass trust. If those documents provide for establishing a bypass trust in an amount equal to "the maximum statutory exclusion," that might be a problem. It may have been fine when the exclusion was $2 million (or $1.5 million in 2005; $1 million in 2003), but $3.5 million may be more than the grantor intended, particularly with the recent drop in asset values. It may no longer be prudent to transfer $3.5 million (if it represents the bulk of the estate) to a bypass trust. For example, if all or most of the grantor's assets are to be transferred to a trust to benefit the surviving spouse, that may not have been the original intent of the deceased spouse (grantor).



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Tax Saving Strategy for a Volatile Stock Market

As most investors are painfully aware, stock markets are volatile, i.e., they move up and down generally in response to economic conditions. The past year is certainly indicative of how this volatility can impact the performance and value of a stock portfolio. With lower portfolio values, this may be a good time to analyze your stock positions and take advantage of some tax-saving opportunities as well. While generally it's not wise to let tax implications drive investment decisions, you should not ignore them either.

As you may know, the current maximum federal income tax rate on long-term capital gains (assets held for longer than one year) from selling stock and mutual fund shares held in taxable accounts is only 15%, which is pretty good by recent historical standards. However, 0% is even better, and 0% may be all you'll owe if you see this as a good time to revamp your taxable account's stock and mutual fund portfolio. Let's assume the revamping would involve selling some winners (current market value above what you paid), as well as some losers (shares currently worth less than what you paid). As long as the losses from the losers fully offset the gains from the winners, you'll owe nothing to the IRS as a result of your efforts.

But why stop there? You can continue trimming unwanted loser shares until you've generated a $3,000 net capital loss for the year. You can then deduct that $3,000 loss against this year's ordinary income—salary, self-employment income, interest, dividends, alimony received, and so on. (If you are married and file separately from your spouse, the annual net capital loss deduction limit is only $1,500.) This tax-saving strategy of selling unwanted loser shares before year-end is what Wall Street types call "harvesting" losses (to put a positive spin on a negative thing).

Once again, why stop there? If your loss harvesting is more extensive, you can generate a net capital loss that is well above the annual deductible limit ($3,000 or $1,500). This can turn out to be a tax blessing, since you can use that "excess loss" to shelter later capital gains. In fact, the tax shelter provided by your excess loss gives you great investing flexibility. How? You can use the excess loss to shelter short-term gains from sales later this year, or in future years, as well as long-term gains. (You can carry forward any excess loss remaining at the end of this year to 2010 and beyond until you have enough gains to use it up.)

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More specifically, to the extent of your excess loss, you don't have to worry about holding onto profitable positions for over a year just to get a lower tax rate. With your excess loss in hand, you can sell profitable positions any time you want without triggering any federal income tax bill whatsoever (assuming your excess loss is big enough to provide all the shelter you need). Even better, that excess loss might wind up sheltering gains in future years when tax rates are higher. All in all, owning an excess loss is really quite liberating when you think about it the right way. (To be sure, selling losers to generate that excess loss may be psychologically painful, but the welcome feeling of liberation will set in almost immediately thereafter.)

So, while many investors have lost a great deal of money in this volatile stock market, there may be an opportunity for tax savings. Juggling your winners and losers can be difficult. Please call us about the ideas discussed herein or any other tax compliance or planning issues.

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Hybrid Vehicle Credit Update

If you are considering a hybrid vehicle purchase in 2009, a tax credit of up to $3,400 may be enough to help make that decision. In addition, thanks to the American Recovery and Reinvestment Act of 2009 (Stimulus Act), the really good news for 2009 purchases is that the credit is now allowed against alternative minimum tax (AMT). Top this with the fact that the credit has no AGI phase-out limit, and you've got a whole new ballgame. But, you need to be careful—the amount of credit available depends on which hybrid you buy, and some of the most popular models are no longer eligible. Also, only purchases of new (not used) vehicles qualify.

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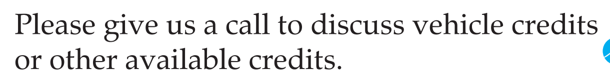
The actual credit allowed varies by vehicle. Furthermore, the credit is phased out once a manufacturer sells 60,000 hybrid vehicles. Lexus, Toyota, and Honda all hit this mark in previous years, so no 2009 purchase of their hybrids qualifies for a credit.

Ford and Mercury hit the 60,000 sales mark during the last quarter of 2008, which means the full credit for these vehicles is no longer available. However, 50% of the credit for Ford and Mercury vehicles will be allowed for purchases made from April 1, 2009, through September 30, 2009, and 25% of the credit will be available for purchases made from October 1, 2009, through March 31, 2010. So, if you're interested in a Ford or Mercury hybrid, you'll want to make the purchase before October 1, 2009, to get 50% (rather than 25%) of the credit.

The full credit is still available on hybrids manufactured by Mazda, Mercedes-Benz, Nissan, and Volkswagen and on certain General Motors vehicles.

There is also a credit for advanced lean burn technology vehicles, but no one had produced vehicles to which this credit applied until the last half of 2008 when Mercedes-Benz and Volkswagen released their versions. Since then, BMW and Audi have added vehicles to this list.

Please give us a call to discuss vehicle credits or other available credits.



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