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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Tax Advantages of Small Business Stock

As you may be aware, gains and losses on sales of corporate stock owned personally are generally treated as capital gains and losses. Although capital gains are potentially taxed at preferential rates, capital losses are usually unattractive because they can only offset capital gains plus $3,000 ($1,500 for married filing separate returns) of ordinary income (from wages, dividends, interest, etc.). Thus, if you realize large capital losses—but no capital gains, the tax benefit from the capital losses may have to be spread over many years in the future.

However, there is a tax provision that allows you to treat losses incurred from the sale of qualified corporate stock as an ordinary (rather than capital) loss. That's beneficial because an ordinary loss offsets ordinary income. The deductible ordinary loss for this provision is, however, subject to an annual limitation of $50,000 ($100,000 if you file a joint return).

Of course, you don't intend for your new business to generate a loss; however, this tax provision (known as Section 1244) is like insurance—you hope you will not need it, but it's nice to have just in case. Any gain on the sale of Section 1244 stock is capital gain and qualifies for the favorable capital gains tax rates. Only losses are characterized as ordinary. Thus, there's really no downside to qualifying for Section 1244 treatment if your initial capital structure can be set up to meet the requirements.


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To qualify as Section 1244 stock, your new business must be a U.S. corporation (including an S corporation), and it must have no more than $1 million in capitalization at the time the stock is issued. The stock must be issued to an individual or partnership in exchange for money or qualified property. Stock issued in exchange for services will not qualify. In addition, the corporation must derive more than half of its gross receipts from noninvestment activities for a specified period (generally, five years) before the year the stock is disposed of at a loss.

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.

Business Mileage Rate Increase

The IRS recently announced that the optional mileage allowance for owned or leased autos (including vans, pickups, or panel trucks) will increase by 4.5¢, from 51¢ to 55.5¢ per mile for business travel from July 1, 2011, through December 31, 2011. This increase is to better reflect the real cost of operating an auto in this period of higher gas prices. This rate can also be used by employers to reimburse employees tax-free when employees supply their own autos for business use under an accountable plan and to value personal use of certain low-cost employer-provided vehicles. The rate for using a car to get medical care or in connection with a move that qualifies for the moving expense will also increase by 4.5¢ for the last half of 2011, from 19¢ to 23.5¢ per mile.

2011 Adoption Expenses

Taxpayers with certain eligible adoption expenses can benefit at tax time. They can claim either a refundable tax credit or, if their adoption expenses are reimbursed by their employer, an income exclusion for the reimbursement. The income exclusion is only available if their employer maintains an adoption assistance program. The credit and exclusion are subject to a dollar limitation and phase-out for taxpayers whose income exceeds certain thresholds.

For 2011, taxpayers can claim a *refundable* tax credit for up to $13,360 of qualifying adoption expenses. (A refundable credit can create a tax refund in excess of taxes paid or withheld.) This is not an annual limitation; instead, it applies to the adoption of each child and is cumulative (for that child) over all tax years. When applying the limitation, adoption expenses incurred in an unsuccessful attempt to adopt an eligible child are included with those of the first subsequent successful adoption. The limitation is the same for both married and unmarried taxpayers, but married couples must file a joint return to claim the credit.

The credit for an adoption involving a child with special needs that becomes final in the tax year is automatically $13,360, regardless of the actual amount (even if less than $13,360) of qualifying adoption expenses incurred.

Help a Grandchild Retire

Grandparents are in a unique position to help their grandchildren plan for their own retirement from an early age. This is something that even grandparents of modest means can do and ultimately makes a huge impact.

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Consider Alice, a grandparent with a 10-year-old grandson, Sam. Alice hires Sam to work in her yard on Saturdays. Alice pays Sam a total of $350 during the calendar year. (By keeping his wages under $400, Sam avoids having to pay self-employment tax.) Since the $350 qualifies as earned income for Sam, he is eligible to contribute a like amount to an IRA. Alice isn't wealthy, but she has the means to make Sam's IRA contribution for him as a gift. Alice and Sam continue this arrangement for the next eight years (until Sam starts college).

Alice's total contribution to Sam's IRA is $2,800 ($350 × 8). Let's assume Sam never adds to the account, but lets it continue to grow for 50 years (until he reaches age 68). If the account grows at an average rate of 7%, it will be worth approximately $106,000 when Sam is 68. Better still, if the account is a Roth IRA, distributions will never be taxed. So, Alice's modest gifts to Sam many years before will have grown into a tidy sum to help fund Sam's retirement.

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Defer Taxes with an Installment Sale

If you are selling commercial real estate (e.g., an apartment or office building) in a difficult market, you will likely be asked to provide financing to get the deal done. If this is the situation, where at least one payment is received after the tax year in which the sale occurs, you can use the installment sale method to defer a portion of the income tax due on a gain. In fact, unless you elect out, the installment sale method is required by the IRS.

Under the installment sale method, the seller recognizes a portion of each payment as gain when received. Typically, each payment the seller receives consists of three parts: (1) a return of basis (investment) in the property sold, (2) gain (profit) on the sale, and (3) interest on the installment note. Only the gain and interest portions of each payment are taxable to the seller.

Reporting gain from the disposition of property under the installment sale method allows the seller to spread the tax liability over several years rather than all in the year of sale. Thus, the seller's payment of tax corresponds with the actual cash flow generated from the sale.

Several restrictions and limitations exist on the use of the installment sale method. In general, persons who regularly sell or otherwise dispose of personal property on the installment plan or who hold real property for sale to customers in the ordinary course of business ("dealers") can only use the installment sale method for sales of farm property, timeshares, and residential lots. However, in the case of timeshares and residential lots, interest must be computed and paid each year on the deferred tax liability. Also, any item that must be included in ending inventory (e.g., auto parts) is ineligible for the installment sale method.

Example: Deferring taxable gain using the installment sale method.

Tyler is a real estate investor, but is not a dealer in real property. In February 2011, he sold an apartment complex for $5 million (net of expenses), receiving $500,000 in cash and a $4.5 million note. His basis (investment) in the property was $3 million. The note calls for annual installment payments beginning in February 2012. He will receive interest on the note commensurate with the market and the buyer is not a related party. Tyler will use the installment sale method to report his taxable gain.

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Tyler's total gain on the sale of the apartment complex is $2 million (the $5 million sale proceeds less his $3 million basis), which is 40% (gross profit ratio) of the selling price. For 2011, he will report a taxable gain of $200,000, computed by multiplying the $500,000 received in cash during 2011 by the 40% gross profit ratio. The remaining $300,000 is a nontaxable return of Tyler's original investment. As installment payments are received beginning in 2012, he will report any interest received and 40% of the principal payment as taxable gain. The remaining 60% of the principal payment is a return of his investment.

In certain circumstances, it may be beneficial to elect out of the installment sale method and report the entire gain in the year of sale. When the taxpayer has expiring carryovers (i.e., net operating losses, charitable contributions, business credits), reporting the entire gain in the year of sale could allow use of those carryovers and minimize any tax liability. In addition, if you are concerned that capital gain tax rates will increase in the future, it may be advantageous to elect out of installment sale treatment and avoid higher taxes down the road.

This is a somewhat complicated topic, so please contact us if you have any questions regarding using or electing out of the installment sale method of deferring taxable gain.

Combined Business and Vacation Travel

If you go on a business trip within the U.S. and add on some vacation days, you know you can deduct some of your expenses. The question is how much. First, let's cover just the pure transportation expenses. By this, we mean the costs of getting to and from the scene of your business activity, which includes travel to and from your departure airport, the airfare itself, baggage fees and tips, cabs to and from the destination airport, and so forth. Costs for rail travel or driving your personal car also fit into this category. The bottom line is that your domestic transportation costs are 100% deductible as long as the primary reason for the trip is business rather than pleasure. On the other hand, if vacation is the *primary* reason for your travel, then generally none of your transportation expenses are deductible.

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The IRS does not specify how to determine if the primary reason for domestic travel is business. Obviously, the number of days spent on business versus pleasure is the key factor. We can look to the rules covering foreign travel for guidance on this issue. These rules say your travel days count as business days, as do weekends and holidays if they fall between days devoted to business, and it would be impractical to return home. "Standby days" (days when your physical presence is required) also count as business days, even if you are not called upon to work on those days. Any other day principally devoted to business activities during normal business hours is also counted as a business day, and so are days when you intended to work, but could not due to reasons beyond your control (local transportation difficulties, power failure, etc.).

You should be able to claim business was the primary reason for a domestic trip whenever the business days exceed the personal days. Be sure to accumulate proof and keep the proof with your tax records. For example, if your trip is made to attend client meetings, log everything on your daily planner and copy the pages for your tax file. If you attend a convention or training seminar, keep the program and take some notes to show you attended the sessions.

Once at the destination, your out-of-pocket expenses for business days are fully deductible. Out-of-pocket expenses include lodging, hotel tips, meals (subject to the 50% disallowance rule), seminar and convention fees, and cab fare. Expenses for personal days are nondeductible.

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