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Tax Letter
For Businesses

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2007 Year-End Tax Planning for Businesses

The time to consider tax saving opportunities for your business is before its tax year-end. Some of these opportunities may apply regardless of whether your business is conducted as a sole proprietorship, partnership, limited liability company, S corporation or regular corporation. Other opportunities may apply only to a particular type of business organization. This *Tax Letter* is organized into sections discussing year-end, and year-round, tax saving opportunities for:

- All businesses
- Partnerships, limited liability companies and S corporations
- Regular corporations

Tax planning for businesses also requires consideration of the tax consequences to the individual owners. Accordingly, we suggest you also review our November *Tax Letter* titled 2007 *Year-End Tax Planning for Individuals*.

This *Tax Letter* only discusses federal tax planning. However, state taxes also should be considered since the tax laws of many states do not follow the federal tax laws. Your client service professional can be consulted for guidance regarding individual state tax planning or multi-state tax planning opportunities when your business operates in more than one state.

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Tax Saving Opportunities for All Businesses

2007 Versus 2008 Marginal Tax Rates

Whether you choose to accelerate taxable income into 2007 or defer it until 2008 depends, in part, on the marginal tax rate for each year projected for your business. Generally, unless your 2007 marginal tax rate will be significantly lower than your 2008 marginal tax rate, you should defer taxable income to 2008.

The marginal tax rate is the rate applied to your next dollar of income or deduction. Projections of your business' 2007 and 2008 income and deductions are necessary to determine the marginal tax rate for each year.

Your client service professional can be consulted to recommend how your business can shift income and deductions between these years to minimize your tax liability. (Also see our November 2007 *Tax Letter for Individuals*.)

Since the top tax rates in 2007 can be as high as 35 percent for individuals and corporations, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.

Cash Versus Accrual Accounting

Except for farming businesses and certain qualified personal service corporations, regular corporations and partnerships that have a regular corporation as a partner must use the accrual method of accounting if their average annual gross receipts for the three prior tax years are more than $5 million, regardless of the type of business in which they are engaged. If their average annual gross receipts are $5 million or less, regular corporations and partnerships that have a regular corporation as a partner can use the cash method of accounting unless they have inventories, in which case they must use the accrual method of accounting.

All other taxpayers, including S corporations and C corporations that are personal service corporations, can use the cash method of accounting regardless of their average annual gross receipts. However, if they have inventories, they must use the accrual method for purchases and sales, with the exception of certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million. Supplies consumed in the rendering of services are not inventory. In addition, some taxpayers in certain businesses have been successful in persuading courts that certain types of tangible property transferred to customers in connection with the provision of services are not inventory if the property is integral to the services.

Treasury has provided a de minimis exception with regard to the use of the accrual method of accounting. Under this exception, all taxpayers can use the cash method of accounting if they have average annual gross receipts of $1 million or less. If such businesses have inventories, they can deduct the cost of the inventory only when sold.

Planning Suggestion: A corporation that must change to the accrual method because its average annual gross receipts for the three prior tax years exceed $5 million, should consider an S election if the accrual method is undesirable. An S election, to be effective beginning with the current year, must be made by filing IRS Form 2553 on or before the 15th day of the third month of the tax year for which it is to take effect. (The Internal Revenue Service has the authority to remedy a late or improperly filed Form 2553, even for a prior year.) Please consult your client service professional to determine whether an S election is appropriate for your corporate business.

A business using the accrual method that qualifies to use the cash method may obtain permission from the IRS to change to the cash method by filing an IRS Form 3115. (An automatic consent procedure is available for certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million to change to the cash method.) On the other hand, a business currently using the cash method that wishes to voluntarily change to the accrual method may, in certain circumstances, do so automatically by filing an IRS Form 3115 with its 2007 income tax return. The accrual method may be desirable, for instance, if accrued expenses exceed accrued income.

Any change of accounting method must be made in compliance with IRS approval procedures. Your client service professional can be contacted for further information.

Advance Payments

Cash method taxpayers recognize revenue when cash is actually or constructively received. Accrual method taxpayers recognize revenue upon the earliest of when (1) payment is earned through performance, (2) payment is due, or (3) payment is received. However, under a May 2004 IRS Revenue Procedure, payments received by an accrual method taxpayer in advance of services being performed or goods being delivered can be deferred to the next succeeding taxable year if such payments are reported on the taxpayer's "applicable" financial statements as deferred revenue, or if earned in a later taxable year in the absence of applicable financial statements. Deferral is also available for advance payments received for the use of intellectual property, certain guaranty or warranty contracts, and the sale, lease, or license of computer software. If an accrual method taxpayer wishes to change its present method of accounting for recognizing advance payments to a method consistent with the IRS Revenue Procedure, generally such change can be made automatically by filing an IRS Form 3115 with its timely-filed tax return.

In addition, under existing income tax regulations, advance payments received with respect to an agreement (e.g., a gift card) for the sale of inventoriable goods may be deferred for two years unless required to be included in income earlier for financial statement purposes. Qualifying taxpayers wishing to change to this method of accounting are required to obtain the advance consent of the Internal Revenue Service by filing an IRS Form 3115 with the IRS no later than the last day of the year of change.

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Related Party Transactions

Accrual method taxpayers may not deduct salaries, bonuses, interest, rent and other expenses owed to related cash method parties until payments are made.

Related parties include:

- An individual and his or her more than 50 percent-owned corporation
- Partnerships and their partners
- S corporations and their shareholders
- Two corporations having more than 50 percent common ownership
- A corporation and a partnership, if the same persons own more than 50 percent of each entity

Unrelated Party Compensation

Accrued compensation, including vacation pay which is payable to unrelated employees, reduces an employer's taxable income. However, these deductions are also subject to restrictions. To obtain current deductions, accrual method employers must pay 2007 compensation to unrelated employees (and cash method independent contractors) within 2 1/2 months after year-end. Otherwise, this compensation is treated as deferred compensation which is deductible only when paid.

Note: Vested deferred compensation, although not currently deductible, is considered "wages" for FICA and FUTA tax purposes. Note also that under new deferred compensation rules discussed below and in our 2007 year-end *Tax Letter for Individuals*, certain items that may previously have been effectively deferred will now be treated as received currently by the employee (with a corresponding deduction to the employer).

Planning Suggestion: Employers with tax years that end in October, November or December 2007 should pay accrued compensation to unrelated employees in early 2007 (within 2 1/2 months of the employer's year-end) in order to obtain the following advantages:

- 2007 deduction for employers
- 2008 income for employees

Deferred Compensation

The American Jobs Creation Act of 2004 created new Internal Revenue Code Section 409A imposing new restrictions on the timing of distributions from and contributions to deferred compensation plans. Employers must modify their plans to conform to the new rules by December 31, 2008; however, plans need to be operated in "good faith" compliance before January 1, 2009. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options, stock appreciation rights, phantom stock and restricted stock unit plans.

Companies that are non-compliant with these new rules will not incur penalties directly; however, the participants in the plans will be subject to immediate taxation of plan balances plus an additional 20 percent tax and interest penalties. Companies also have a reporting requirement with respect to amounts either contributed to a plan or distributed from a plan during the taxable year.

Deductible Versus Capitalized Costs

In an effort to provide more certainty as to whether various costs, especially costs that provide a benefit beyond the current taxable year, can be expensed or are required to be capitalized, the IRS issued comprehensive final regulations in December 2003, regarding the treatment of costs to acquire or create intangible assets. For example, under these regulations:

- Employee compensation is deductible even if the employee's functions relate to acquiring or creating intangible assets, such as contract rights
- Prepaid costs to obtain a right or benefit not extending beyond the earlier of 12 months or the end of the following tax year may be deductible

Your client service professional can be consulted for information about how to change your tax method of accounting to comply with these regulations.

Depreciation Deductions

The timing of asset acquisitions is critical to obtain maximum depreciation deductions. Using other depreciation rules to your advantage will also reduce your taxes.

Planning Suggestion: If you expect to buy property in 2008, you may benefit by accelerating the purchase so that you place the property in service in 2007.

The time when you place assets in service during the year establishes the amount of depreciation. Generally, all personal property is subject to a half-year depreciation convention. In other words, one half-year's depreciation is allowable for the year in which the property is placed in service. A mid-month convention must be used for real estate.

If the total basis of personal property placed in service during the last three months of a tax year exceeds 40 percent of the total basis of personal property placed in service during the entire year, then a mid-quarter convention must be used instead of the half-year convention for all personal property placed in service during the tax year.

Example: "T," a calendar year taxpayer, placed a machine in service on October 1, 2007. No other property will be placed in service during 2007. Therefore, the mid-quarter convention applies, and T's 2007 depreciation must be computed as though the machine was placed in service on November 15, 2007, instead of July 1, 2007.

Caution: Generally, no depreciation is allowable if the property is placed in service and disposed of in the same tax year.

AMT Depreciation

The alternative minimum tax (AMT) is imposed on corporations and individuals and is added to the regular tax if and to the extent the AMT exceeds the regular tax. AMT is based on alternative minimum taxable income (AMTI), which consists of a taxpayer's regular taxable income increased by various adjustments to items that for regular tax purposes result in the deferral of income (e.g., accelerated depreciation) and by various tax preference items.

"Small corporations," corporations with average gross receipts of less than $7.5 million for the prior three taxable years (less than $5 million for the corporation's first 3 taxable year period), are exempt from AMT.

Planning Suggestion: If AMT is anticipated, you may wish to consider leasing instead of purchasing depreciable property, since depreciation computed for regular tax purposes may have to be adjusted for AMT purposes. Your client service professional can discuss with

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you the advantages and disadvantages of this and other possible measures to avoid the AMT.

Asset Expense Election

Generally, if you purchase depreciable tangible personal property (including off-the-shelf computer software), you may elect to treat up to $125,000 as a deduction for property placed in service in the taxable year beginning in 2007. However, the benefits of this election begin to phase out if more than $500,000 of qualifying property is placed in service. (The maximum amount that can be expensed ($125,000) is reduced "dollar for dollar" for eligible property placed in service in excess of $500,000). This asset expense election is further increased for qualifying property placed in service by a qualifying "enterprise zone business." The asset expense election for sport utility vehicles is limited to $25,000. If 2007 income is not sufficient to use the entire $125,000 asset expense election, the unused amount may be used in 2008 or subsequent years. Please consult your client service professional for further information.

Planning Suggestion: Plan purchases of eligible property to assure maximum use of this annual asset expense election.

Leasehold Improvements

Tax consequences should be considered when negotiating a lease. Generally, the cost of leasehold improvements must be depreciated over 39 years rather than depreciated over the lease term. However, when the lease terminates, the tenant may deduct any unrecovered cost.

Qualified leasehold improvement property placed in service prior to January 1, 2008, is depreciated over 15 years using the straight-line method, rather than over 39 years. Qualified leasehold improvement property is any improvement to the interior portion of nonresidential real property made under or pursuant to a lease by the lessee, sublessee, or lessor. The improvement must be part of the interior of the building that is used exclusively by the lessee or sublessee and must be placed in service more than three years after the date the building was first placed in service.

Personal Property Versus Real Property

For regular tax purposes, real property depreciation deductions are stretched out over 27.5 years for residential rental property and 39 years for nonresidential property. However, depreciation deductions may be accelerated for real property components that are essential to manufacturing or other special business functions.

Example: Taxpayer constructed a $10 million manufacturing facility, which was placed in service during 2007. The design required an overhead crane, a special reinforced foundation to support equipment and other specific features to accommodate the manufacturing process. A cost segregation study revealed that approximately $5 million of the facility's cost can be recovered over 7 years instead of 39 years for regular tax purposes.

Planning Suggestion: Arrange for a cost segregation study to identify personal property and determine optimum depreciable lives for both new and prior acquisitions and construction. The position of the Internal Revenue Service is that the present depreciation method for property previously misclassified can be changed, and the full amount of any prior depreciation understatement can be deducted in the current year. Your client service professional can be consulted for further information and assistance.

Research Tax Credit

The Research Tax Credit (RTC) was enacted to encourage research and development (R&D) in the U.S. and is broadly applicable across industries and R&D activities. Many sizeable RTC opportunities go unnoticed, and many RTC claims are erroneously calculated or ineffectively documented. If your business attempts to develop or improve (even incrementally) products, manufacturing or other processes, software, techniques, formulae or the like, now is the time to assess whether your business is taking full advantage of this valuable incentive.

The RTC comprises three credits: (1) a regular credit; (2) an alternative incremental credit (AIC); and (3) an alternative simplified credit (ASC). These credits are based on three types of payments: (1) qualified research expenses (QREs), i.e. certain expenses paid or incurred, generally, for product, process, and software development and improvement activities; (2) payments to qualified organizations for basic research; and (3) payments to energy research consortia for energy research. Credits based on QREs and basic research payments are incremental; those based on energy research payments are not.

The Tax Relief and Health Care Act of 2006 greatly enhanced the RTC by (1) increasing credit rates for the AIC (to as much as 5%) and (2) establishing the ASC. Consequently, companies that previously could not materially benefit (if at all) from the RTC may now benefit.

The IRS has increased its focus on the RTC, designating it as a "Tier 1" issue. This designation restricts an IRS examiner's discretion to resolve certain issues, e.g., issues related to the use of non-statistical sampling, certain estimates and extrapolations, non-contemporaneous documentation, and cost-capturing techniques that do not tie qualified costs to projects or "business components."

Note: Although the federal RTC is set to expire after 2007, pending legislation is expected to extend it. The RTC has been extended 12 times since 1981, most recently by the Tax Relief and Health Care Act of 2006, which provided a seamless extension through 2007.

If you have questions about the RTC, your client service professional can put you in touch with one of our RTC specialists.

Domestic Production Activities Deduction

The American Jobs Creation Act of 2004 included a tax deduction with respect to income from certain domestic production activities (Section 199 of the Internal Revenue Code). For tax years beginning in 2007, 2008 and 2009 the deduction equals 6 percent of "qualified production activities income" subject to certain limitations. Qualifying domestic production activities may include:

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- Manufacture, production, growth or extraction of tangible personal property;
- Film production;
- Electricity, natural gas or water production;
- Construction or renovation of real property; and
- Engineering and architectural services.

Computer Software Costs

The tax treatment of costs to develop, purchase or lease computer software is as follows:

- Software development costs, including the costs of customizing and implementing purchased software, may be treated as either current expenses and deducted in full or as capital expenditures and amortized ratably over 60 months from the completion of the development or 36 months from the date the software is placed in service.
- The cost of purchased software that is separately stated from the cost of computer hardware may be amortized ratably over 36 months beginning with the month the software is placed in service.
- The cost of leased software may be deducted as paid or incurred.

If you have treated software costs differently in a prior year, a change of accounting method can be made. Your client service professional can be consulted for further information.

Employment Related Credits

The work opportunity credit is available (even against the alternative minimum tax) to employers who pay wages to an individual who is a member of a "target group." An individual who fits into one of the following target groups qualifies for the credit: (1) qualified Aid to Families With Dependent Children (AFDC) recipient; (2) qualified veteran; (3) qualified ex-felon; (4) designated community resident; (5) vocational rehabilitation referral; (6) qualified summer youth employee; (7) qualified food stamp recipient; (8) qualified SSI recipient; (9) "New York Liberty Zone" employee; and (10) Hurricane Katrina employee. For a qualified business in the New York Liberty Zone, the work opportunity credit may be used not only for new hires, but also for existing or rehired employees. The work opportunity credit for New York Liberty Zone employees also applies to businesses located in the Liberty Zone on September 11, 2001, that relocated within the five boroughs of New York City because of the destruction of its workplace.

If the worker works at least 400 hours in the first year, the credit is 40 percent of the first $6,000. If the worker works at least 120 hours and less than 400, the credit is 25 percent. Therefore, once the employee works the 120 hours, he qualifies the previous 120 hours for the 25 percent credit. Once the employee works 400 hours, he qualifies the previous 400 hours for the 40 percent credit. In some cases, the employer may want to extend the tax return to qualify some workers for the 40 percent credit.

A welfare-to-work credit is available to employers of long-term family assistance recipients. A "long-term family assistance recipient" means being a member of a family receiving assistance under Aid to Families With Dependent Children or successor program for specified time periods.

The amount of the credit is equal to 35 percent of the "qualified first-year wages" and 50 percent of the "qualified second-year wages." The amount of qualified wages with respect to an individual cannot exceed $10,000 per year. Thus, the maximum credit is $8,500 per qualified employee.

If a welfare-to-work credit is allowed to an employer with respect to an individual for any tax year, the employer cannot also take a work opportunity credit with respect to that individual for that tax year.

Employers are also eligible to receive a tax credit equal to 25 percent of qualified expenses for employee child care facilities and 10 percent of qualified expenses for employee child resource and referral services, up to $150,000 per taxable year.

Passive Losses

Generally, passive losses currently offset only passive income. Unused passive losses are carried to future years. An unused (suspended) loss generally is deductible when a taxpayer disposes of his interest in the passive activity. IRS regulations define "activity" broadly.

Personal service corporations (PSCs) are subject to the passive loss restrictions. "Closely held C corporations" (other than PSCs) can use passive losses to offset active income except for interest, dividends or other portfolio income. A closely held C corporation is defined as a C corporation in which more than 50 percent of the value of its outstanding stock is owned by five or fewer individuals.

Planning Suggestion: Your client service professional can assist you in determining whether it would be advisable for you to transfer personally owned passive loss activities to your closely held corporation (if it is not a PSC). Also, if you anticipate having unusable passive losses this year, those losses may be available to offset gains from partnership or S corporation distributions in excess of your basis.

Passive losses of S corporations and partnerships are passed through to their owners. Special rules apply to publicly traded partnerships.

Rental Real Estate

For real estate professionals, rental real estate activities are not subject to the passive loss rules if, during a tax year:

- More than 50 percent of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. However, in determining material participation, a spouse's participation is taken into account. Services performed as an employee are ignored unless the employee owns more than 5 percent of the employer.

In determining whether he materially participates in any of his real estate activities for purposes of applying this test, each interest of the taxpayer in rental real estate must generally be treated as if it were a separate activity. However, the taxpayer may alternatively

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elect to treat all of his interests in rental real estate as a single activity. The election is irrevocable but is often necessary to qualify.

A closely held C corporation will satisfy these tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage.

Inventories

For tax years beginning after 1986, specified overhead costs, which previously were deductible, had to be capitalized by being added to inventory. This accounting method change increases taxable income to the extent that inventory is on hand at year-end. Special rules apply to LIFO inventories.

Planning Suggestion: Some taxpayers either have not complied with these Uniform Capitalization Rules, or have either included too little or too much overhead into their inventory cost. Your client service professional can help you review whether changes should be made to your inventory costing method. The IRS provides incentives for voluntarily making corrective changes to accounting methods.

Inventory Shrinkage

Businesses that do not take a physical inventory count at the end of their taxable year may accrue a deduction for estimated inventory "shrinkage" at year-end. Inventory shrinkage is a catchall amount attributable to items such as undetected theft, breakage and bookkeeping errors, which cause a taxpayer's actual inventory to be less than the amount recorded on its books. In estimating shrinkage at year-end, businesses may take into account their experience in prior years, sometimes adjusted for special circumstances and other factors that management considers appropriate.

The adoption of a method of estimating inventory shrinkage is a change of accounting method, which requires conformity with IRS procedures. Your client service professional can be consulted for further information.

LIFO Inventories

Use of the LIFO method, in inflationary times, allows a Taxpayer the ability to increase deductions and lower taxable income. This is accomplished by removing the impact of inflation from ending inventory.

Planning Suggestion: Taxpayers using LIFO should monitor their inventory levels to avoid invading LIFO inventory layers and a resulting increase in taxable income.

The IRS issued generally favorable LIFO rules in 2002 to allow taxpayers to elect a revised inventory price index computation (IPIC) method. Contact your client service professional to discuss whether this election would benefit your business.

Caution: If a corporation using the LIFO method elects to be an S corporation, it must include in income for its last tax year as a regular corporation its "LIFO recapture amount," computed as follows:

Example:

Inventory's value at FIFO	$2,000,000
Less inventory's value at LIFO	1,600,000
LIFO recapture amount	$ 400,000

Any resulting tax is payable in four equal installments without interest. The first installment must be paid on the due date, without extensions, of the return for the last tax year as a regular corporation. The next three installments must be paid by the due date, without extensions, of the S corporation's tax return for the succeeding tax years.

Rescinding a Transaction

Because tax consequences are based on an annual accounting concept that uses the facts as they exist at the end of a tax year, transactions occurring during the year may be disregarded if rescinded before year end.

Example (1): A calendar-year taxpayer sells property at a gain on July 1, 2007. If the buyer and seller agree to rescind the sale by December 31, 2007, the sale is disregarded for tax purposes.

Example (2): A regular corporation and its shareholders are calendar-year taxpayers. The shareholders make capital contributions to the corporation during 2007 for an expansion project which is later abandoned. If the capital contributions are returned to the shareholders by December 31, 2007, the contributions will be treated as though they were never made and thus will have no tax effect. However, if they are returned after 2007, they may be treated as dividends or other taxable distributions.

Caution: Your client service professional and your attorney should be consulted if you wish to rescind a transaction.

Tax Saving Opportunities for Partnerships, Limited Liability Companies and S Corporations

Partnerships

Regulations governing the allocation of partnership income and loss can sometimes lead to unanticipated results. The allocation of losses may be particularly sensitive to routine changes in partnership liabilities. Even if these changes do not affect allocations, they may trigger income to the partners in certain circumstances. Contributions, distributions, and interest transfers can also present income recognition issues. Many of these issues depend on the position of the partnership at the end of its taxable year. Therefore, unforeseen tax consequences can often be mitigated with year-end planning. For example, the implementation of loan guarantees or indemnification agreements can sometimes prevent tax problems related to partnership liabilities.

Beginning in 2007, qualified joint ventures owned by a husband and wife filing a joint return is not treated as a partnership for Federal tax purposes. A qualified joint venture is a trade or business with respect to which (1) the only owners are a husband and wife, (2) both spouses materially participate, and (3) both spouses elect for the joint venture not to be treated as a partnership. Instead of reporting as a partner of a partnership, the husband and wife are treated as sole proprietors, each report-

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ing on a Schedule C of their joint Federal income tax return.

Limited Liability Companies

Generally, the same federal tax rules that apply to a partnership also apply to a two-or-more member limited liability company (LLC) that has chosen to be taxed as a partnership, rather than a corporation, under applicable income tax regulations. Under these same regulations, a single-member LLC owned by an individual can choose to be taxed either as a sole proprietorship (Schedule C business) or as a corporation, and a single-member LLC owned by a corporation can choose to be taxed as part of its corporate owner (i.e., a division) or as a separate corporate subsidiary.

S Corporations

With individual income tax rates now equal to or closer to corporate tax rates, now may be the time to consider making an S corporation election for your regular corporate business, if eligible. Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation in order to take advantage of anticipated losses. Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.
- If the corporation has earnings and profits (E&P) on hand which were accumulated during the time it was a regular corporation, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Since loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a note to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (15 percent) capital gain tax rate.
- Distributions to shareholders which exceed the corporation's accumulated adjustments account (AAA) may result in inadvertent dividends if the corporation has E&P accumulated from the time it was a regular corporation. Therefore, distributions should be delayed if the amount that will be in the AAA at year-end is uncertain.
- Until December 31, 2010, dividends from domestic and qualified foreign corporations are taxed at a maximum 15 percent rate. Accordingly, S corporations with regular corporation E&P may wish to consider making a dividend distribution of this E&P, which would be taxed to its shareholders at the present maximum 15 percent dividend rate.
- Consider gifting S corporation stock to shift income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation). A built-in gain is determined as follows:

Example:

Total gain on asset's sale	$1,000,000
Less appreciation accruing while an S corporation	300,000
Built-in gain	$ 700,000

If an S corporation has sold property and recognized built-in gains, it should consider offsetting these gains by recognizing built-in losses. Alternatively, the built-in gains tax may be deferred or, in some circumstances, eliminated if the corporation's taxable income can be eliminated.

Caution: Estimated taxes must be paid on net recognized built-in gains. (These estimates cannot be based on the preceding year's tax, if any.)

Checklist of Tax Saving Opportunities for All Businesses

- Accelerate deductions into 2007 and defer gross income to 2008, unless 2007 taxable income is expected to be substantially below 2008 taxable income.
- Pay accrued expenses owed to a related party before the end of 2007, to enable an accrual-basis business to deduct these expenses currently. Pay accrued compensation, including vacation pay which is owed to unrelated individuals, within 2 1/2 months after year-end, in order to deduct the compensation this year.
- Shift equipment purchases from 2008 to 2007, to increase 2007 depreciation, utilize the first-year depreciation deduction, or maximize the use of the current $125,000 annual expense election.
- Businesses using the LIFO inventory method should monitor their inventory levels before year-end to avoid invading LIFO inventory layers which would generate taxable income.
- Businesses with inventories should consider using the new LIFO IPIC rules
- If you wish to reverse a transaction that you consummated during 2007, and are able to rescind it, the rescission must occur by year-end.
- Have a cost segregation study of current or prior facility acquisitions or construction performed to identify those assets that may qualify for faster depreciation.
- Review the accounting methods used in your business for tax purposes to determine whether any should be changed.

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Recent changes have made more corporations eligible to become S corporations. For instance, financial institutions not using the reserve method of accounting can become S corporations; S corporations can now have up to 100 shareholders and in determining the number of shareholders, extended family groups can be treated as a single shareholder; certain tax-exempt organizations can be shareholders; S corporations can hold controlling interests in other corporations; and wholly owned subsidiaries of S corporations can elect to be disregarded as entities separate from their parent S corporations.

In addition, income allocable to an employee stock ownership plan (ESOP) as a shareholder of an S corporation is not currently taxed, but rather is taxed to the ESOP beneficiary at the time of distribution.

Note: The American Jobs Creation Act of 2004 and the Small Business and Work Opportunity Tax Act of 2007 made several liberalizing changes with respect to S corporations.

Tax Saving Opportunities for Regular Corporations

Retention of Corporate Earnings

The present 35 percent top rate for individuals may exceed the marginal tax rate of your corporation. In this case, it may be desirable to retain corporate income by deferring compensation to employee-shareholders.

Caution: A corporation that accumulates E&P beyond its reasonable business needs may be subject to an additional 15 percent tax on its accumulated taxable income. However, $250,000 in E&P may generally be accumulated before this tax applies. Special rules pertain to holding, investment, and personal service corporations.

Personal Service Corporations

Personal service corporations (PSCs) are denied the benefit of the lower corporate tax brackets and are taxed at a flat 35 percent rate. A PSC is a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting.

PSCs and certain small businesses on the accrual method of accounting are permitted to eliminate from accrued service income an amount that, based upon experience, will not be collected.

Caution: A PSC that elected a fiscal year is subject to a "minimum distribution" requirement. Such a PSC must monitor the level of payments (compensation, rent, etc.) to employee-shareholders to avoid postponing part or all of the deduction for these payments. Therefore, if your top individual tax rate exceeds the top rate to your corporation, it may be advisable to terminate a fiscal year election, if you have not done so already.

Corporate Stock and Stock Options

A corporation may obtain a deduction by the issuance of its stock or stock options that have a "readily ascertainable fair market value" (generally the case when the option is actively traded on an established securities market) to pay otherwise deductible expenses. For example, stock issued to employees or independent contractors constitutes deductible compensation to the issuer at the time the stock is unconditionally vested. In the case of options, the deduction is generally available when the option is exercised.

Caution: The issuer is only allowed a deduction if the employee or independent contractor includes the same amount of the deduction in income. This requirement is deemed satisfied if the issuer timely files a Form W–2, in the case of an employee, or a Form 1099, in the case of an independent contractor.

Planning Suggestion: For stock vested upon transfer, fiscal year corporations may take the deduction in the fiscal year such stock is transferred to the employee or independent contractor, rather than waiting until the next fiscal year in which the employee or independent contractor's tax year ends. This acceleration opportunity may be effected by filing an application for a change in method of accounting (IRS Form 3115) no later than the last day of the year of change.

Disqualifying dispositions of Incentive Stock Options (ISOs) by employees during the year will also result in compensation deductions for the employer. Companies that have issued ISOs to their employees should determine whether there have been any disqualifying dispositions of the underlying stock during the year.

Stock or stock options (warrants) issued to a lender result in deductible "original issue discount."

Your client service professional can be consulted for further information regarding ISOs and nonqualified stock options. Also see our discussion of stock options in our *Tax Letter for Individuals*.

Estimated Taxes

Corporate estimated tax payments may significantly affect your business' cash flow. Accordingly, planning for the lowest required payment is essential. The requirements differ for small and large corporations.

A small corporation is one that had taxable income of less than $1 million for each of the three preceding tax years. Conversely, a large corporation is one that had taxable income of $1 million or more for any of the three preceding tax years. Taxable income, for this purpose, is computed without net operating and capital loss carryovers and carrybacks.

Checklist of Tax Saving Opportunities for Partnerships and S Corporations

- Partners of a partnership and shareholders of an S corporation should determine, before year-end, if they have sufficient basis in their partnership interest or S corporation stock and loans.
- If an S corporation has sold property and recognized "built-in gains" during the year, consider offsetting these gains by recognizing any "built-in losses" or by reducing the corporation's taxable income.

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A small corporation may base its estimated tax payments on the preceding year's tax. However, a large corporation may base only its first estimated tax payment on the preceding year's tax. For either type of corporation, an estimate may be based on the preceding year's tax only if the preceding tax year consisted of 12 months and the preceding year's return showed a tax liability.

Estimated tax payments that cannot be based on the prior year's tax can be based on 100 percent of the expected tax for the current year or tax calculated on the current year's annualized income. The annualized income method provides a safe harbor from estimated tax penalties if the expected tax for the entire year is difficult to determine. If the annualized income method is used, payments are made as follows:

Installment Number	Annualization Period	% of Tax to Be Paid
1	1st 3 months of tax year	25
2	1st 3 months of tax year	50
3	1st 6 months of tax year	75
4	1st 9 months of tax year	100

Alternatively, a corporation may annually elect one of the following annualization periods:

Installment Number	Optional Annualization Periods I	or	Optional Annualization Periods II
1	1st 2 months of tax year		1st 3 months of tax year
2	1st 4 months of tax year		1st 5 months of tax year
3	1st 7 months of tax year		1st 8 months of tax year
4	1st 10 months of tax year		1st 11 months of tax year

Option I or II must be elected by the due date of the first quarterly installment for each year. Form 8842 can be used to make the election.

In some cases, lower payments may be made under the adjusted seasonal installment method. No estimated taxes are required for a particular year if the tax shown on the return for that year is less than $500.

Estimated taxes also are required if there is an AMT liability for the current year.

Planning Suggestion: A corporation anticipating no 2007 tax should consider taking action to produce a small tax by reporting low taxable income so that estimated 2008 tax payments can be based on 2007 tax.

Examples:

- X Corporation will have a $100 net operating loss and no tax for 2007. X must pay 2008 estimated taxes based on its 2008 regular or AMT income to avoid penalties.
- Y is a small corporation. Its 2007 return will show a $500 tax liability. Y will be able to pay only $500 as 2008 estimated taxes and avoid penalties, even though its actual 2008 tax may be much higher. If Y's 2008 tax is $100,500, it would pay the $100,000 balance on March 15, 2009.

"Quick Refund" for Excess Estimated Tax

If estimated taxes paid exceed the expected annual tax, a corporation may apply for a "quick refund" (on IRS Form 4466) of the excess tax before the tax return is filed, but only if this excess tax is at least $500 and 10 percent of the expected annual tax. This quick refund may be requested after the close of the corporation's tax year, but no later than the 15th day of the third month following the tax year-end (the original due date of the corporation's income tax return). The IRS must act on this refund application within 45 days after it is filed.

Example: "Z," a calendar-year corporation, paid $50,000 in estimated taxes for the first three quarters of 2007. In the fourth quarter of 2007, Z incurs a large loss so that the tax due for the year is expected to be only $10,000. Z may request a $40,000 refund after December 31, 2007, and by March 15, 2008. The IRS must act on Z's refund application within 45 days after it is filed.

Postponing Tax Payments if Net Operating Loss Expected

Generally, a taxpayer cannot obtain an extension of time for paying a tax. However, if a corporation expects a net operating loss (NOL) for the current year, it may extend the time for paying the tax for the immediately preceding tax year. The postponement is available only for tax payments due after this extension is filed and applies to the extent that the NOL can be carried back to the two preceding tax years. Although the tax payment is postponed, interest is still charged from the original due date of the tax payment until the original due date of the current year's return.

Example: "Q," a fiscal year corporation determines that it will have an additional $30,000 tax to pay December 15, 2007, for its tax year ended September 30, 2007. Q also expects to have a $100,000 NOL for its year ending September 30, 2008, which may be carried back to its two preceding tax years. Q files IRS Form 1138 before December 15, 2007 to extend the time for paying the $30,000 tax otherwise due December 15, 2007. Interest on the postponed tax payment will be charged from December 15, 2007 until December 15, 2008.

Checklist of Tax Saving Opportunities for Regular Corporations

- Maximize the retention of corporate income by deferring compensation to high-income employee-shareholders.
- If a net operating loss is expected for 2007, but taxable income is anticipated for 2008, attempt to generate nominal tax liability for 2007 to enable 2008 estimated tax payments to be based on the 2007 tax.

Super Expedited Refund Claim in Hardship Cases

If a corporation incurs an NOL in the current year, it may request a "quick refund" from a carryback of that NOL by filing IRS Form 1139 (Corporation Application for Tentative Refund) on or after the date of filing the tax return for the NOL year – but no later than one year after the end of the NOL year. Generally, the IRS must act on this refund request within 90 days of its filing. If Form 1139 is not timely filed, the corporation must file an amended tax return (Form 1120X) for the prior year to carryback the NOL.

In extreme cases, where a corporation can demonstrate hardship if it has to wait even 90 days for the refund, the taxpayer also should file IRS Form 911 (Application for Taxpayer Assistance Order to Relieve Hardship). We have been successful in obtaining refunds within a week or two where a desperate need for the refund was demonstrated, such as the need to meet payroll.

Planning for Net Operating Losses

NOLs are a valuable corporate attribute. Even net operating losses that were not fully reported on a prior year return can be carried forward. However, the ability to use an NOL carryforward may be limited where a loss corporation has experienced a change of stock ownership – for example, as a result of a merger or acquisition. Your client service professional can assist you with the appropriate planning needed to preserve and maximize the use of NOLs by your corporate business.

Succession and Family Business Planning

Year-end is the traditional gift-giving season. This should also be a time to plan for your company's succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes. We urge you to consult with your client service professional for ideas to preserve your family wealth.

Conclusion

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely held entities requires a delicate balance between planning for the business and planning for its owners.

This 2007 year-end *Tax Letter for Businesses* and our 2007 year-end *Tax Letter for Individuals* cannot cover every tax saving opportunity that may be available to you and your business. Since taxes are among your largest expenses, we urge you to meet with your client service professional. We can provide a comprehensive review of the tax saving opportunities appropriate to your particular situation.

For More Information

If you would like further information or to discuss the implications of the matters discussed in this *Tax Letter for Businesses*, please contact the Ryan, Sharkey & Crutchfield partner serving you or call our main phone number listed below.

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Material discussed in this *Tax Letter for Businesses* is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

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