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# Management



# Tax Concepts



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# Size up your business structure

## *Despite tax rate extensions, still a useful endeavor*

Last year, the possibility of a rise in individual tax rates had many business owners questioning whether so-called “pass-through” entities were still viable. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 put on hold any such concern until 2013. That’s when individual rates are now scheduled to rise, instead of 2011. Nonetheless, there’s never a bad time to size up your business structure to review its strengths and weaknesses.

### The corporate world

There are a number of good reasons for incorporating your business to operate under either the C or the S corporation structure. Incorporation generally offers the owners greater protection than a partnership does against legal claims that can’t be satisfied with assets of the company. Also, C and S corporations can, to a certain extent, add new shareholders and transfer business shares more easily.

From a tax perspective, C corporations often get a bad rap because they’re subject to double taxation. That is, the corporation pays taxes on its income, and then that income is taxed again when it’s paid out in dividends or liquidating distributions to its shareholders. The impact of that second level of tax was reduced but not eliminated when qualified dividends began to be taxed at a lower rate (generally 15%).

Another tax downside of a C corporation is that C corporation shareholders don’t build up additional tax basis when income is recognized by the business. S corporation or LLC owners do.

Double taxation and no basis build-up still drive many business owners to make an “S election.” If you’re considering doing so, be aware that there are eligibility requirements. For example, you must have no more than 100 shareholders, all of whom must be U.S. citizens or residents. Also, partnerships, LLCs, certain trusts and other corporations generally don’t qualify as shareholders.

S corporations are referred to as “pass-through” entities because income and losses pass through the corporate structure to the shareholders, who must then report the income or loss on their tax returns. Those shareholders pay tax on the income and may deduct losses only to the extent of their tax basis. Losses may also be subject to passive activity loss limitations.

In addition, “dividend” distributions of company income to S corporation shareholder-employees aren’t subject to employment taxes, but shareholder-employees must take “reasonable” wages to avoid



## Key considerations for an S-to-C conversion

Because of possible tax rate increases for individuals, many S corporation owners have pondered whether converting their companies to a C corporation would be beneficial. Doing so would limit their personal tax liability to the dividends they receive from the business rather than their entire share of the company's income.

Of course, it would also subject the corporation itself to taxation. (See main article for further details.) There's also the potential for "built-in gains tax" if you convert and then sell any assets owned at the time of conversion within a period of years. Naturally, there are a variety of items to consider before making this move. First, project your company's growth over the next couple of years to help you predict dividend payment amounts.

Also, don't forget about corporate and individual income tax rules in all of the states in which you operate, as well as whether federal corporate tax rates are expected to change. Note that, if your business is expected to generate capital gains (whether in the normal course of business or as part of your exit strategy), those gains won't result in favorable federal tax treatment within a C corporation structure.

Last, bear in mind that, though terminating an S corporation election is relatively simple (additional tax reporting may be required), you must generally remain a C corporation for five years after converting before electing S status again. Check with your CPA for details.

potential penalties. What's considered reasonable depends on the facts and circumstances.

### Another pass-through option

If the notion of a pass-through entity strikes your fancy, but incorporation seems too restrictive, look into forming a limited liability company (LLC). With an LLC, there's no maximum number of — or restrictions on the type of — owners.

That said, this structure is generally more common for a smaller assemblage of owners. True to its name, an LLC also offers legal liability protection.

Again, as a flow-through entity, an LLC may have tax ramifications you might not expect. Your ability to deduct employee fringe benefits may be limited under an LLC because you and your fellow owners are technically considered partners. Additionally, LLC earnings could subject you to self-employment tax. While an S corporation can decide to distribute a reasonable portion of its income as a dividend and avoid payroll costs, an LLC doesn't have this option.

If you're currently operating as an LLC, converting to a C or S corporation is relatively easy and generally tax free. But going from a corporate structure to an LLC is considered a liquidation of the corporation and could present tax difficulties. Your CPA can explain further.

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### The simple approach

Many companies start life as a sole proprietorship or general partnership because these entity types are relatively easy to get off the ground. But there

are legitimate reasons for making the move to another business structure.

For instance, as noted above, other entity types (such as a corporation or an LLC) protect owners from being personally liable for debts or lawsuits against their businesses. And a multimember LLC arguably protects the assets of the business from unrelated claims against the owners.

There may be tax advantages to a more complex ownership entity as well. Sole proprietors

and partnership owners must report all business income or losses on their personal income tax returns and, depending on the nature of the business, that income may be subject to self-employment taxes.

### A major decision

Changing your company's business structure is a major decision. If you decide to make a switch, you'll need to weigh a number of factors — including the tax impact and your strategic goals. ♦

## Is it time for a road trip?

### *Be sure to consider the tax impact of crossing state lines*

In looking for ways to keep your company competitive, you may consider taking a little “road trip” and doing some (or more) business across state lines. This certainly isn't a bad idea. Conducting business in multiple states may open new markets and allow you to better leverage your company's distinctive strengths. But doing so can also create unexpected tax liability.

### You are here

Another state can apply its income, franchise (a tax on the privilege of doing business in a state) or sales and use tax to your business if you've established a sufficient connection, or “nexus,” with that state.

Historically, nexus required a physical presence in the state, such as offices, manufacturing facilities or employees. Physical presence is still required today to trigger sales and use tax collection obligations, but many states require only a minimal presence to establish nexus for income and franchise tax purposes — and the courts have often agreed.

Federal law prohibits a state from taxing a company's income if its only activity in the state consists of soliciting orders or sales of tangible personal property that are approved and shipped from outside the state. But this law doesn't apply to intangible property. Thus, several recent cases have allowed states to tax an out-of-state firm's income on intangibles, such as trademark licenses or credit cards, even though the firm had no physical presence in the state. A substantial economic presence was sufficient.

Franchise tax often requires even less of a connection. Simply soliciting orders or sales in the state may be enough.

### Many factors

Whether your company is exposed to multistate taxation depends on many factors, including the nature of your business, the tax laws in each of the states in which you do business, and your activities in those states. Nexus is determined on a state-by-state basis, so if you plan to expand into two or more neighboring states, you may face different rules for each.



That said, some activities or circumstances within a state will generally trigger nexus. Examples include having legal domicile or a principal place of business there, of course. But even just maintaining an office or other facility there will probably do the trick. Rendering services of any kind or soliciting orders will also create a strong likelihood of nexus.

*“Several recent cases have allowed states to tax an out-of-state firm’s income on intangibles even though the firm had no physical presence in the state.”*

Therefore, the best course of action is to learn each prospective state’s rules and project your tax liability before expanding. Doing so will limit or eliminate any unpleasant surprises that could make the move less beneficial than you anticipated.

### On the bright side

Multistate taxation isn’t necessarily a bad thing. For example, to avoid multiple taxation of the same

income, most states require that you apportion income among the states where you’re subject to income tax, typically using a formula based on your company’s sales, property and payroll in each state, though states weight each factor differently and some use only one or two of the factors.

Suppose that your company is located in a state with a very high corporate income tax, but you do a significant amount of business in states with low or no income taxes. Because you lack nexus with those states, all your income is taxed by your home state.

But if you create nexus with one or more of those states (by setting up a small office, for example, in a state where your sales are significant), you may be able to allocate some income to those states and lower your overall tax bill.

### Not a bad idea

Although we’ve seen glimmerings of an economic recovery in certain sectors, many business owners remain understandably cautious about making any sudden moves.

But that doesn’t mean expanding your operations beyond your current locale is a bad idea. Just be sure to work with your CPA to understand the tax ramifications first. ♦

# Giving to charity can mean saving on taxes

Like many people, you may intend to make donations to charity but never get around to really thinking about it until tax time. Although it's too late to make donations that you can deduct on your 2010 return, now is a great time to review the basics of charitable giving and put together a donation plan for 2011.



## Fundamental measures

For starters, make sure you're donating to a qualified charity. Although this may seem obvious, there are so many organizations soliciting contributions these days that it can be easy to confuse an organization that's not a qualified charity with a legitimate charity. Plus, because of some recent IRS rule changes, some charities may soon lose their tax-exempt status due to noncompliance. The IRS maintains a database you can check at <http://apps.irs.gov/app/pub78>.

Many donations to qualified charities are fully deductible, but not all. For instance, if you contribute services, you may deduct only your out-of-pocket expenses — not the fair market

value of your services. And if you donate tangible personal property that isn't related to the charity's primary function, your deduction will be limited to your basis in the property (generally what you paid for it).

Also mind your record keeping. Retain a bank record (such as a canceled check) or written communication from the charity stating the organization's name and your contribution's date and amount.

For more substantial donations, you should expect to provide more substantive documentation. In fact, when it comes to any major charitable contribution, work with your tax advisor to determine just how much of a tax benefit you stand to receive as well as what records you'll need to keep.

## New developments

Charitable giving got a boost from the passage of the Tax Relief act this past December. It extends a couple of valuable charitable giving breaks through 2011.

First, if you're age 70½ or older, you may still make a direct contribution from your IRA to a qualified charitable organization of up to \$100,000 per tax year without owing any income tax on the distribution. You can use the contribution to fulfill a minimum distribution requirement.

Second, if you'd like to donate some capital gains real property for conservation purposes, you can claim a deduction of up to 50% of your adjusted gross income (AGI). That's a substantially higher percentage than the 30% of AGI limit that typically applies to capital gains property contributions.

## Never a bad time

There's never a bad time to donate to charity. But you may want to seize this opportunity to learn the tax benefits while taxes are already on your mind. ♦

# Why Social Security still matters (and when to use it)

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Although no one should depend solely on Social Security for retirement, many people go the opposite route and discount its value entirely. The truth likely lies somewhere in between: Social Security still matters as a way to supplement your nest egg, but you've got to do that supplementing at the right time.

## When to say when

Much depends on your retirement date and what your income will look like at that time. Maybe you want or need to retire early and would like the investments in your portfolio to keep growing. If this is the case, and it looks like your income will fall short, collecting your Social Security benefits early may be the right move.

You can start taking retirement payments as early as age 62. Granted, the amount of your monthly benefit will be lower, but you'll receive more payments over the remainder of your life and, therefore, might receive more total benefits.

## When to say "not yet"

If you don't plan to retire completely, and your income will meet your needs, it's usually best to put off collecting Social Security until at least "normal" retirement age (ranging from age 65 to age 67, depending on the year you were born). Otherwise, your Social Security benefits will generally be reduced by an additional \$1 for every \$2 you earn exceeding a threshold that's set annually — \$14,160 for 2011.

If you can postpone receiving Social Security benefits beyond normal retirement age, you'll receive even higher monthly payments. The amount increases each month that you delay up to age 70, at which point you'll have maximized the benefit of waiting.

Also keep in mind that, whatever your age, other income over specified limits will subject up to 85% of your Social Security payments to federal income taxes.

So, if you plan to retire at age 70, you could be better off financially by waiting until that time to start taking Social Security. That would allow you to increase your monthly payment and could mean that less of your Social Security income would be subject to income tax. Thus, you'd end up with more money in your pocket each month.

## A careful balance

Of course, if you don't live long after you start collecting Social Security, waiting too long could reduce your lifetime benefits. So there's a careful balance that you need to reach. ♦



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