Year-End Tax Planning Strategies

Presented by CohnReznick’s Government Contracting Industry Practice

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INTRODUCTION

• Goals
  • Identify at Least One Tax Saver
  • Raise Awareness
  • Have Some Fun
• Please Silence Your Cell Phones
• Questions, Please
• Let Us Know How We Did
AGENDA

- Tax Law Changes
  - Small Business Jobs Act of 2010
  - Healthcare Reform
    - “Bush era” tax cuts scheduled to expire in 2011
- Business tax planning
- Individual tax planning
TAX PLANNING SINCE 2001/2003

• Stable rates among lowest in history
• “Traditional” tax planning focused on deferring income/accelerating deductions
• When income is deferred, you “make” the time value of money on the tax
• A growing company on the cash basis could defer several years of income (and taxes) and “make” time value of money on that
2010 – SWITCH GEARS?

• Deferred income is like water behind a dam
  • Builds up—the pressure is tax that eventually must be paid
• Possibility of tax rate increase poses a risk
  • Potential loss = % rate increase \times \text{deferred income recognized after rates rise}
• For the first time in many years, it may be time to accelerate income and defer deductions
SMALL BUSINESS JOBS ACT OF 2010

• Signed into law September 27, 2010
• Expanded asset expensing (Section 179) of up to $500K
• Extended 50% 1st Year Bonus Depreciation Election
• 100% exclusion on Small Business Stock
  • 3-month window!
• Carry back credits 5 years
• S corporation shortened Built In Gains Tax Recognition Period to 7 years for 2009 and 2010 elections
• SE health deducted for SE tax calculation
• Designated Roth rollovers
HEALTHCARE REFORM

• Signed into law March 2010

• Tax Changes Affecting Individuals
  • For 2011
    • No reimbursements from HRAs, HSAs, FSAs, and MSAs of over-the-counter medications
  • For 2013
    • Floor on medical expense deduction raised from 7.5% of AGI to 10% (over 65 remains at 7.5%).
    • FSAs limited to $2,500 (from unlimited)
    • 3.8% surtax on high income taxpayers
TAX ON HIGH INCOME TAXPAYERS

• Effective 2013 but start planning now

• Additional .9% Medicare tax on wages and SE Income
  • Wages/SE income over $200K (single) or $250K (married)
  • Thus, total of 2.35% for employees and 3.8% for self-employed
  • Tax on employee portion only
TAX ON HIGH INCOME TAXPAYERS

• 3.8% Medicare tax on investments
  • tax on lesser of net investment income or modified AGI above $200K (single) or $250K (married)
• “Net investment income”
  • Interest, dividends, royalties, rents, gross income from passive activities, gains on disposition of investment type property, less expenses
  • Does not include retirement income, but retirement income raises MAGI
• Expect Congress and IRS to make changes before 2013
INDIVIDUAL TAX RATES LIKELY TO RISE

• When?
  • Bush era tax cuts scheduled to lapse in 2011
  • Congress not likely to act before Nov. election

• Who will be affected?
  • Possibly everyone starting in 2011
  • Certainly high income earners in 2013

• How can you be prepared?
## INDIVIDUAL TAX RATES - ORDINARY INCOME CURRENT LAW

<table>
<thead>
<tr>
<th>Taxable Income for Married Couples</th>
<th>2010</th>
<th>2011-2012</th>
<th>With Surtax 2013</th>
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<tbody>
<tr>
<td>$ 0 – 16,750</td>
<td>10%</td>
<td>15%</td>
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<tr>
<td>$ 16,750 – 68,000</td>
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<tr>
<td>$ 68,000 – 137,300</td>
<td>25%</td>
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<tr>
<td>$137,300 – 209,250</td>
<td>28%</td>
<td>31%</td>
<td>34.8%</td>
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<tr>
<td>$209,250 – 373,650</td>
<td>33%</td>
<td>36%</td>
<td>39.8%</td>
</tr>
<tr>
<td>over $373,650</td>
<td>35%</td>
<td>39.6%</td>
<td>43.4%</td>
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</table>
### Dividends and Capital Gains Rates

#### Current Law

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OTHER TAX LAWS SCHEDULED AFTER 2010

• Itemized deductions to be reduced by 3% of AGI
• Phase-out of personal exemptions returns
• Sec. 121 home sale exclusion by heirs, estates, revocable trusts goes away
• Reduced dependent care credit
• Capital gain and qualified dividends no longer taxed for AMT at regular tax rate
• Accumulated earnings tax and PH company tax rises from 15% to 39.6%
• Estate and gift tax top rate increases to 55%
BUSINESS TAX PLANNING PROCESS – WHEN AND HOW?

• Start at time your prior year return is prepared.
• If estimated tax payments are necessary, these should be given to you with your return or extensions.
• Monitor throughout the year as some people and businesses need quarterly projections while others need “safe” vouchers.
• Do full tax projections from October through December while there is still time to implement tax-saving ideas.
• If a specific transaction is being proposed (sale of a business, stock sale, large bonus, large charitable contribution), call your tax accountants for projections of how the transaction will affect your taxes as soon as possible.
TAX PLANNING PROCESS – WHAT IS IT AND WHY BOTHER?

• Projects tax liability for the current year or for current and subsequent years
• Can be done for “what if” scenarios for specific transaction
• Steps: gather info, project tax, & implement recommendations
• Minimum goals: Penalty protection and no surprises in April
• Other goals: lowest possible tax or…..
• Coordinate with other financial planning efforts
• Consider both the business entity and individual owner(s) for closely held businesses
TAX PLANNING PROCESS – COORDINATION IS KEY

- Correlation of year-end tax planning with indirect rates
- Associate tax strategies with financial statement issues
- Identify whether reasonable compensation is an issue
- IF S Corp loss, do the shareholders have basis to deduct the loss
- Section 179 fixed asset limits
- Remember contribution limits and bonus payments for C Corps
- Consider not deferring income on the premise that tax rates will increase
- But if strategy is to defer income
  - Consider deferring billings to avoid collection by year end for cash-basis taxpayers
  - Draw on lines of credit or use credit cards to pay bills to secure deductions for cash basis entity
- If any capital gains, offset with realized losses
Accounting Method Choice is Influenced By Business Type and Entity Type:

- Types of Entities:
  - Sole Proprietor: taxed at individual level
  - Partnership: taxed at partner level
  - LLC: mostly taxed at member (partner) level
  - C Corporation: taxed at corporate level
  - S Corporation: taxed at stockholder level
CASH BASIS ACCOUNTING

- Only pay tax on revenues collected during the year minus deductible expenses paid.
- Don’t pay tax on your accounts receivable and prepaid expenses deductible.
- Users are *generally* limited to partnerships, LLC’s and S corporations in service industries, as well as C Corporations in service industries with up to $5M in revenues.
- *Generally* can’t be used by businesses involved in retail, wholesale, or manufacture of “goods,” construction contractors and other “non-service” types of business.
- Popular with taxpayers- not so much with IRS and Congress.
- A growing business can defer taxes for many years using this method.
- Double edged sword-when business is flat or contracting, taxes deferred in past come due.
FIXED ASSETS – EXPENSING ELECTIONS

- May expense up to $500,000 a year
- Machinery, equipment, furniture or other “qualifying property”
- Limited to taxable income and for larger businesses
- Consider timing of purchases
- Interaction with bonus depreciation
GOVERNMENT CONTRACTORS – UNBILLED RECEIVABLES

- IRS rule for accrual taxpayers - “all events test”
- Financial statement report Income when “earned”
- Different types of contracts
  - Non-severable
  - Severable
  - Milestone
  - Cost Plus
  - Time & materials
- Examples of unbilled receivables
  - Fee retention
  - Estimated award fee
  - Cost rate variance
  - Milestone payments
INDIVIDUAL TAX PLANNING APPROACH

• Project 2010 and 2011 taxable income
• Start with 2009 information and adjust
• Project marginal tax bracket for 2010 v. 2011
• If higher for 2011 consider accelerating income, deferring deductions
• Consider AMT
• Consider limitations, carryovers
STRATEGIES TO ACCELERATE TAXABLE INCOME

• Cash basis businesses
  • Step up collection efforts before year-end
  • Defer payments to January where practical
• Consider Roth IRA conversion
• Sell appreciated stocks (watch out for short-term holding period)
• Elect out of installment method
• Make dividend payments from closely-held C corporations
• Make 4th Q state estimated payment in Jan
STRATEGIES TO DEFER TAXABLE INCOME

- Cash basis businesses
  - Defer billings
  - Prepay expenses
- Elect installment method
- Defer compensation for year-end bonuses
- Prepay state tax (watch for AMT)
Other 2010 Considerations

- SE health insurance can be deducted in computing SE tax
- Make 529 plan contributions by 12/31
- Make retirement plan contributions by due date of return
  - No itemized deduction or personal exemption phase-out
- “Back door” 1% rate increase for 2011 and later
- Use “bunching” to avoid various phase-outs and limits:
  - Education credit/deduction
  - Medical
  - Misc itemized deductions
ROTH IRA CONVERSION BASICS

• Available to everyone beginning 2010
• Converted amount generally taxable
• For 2010 conversions ONLY, ability to defer income to 2011 and 2012
• Ability to unwind conversion until extended due date of tax return (October 15, 2011)
• Partial conversions allowed
• Best to pay tax with non-IRA assets
• “Designated Roth rollovers” after 9/27/2010
POTENTIAL BENEFITS OF ROTH CONVERSION

- Hedge against rising taxes
- Future appreciation completely income tax free
- No required minimum distribution (RMD) after age 70 ½
- Tax-free stream of income to heirs
MITIGATING 2013 TAX ON HIGH INCOME TAXPAYERS USING ROTH IRA CONVERSIONS

• Distributions from a Roth IRA DO NOT count towards MAGI
• Roth IRA conversion income DOES count towards MAGI beginning in 2013
• Paying tax using non-qualified accounts (i.e., outside assets) can result in lower future “net investment income”
• Required minimum distributions from traditional IRAs:
  • Exempt from the surtax, BUT
  • Increase MAGI
  • Creates a 43.4% effective tax rate on IRA distributions
TAX ON HIGH INCOME TAXPAYERS
AN ILLUSTRATION

• Investment Income $249,000
• IRA Distribution (RMD) 100,000
• MAGI $349,000
• Less: Threshold (250,000)
• Excess over threshold $ 99,000
• Surtax (3.8%) $ 3,762
• If no RMD, no surtax
CONCLUSION

- Know your entity type and which methods and strategies will best serve you
- Get ready - project your taxable income now
- Watch Congress between now and year-end
- Revisit your projection and strategy based on tax law changes, especially rates
QUESTIONS/COMMENTS
RESOURCES

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