SEILER LLP
CERTIFIED PUBLIC ACCOUNTANTS

Report

Summer 2011

Succession planning
Transferring ownership to the next generation

Tick, tock, tick, tock
Time is running out to disclose "hidden" foreign accounts

Have you researched the research credit?

Tax Tips
Can you deduct an expense if someone else pays it?, going green and more

Silicon Valley Office
Three Lagoon Drive, Suite 400
Redwood City, CA 94065
tel 650 / 365.4646
fax 650 / 368.4055

www.seiler.com
A Member of HLB International

San Francisco Office
220 Montgomery, Suite 300
San Francisco, CA 94104
tel 415 / 392.2123
fax 415 / 392.1720

Transferring ownership to the next generation

Family businesses rarely last after the second generation. So, if you want your business to continue to thrive — even after you've retired — you need to develop a succession plan for the future. One important step in the succession planning process is determining the best way to transfer ownership interests to the next generation.

All in the family — or not

The first thing many business owners think of when it comes to succession planning is selecting a successor, and your choice likely will have an impact on your ownership-transfer strategies. If multiple family members are competing for the job or if a nonfamily member is best suited to take the reins, conflicts could occur. Allowing family members to participate in the succession planning process will help ensure a smooth transition.

Another thorny issue is how to divide your wealth between family members who work in the business and those who don't. If you want to divide your estate equally among your children or other family members and you have significant nonbusiness assets, you can leave the business to those who are active in it while still treating everyone fairly.

If most of your wealth is tied up in the business, remember that "equal" distribution of ownership interests isn't necessarily "fair." A child who's spent years helping you grow the company may object to sharing control with family members who weren't involved. One way to share the wealth without diluting management control is to give voting stock to children working in the business and nonvoting stock to the rest.

From one generation to the next

From a tax perspective, succession planning is critical because the way you transfer the business to the next generation can have significant gift and estate tax implications. You can minimize estate taxes by transferring business interests during your lifetime.

With proper planning, you'll be able to remove these assets from your estate today without negative gift and estate tax consequences and also avoid gift and estate taxes on any future appreciation in value. But make sure you balance the benefit of reducing transfer taxes against your desire to maintain management control and your need to continue to receive income from the business.

If you're comfortable relinquishing control over the business, the simplest strategy is to begin making regular gifts of ownership interests, taking advantage of the $13,000-per-recipient annual gift tax exclusion and the lifetime gift tax exemption. The increase in the lifetime exemption to $5 million that went into effect this year provides a powerful incentive to make lifetime gifts.

The exemption is scheduled to return to $1 million in 2013. So if you can afford to do so, you may want to lock in this tax savings by transferring interests in your business by the end of 2012.

Be sure to document gifts of ownership interests with appraisals and business valuations. They can help avoid an IRS challenge down the road.

Other strategies

A more complex strategy to consider is transferring business interests to your family through a family limited partnership (FLP). This can allow you to retain some control over the business and benefit from enhanced valuation discounts. Keep in mind that FLPs are complex entities, and they must be structured and operated carefully in order to avoid an IRS challenge.

Alternatively, you might want to *sell* the business to family members. By using a self-canceling installment note (SCIN), you can even provide for the buyers' payment obligations to terminate on your death without adverse tax consequences. This strategy can be risky, however, so be sure to work with your tax advisor.

Finally, consider implementing an employee stock ownership plan (ESOP). It's a qualified retirement plan similar to a 401(k) plan except that it's required to invest primarily in the company's stock. (Often the company stock is its sole investment.)

If your business is eligible, an ESOP can be a tax-efficient means of transferring stock to employees, whether family members or others. At the same time, it enables you to remove some of your equity from the business, so you can finance your retirement or create a source of liquidity to provide for family members outside of the company.

Planning is key to survival

Family businesses come and go. Some last for generations; others fall apart quickly. To ensure your family business continues to thrive for decades to come, work with your tax and business advisors and your attorney to effectively address ownership transfer in your succession plan. ◎

Tick, tock, tick, tock

Time is running out to disclose "hidden" foreign accounts

From time to time, the IRS offers "deals" to taxpayers that have unreported income from undisclosed foreign accounts and other foreign assets. The current program — the 2011 Offshore Voluntary Disclosure Initiative (OVDI) — expires Aug. 31.

The program isn't just for "tax evaders." Many taxpayers unknowingly violate federal tax laws by failing to report income from foreign accounts or assets.

What the law requires

As a general rule, U.S. citizens and residents are subject to federal tax on all of their income, regardless of the source. This includes foreign income, subject to certain exemptions and exclusions.

Whether foreign income is taxable or not, you're required to file annual information

returns reporting the existence of foreign bank and investment accounts if their aggregate value exceeds $10,000, as well as the existence of certain interests in and transactions with foreign trusts, corporations and partnerships.

Failure to comply with these requirements can result in substantial civil penalties and even criminal charges.

The benefits of coming clean

Voluntary disclosure provides three significant benefits:

1. It generally eliminates the risk of criminal prosecution.
2. It reduces the severity of civil penalties.
3. It enables you to calculate, with a reasonable degree of certainty, what it will cost you to become current with your federal tax obligations.

Even if your failure to comply was inadvertent, taking your chances with an IRS civil or criminal investigation can be risky. If you qualify for the OVDI program, you can settle your tax obligations by paying your unpaid taxes, interest and accuracy-related penalties, plus a penalty equal to 25% of the highest aggregate balance or value of foreign accounts and assets during the period covered by the program (2003 to 2010) — unless the penalties that would otherwise be imposed are lower.

In its "Frequently Asked Questions and Answers" about OVDI, the IRS provides an example involving a taxpayer with foreign accounts. These accounts have an aggregate value ranging from $1,050,000 in 2003 to $1,400,000 in 2010.

Under OVDI, the taxpayer pays $140,000 in unpaid taxes (plus interest), a $28,000 accuracy-related penalty, and a $350,000 additional penalty ($1,400,000 × 25%), for a total of $518,000 plus interest. If the taxpayer doesn't come forward voluntarily and the IRS discovers the foreign accounts, the taxpayer will face up to $4,543,000 in taxes and penalties — *plus* interest.

Smaller penalties available

The OVDI also offers smaller penalties under certain mitigating circumstances. For example, if the highest aggregate balance or value of foreign accounts and assets is less than $75,000, a taxpayer will qualify for a 12.5% penalty instead of the 25% penalty. And a 5% penalty is available under certain circumstances, such as inheritance of a foreign account with minimal account activity.

To take advantage of OVDI, you must meet several requirements by Aug. 31, 2011, including providing copies of previous federal income tax returns; providing amended returns for tax years covered by the voluntary disclosure; filing required information returns; and paying all required taxes, interest and penalties.

Making the next move

If you have undisclosed foreign accounts or assets, consider participating in OVDI to preclude criminal prosecution and keep monetary penalties to a predictable minimum. Be aware that OVDI is designed for taxpayers who have *under*reported foreign income. If you reported all of your foreign income on previous years' returns, but neglected to file required information returns, you may be able to avoid penalties by filing the delinquent returns by Aug. 31. ◎

Have you researched the research credit?

In 1981, a tax credit for increasing research activities was introduced. Congress has renewed this "temporary" credit multiple times over the last three decades. And as they've done before, Congress has extended it for two more years, from Jan. 1, 2010, through Dec. 31, 2011.

Although you may think this credit — also known as the "research and development," "R&D" or "research and experimentation" credit — is just for scientists or engineers, it's actually available to companies in a wide range of industries, including manufacturing, health care, technology and even retail and finance. If your company develops new products, software or process improvements, researching your eligibility for the research credit can pay off.

Which activities qualify?

To qualify for the credit, research activities must:

- Be designed to discover technological information, including research in the physical or biological sciences, engineering and computer science,
- Relate to a new or improved business component — that is, a product, process, software, technique, formula or invention,
- Strive to eliminate uncertainty concerning the development or improvement of a business component, and
- Be part of a "process of experimentation."

These activities extend beyond laboratory experiments to include a variety of activities designed to develop or enhance product performance or functionality, manufacturing processes, or information technology.

Simply conducting research isn't enough. Remember: The credit is for increasing *research activities.*

There are some exceptions, however. The Internal Revenue Code (IRC) excludes certain activities from eligibility for the research credit, including research conducted after commercial production begins; research used to adapt or reproduce existing business components; market research; and research related to style, taste, cosmetic or seasonal design factors.

How much is the credit?

Expenses eligible for the research credit — known as qualified research expenditures (QREs) — include W-2 wages, supplies and a portion of certain consulting and contract research fees related to qualified research activities. But simply conducting research isn't enough. Remember: The credit is for *increasing* research activities.

So, the traditional credit is equal to 20% of the amount by which your QREs in a given tax year exceed a base period amount. The base period amount is calculated by first determining your fixed-base percentage — the ratio of QREs to gross receipts for the period 1984 through 1988 — and then multiplying that percentage by your average annual gross receipts (AGR) for the four tax years preceding the current year. (But your base period amount can't be less than 50% of your current-year QREs.)

For example, let's say:

- From 1984 to 1988, your company had $200,000 in QREs and gross receipts of $5 million, resulting in a fixed-base percentage of 4% ($200,000/$5 million),
- In 2011, your AGR for the preceding four years is $2.5 million, so your base period amount is $100,000 (4% × $2.5 million), and
- Your QREs for 2011 total $175,000, exceeding your base period amount by $75,000 ($175,000 - $100,000).

Your research credit would be $15,000 (20% × $75,000).

This approach may not be effective for companies that didn't have at least three years of QREs and gross receipts during the 1984-to-1988 period. These companies can follow the "start-up" rules for determining the fixed-base percentage and base period amount.

For companies otherwise ineligible for research credits because of rapid growth in their gross receipts, the alternative *simplified* credit takes gross receipts out of the equation. This method allows you to claim a credit equal to 14% of the amount by which your current-year QREs exceed 50% of your average QREs for the preceding three tax years. If you had no QREs during those years, you can claim a credit equal to 6% of current-year QREs.

Get the credit you deserve

If you invest in activities that may qualify as research, consult your tax advisors to determine whether claiming the research credit would benefit your company. It may also be worthwhile to review research activities in previous years and, if appropriate, file amended returns to claim missed tax credits. This is particularly true for 2010. (See "Enhanced research credit for 2010" below.) ◎

Enhanced research credit for 2010

If you believe your company is eligible for research tax credits (see main article), take a close look at your research activities in 2010. Last year's Small Business Jobs Act (SBJA) lifted certain restrictions on claiming general business credits, including the research credit, for eligible small businesses.

Ordinarily, a business can claim research credits only against the amount by which its regular tax liability exceeds its alternative minimum tax (AMT) liability. The SBJA eliminated this restriction for 2010 (or, for fiscal-year taxpayers, the first tax year starting in 2010). The act also allows you to carry back 2010 credits five years — instead of one year — creating an opportunity to claim refunds for those years.

Eligible businesses include sole proprietorships, partnerships and nonpublic corporations with average gross receipts of $50 million or less for the prior three years.

tax TIPS

Can you deduct an expense if someone else pays it?

The answer is "yes," at least according to a recent U.S. Tax Court ruling. In *Lang v. Commissioner*, the court permitted a daughter to deduct medical expenses and real estate taxes that her mother had paid on her behalf.

Because the mother wasn't legally obligated to pay her adult daughter's expenses, the court found that she'd made the payments with "donative intent." In substance, therefore, the transaction was the same as if the mother had given the money to her daughter who, in turn, used it to pay her expenses.

Going green with less green

A recent IRS Revenue Procedure makes it easier and cheaper for commercial building owners to claim tax deductions for energy-efficient improvements placed in service in previous years. Instead of amending prior years' returns, owners can take advantage of these tax breaks with an automatic "change of accounting method" and simply adjust income and expense on their 2011 returns.

In addition to helping taxpayers avoid the cost of filing amended returns, Revenue Procedure 2011-14 allows owners to reach back further in time — potentially to the 2006 tax year. An amended return is allowed only for the most recent three tax years.

Borrowing against a life insurance policy

Because interest payments are low and, in most cases, there's no fixed repayment schedule, borrowing against a life insurance policy's cash value can be attractive. But if you're not diligent about paying back these loans, they can generate an unexpected tax bill. In a recent U.S. Tax Court case — *Sanders v. Commissioner* — a taxpayer learned this lesson the hard way.

The taxpayer had paid more than $10,000 in premiums on a $25,000 life insurance policy. Over the years, he borrowed more than $7,000 against the policy's cash value. But he never repaid the loans. Eventually, the insurance company terminated the policy. At the time, the loan balance, including interest, was more than $17,000, which exceeded the policy's cash value.

The insurance company applied the cash value toward the loan, which was economically equivalent to the taxpayer receiving a distribution and using it to repay the outstanding loan balance. Even though the taxpayer received no cash or property, he was subject to tax on the approximately $7,000 by which this "constructive distribution" exceeded his investment in the policy.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2011 TXIja11

SEILER LLP
CERTIFIED PUBLIC ACCOUNTANTS

George D. Marinos, CPA

Expertise: High net-worth individuals; closely-held businesses; real estate; tax planning and compliance for individuals, partnerships and corporations; personal service organizations.

Education: BS, Accounting, University of San Francisco, 1990.

David M. Sacarelos, CPA

Expertise: Real estate; high net-worth individuals; multi-generational families; family office; private foundations.

Education: BS, Accounting, San Jose State, 1987; MS in Taxation, Golden Gate University, 1993.

Developments Affecting California Taxpayers

Payroll tax exemption for certain companies in San Francisco: San Francisco has a 1.5 percent payroll tax for companies with a payroll above $250,000. In April 2011, the City passed legislation providing a six-year exemption of the 1.5 percent payroll tax on new hires for companies in a special zone. The tax break applies to all qualifying businesses that relocate to a portion of the Mid-Market and Tenderloin neighborhoods, which is an area on or near Market Street between Fifth Street and Van Ness Avenue. In June 2011, the City also passed legislation exempting stock options offered by start-ups from the city's 1.5 percent payroll tax. These measures create a payroll tax exemption aimed at keeping in San Francisco expanding companies such as Twitter Inc.

California Individual Net Operating Losses (NOLs) Are Suspended for 2010 and 2011: California NOLs are suspended for individuals with federal modified Adjusted Gross Income (AGI) of $300,000 or more for the 2010 and 2011 taxable years. Federal modified AGI is AGI without regard to any federal NOL. ***California does not allow carrybacks of NOLs***. The current year's AMT net operating loss is limited to 90% of the taxpayer's current AMT income.

Bundled Fees Are Fully Deductible: For the fourth consecutive year, the Internal Revenue Service (IRS) has extended interim guidance permitting the full deductibility of bundled fiduciary fees incurred by a nongrantor trust or estate. The IRS issued Notice 2011-37 on April 13, 2011 and stated that nongrantor trusts and estates will not be required to unbundle their fiduciary fees to determine what portion is subject to the 2% threshold for itemized deductions. Instead, taxpayers will be allowed to deduct the full amount of bundled fiduciary fees without regard to the 2% floor until final regulations on this issue are published. The Notice warns that payments made by the fiduciary for expenses subject to the 2% floor which are readily identifiable are subject to such floor.

The IRS will detail in forthcoming regulations what portion of costs paid to an investment advisor by a nongrantor trust for bundled fiduciary fees will be fully deductible or subject to the 2% floor for miscellaneous deductions. The IRS has not indicated when it expects to release the regulations. The regulations are not expected to apply to tax years that occur prior to the first publication of the proposed regulations.

Beginning in 2011, a taxpayer is considered to be doing business in California if it meets any of the thresholds listed below: (1) the taxpayer is organized or commercially domiciled in California; (2) the taxpayer has sales in California in excess of the lesser of $500,000 or 25 percent of its total sales; (3) real and tangible personal property of the taxpayer in California exceed the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property; (4) the amount paid in California by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer; or (5) for the conditions above, the sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of the passthrough entity's (partnerships, S corporations, and limited liability companies treated as partnerships) factors. In Legal Ruling 2011-01, the California Franchise Tax Board admitted that the expanded definition may cause corporate limited partners previously subject to the corporate income tax to now be subject to the corporate franchise tax, including the minimum tax.

SOME OF THE OTHER SERVICES WE OFFER: • ESTATE PLANNING • LITIGATION SUPPORT • BUSINESS VALUATIONS • NON-PROFIT

Did You Know … To have your picture taken by the very first camera you would have had to sit still for 8 hours!

If you would like to receive our newsletter via email, send an email to: **newsletter@seiler.com**. Be sure to include your name and business so we can update our database.

We would welcome the opportunity to help you meet your business and personal financial goals.
Please call us at 650-365-4646 (Silicon Valley) or 415-392-2123 (San Francisco) and let us know how we can be of assistance.

This newsletter is not intended to render legal, accounting or other professional services. The publisher assumes no liability for the reader's use of the information herein.