By Yuri B. Berndt and Joseph G. Socha

A Few New Twists for Business Taxpayers

Yuri Berndt is a member of our business law and wealth preservation and estate planning practice areas. He represents individuals and business clients in the areas of business organization, structuring, and transactions. He also advises clients on tax planning issues. Yuri can be reached at 612.877.5267 or BerndtY@moss-barnett.com.

Joe Socha is a member of our wealth preservation and estate planning practice area. He represents individuals in the areas of estate planning and taxation, including the development and implementation of wealth transfer strategies and income, gift, and estate tax planning and compliance. Joe can be reached at 612.877.5283 or SochaJ@moss-barnett.com.

The 2010 Tax Act extends most, if not all, of the commonly called "Bush income tax cuts" through 2012. While many of the income tax provisions require no immediate action on the part of individual or business taxpayers (for example, the business and individual income tax rates and the 15% long-term capital gains and qualified dividends tax rates all remain the same through 2012), there are a few new or extended provisions that can be beneficial for businesses and their employees right away.

100% Bonus Depreciation in 2011

Businesses, including C-corporations, S-corporations, limited liability companies (LLCs), and sole proprietorships, can write off the entire purchase price of certain assets in 2011. These provisions must be considered when completing current-year budgets and developing long-term business growth strategies. Bonus depreciation on the purchase of qualified new business equipment now equals 100% if placed in service after September 8, 2010, and before January 1, 2012. The bonus depreciation rate declines to 50% for qualified property placed in service after December 31, 2011, and before January 1, 2013. In the simplest terms, a purchase of any new "qualified" property placed in service in 2011 (whether purchased on credit or with cash payment) will result in a tax deduction equal to its purchase price (a write-off of the entire purchase price). Even though we are at the start of 2011, you will want to make sure that you incorporate this deduction in your tax planning for 2011 and make sure qualified property is purchased and placed in service in 2011.

Section 179 Expensing

Section 179 expensing allows a taxpayer to take a tax deduction for the cost of qualified property purchased and placed in service in 2011, subject to certain taxable income and qualified purchase limitations. The Section 179 expensing limit continues to be $500,000 for 2011 but will go down dramatically in 2012. You may ask why this is important given the 100% bonus depreciation. While bonus depreciation is limited to the purchase of "new" qualified property placed in service in 2011, Section 179 expensing is allowed on qualified property, including previously used property. This provision can be very beneficial when considering the purchase of assets of an existing business.

Reduction in S-corporation Built-in Gains Tax Period to Five Years

A corporation that elected to be an S-corporation more than five years ago may benefit from the reduction in the S-corporation built-in gains tax recognition period. Prior to 2010, an S-corporation that sold assets within ten years from the date of its S-corporation election was required to calculate and pay a built-in gains tax (a double tax). This built-in gains tax effectively taxes the gain on the sale of

an S-corporation's assets twice, just as gains are taxed on the sale of a C-corporation's assets (once at the corporation level and a second time when the proceeds are distributed to the C-corporation shareholders). For 2011, this built-in gains tax period has been reduced to five years. What does this mean? If your S-corporation election was made before 2006, you do not have to worry about paying the S-corporation built-in gains tax on the sale of your company's assets in 2011. This can be a significant tax benefit for any seller in 2011 and make more S-corporations open to selling assets.

- ***S-corporation Tax Planning.*** The five-year S-corporation built-in gains period creates a current opportunity to distribute business real estate (or other assets) from an S-corporation to its shareholders (or an LLC owned by the shareholders) in a potentially tax-neutral manner. A distribution of an appreciated asset from an S-corporation to its shareholders is subject to income tax on the asset's appreciation (the difference between its current fair market value and its tax basis). If the S-corporation built-in gains period has not expired, the S-corporation is subject to the built-in gains tax (a double whammy). With the depressed real estate market, the low capital gains tax rate, and bonus depreciation deductions, 2011 might be the right time to separate an S-corporation's real estate (or other lines of business) from the S-corporation structure. There are many business, legal, and tax reasons why this may be beneficial to an owner and to the business.

- ***Corporate Conversions.*** The new five-year S-corporation built-in gains period makes 2011 a good year to consider conversion of an S-corporation to a limited liability company. The details of this type of transaction are beyond the scope of this article, but Minnesota law allows a Minnesota corporation to convert to a limited liability company. A limited liability company, which is treated as a partnership for federal and Minnesota income tax purposes, has a number of advantages over an S-corporation, including when considering expanding the company ownership to management (by using "profits interests") or selling ownership interests to management (with an IRC Section 754 asset step-up, which can produce current deductions for the buyer). An LLC is not the right choice in all situations, but advantageous opportunities may exist. A comprehensive review of the business and its objectives must be completed before undertaking a conversion transaction.

Employee Social Security Taxes

The 2010 Tax Act reduces the employee social security tax rate from 6.2% to 4.2% for 2011. Employees and self-employed individuals pay social security taxes on their earned income (up to a $106,800 limit). The 2% rate reduction means an employee's tax bill, assuming wages of $60,000, will be reduced by $1,200 ($60,000 of wages times the 2% reduction). Employers are still required to pay social security tax at a rate of 6.2% on its employees' compensation. Be sure to change your payroll processing to accommodate the lower withholding level.

In Conclusion

The 2010 Tax Act maintained the "Bush income tax cuts" for individuals, individually and as owners of LLCs and S-corporations. The 2010 Tax Act and the prior "Bush income tax cuts" did not affect federal corporate income tax rates, which continue to range from 15% on the first $50,000 of corporate income to an effective rate of 35%. Likewise, there has been no change to Minnesota's corporate income tax rate of 9.8% or individual income tax rates ranging from 5.35% to 7.85%. The changes in the bonus depreciation, Section 179 expensing, and the built-in gains tax period, however, present significant opportunities for businesses and their owners this year. You should begin planning today to take advantage of these opportunities.