

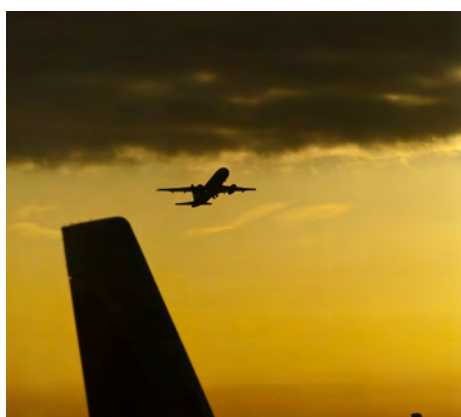


Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*sm

Business Owners May Defer Tax on an Employee Stock Ownership Plan Sale

April 2012



Many owners of small companies plan to sell at some point, perhaps to finance their retirement. If you are in that situation, you may have a very low cost basis in the company's shares. On a sale, you could owe a substantial amount of income tax, especially if tax rates on long-term capital gains have increased by the time you sell.

You can prepare now for a huge future tax break. To do so, plan on selling your shares to an employee stock ownership plan (ESOP). An ESOP is a qualified retirement plan with the tax advantages you'd expect, such as tax deductions for contributions. ESOPs also provide employee motivation and a market for the shares you own.

Happy ending

Yet another ESOP advantage can be found in Section 1042 of the tax code. Under this section, you may defer the tax on the capital gain you report from selling your company's stock to an ESOP. To qualify, you must meet several criteria, such as the following:

- The ESOP must own at least 30% of the total value of your company's outstanding stock (other than certain preferred stock) or at least 30% of each class of your company's outstanding stock (other than certain preferred stock). This must be true immediately after you sell your shares.
- You must have owned your company shares for at least three years before the sale.
- Your company must be a C corporation.
- If the company's stock is not readily tradable on an established securities market, you must have a qualified appraisal that supports the selling price.
- You must reinvest the sales price in qualified replacement property (QRP) during a replacement period that begins three months before the sale of company stocks and ends 12 months after the sale.

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Bar Boom

The number of lawyers in the United States rose from 723,189 in 1988 to 1,225,452 in 2011, an increase of nearly 70%, while the U.S. population increased by less than 27%.

Trusted Advice

Transferring Qualified Replacement Property

- ✓ Under the tax code, the death of a person holding qualified replacement property (QRP) from an ESOP sale will not trigger the deferred tax.
- ✓ Another exception applies when QRP is given away. The recipient assumes the deferred tax liability upon disposition of the QRP.
- ✓ In at least one private letter ruling, the IRS stated that transferring QRP as part of a divorce settlement will be treated as a gift. The deferred gain won't be taxed immediately.
- ✓ Although private letter rulings apply only to the taxpayer making the request, this decision may indicate how the IRS will treat similar situations.

Generally, QRP includes securities issued by domestic corporations. Such corporations must be active businesses, which, for these purposes, means that no more than 25% of the corporations' gross receipts were passive investment income for the year preceding the year the securities were purchased.

Example 1: Bart Rogers, age 65, is the sole owner of his small business, which he started 30 years ago. Bart sells his company to an ESOP and nets a \$2 million long-term capital gain. Assuming a 15% tax rate, Bart would owe \$300,000 to the IRS.

However, Bart reinvests all of the sales proceeds in a portfolio of domestic stocks and bonds that are QRP. He owes no immediate income tax from the sale, thanks to the Section 1042 tax deferral. Bart receives the income from, and participates in any appreciation of, the \$2 million worth of securities.

Noteworthy

In the previous scenario, the tax deferral will go on as long as Bart holds onto his QRP. But what happens if Bart invests in a bank stock for its high dividend and then decides to sell after the bank reports a loss? What happens if Bart invests in a corporate bond that's redeemed in a few years?

In such cases, Bart no longer owns the QRP. Under Section 1042, if Bart relinquishes the QRP, in whole or in part, he'll recognize the gain that he deferred due to his purchase of the QRP and owe tax on it. Suppose Bart invests 25% of the sales proceeds in Big Bank Co. stock. He'll owe tax on 25% of the deferred gain if he sells his Big Bank Co. shares.

If you want to extend the tax deferral as long as possible, you can put the sales proceeds into so-called "ESOP notes." These

are floating-rate notes issued by highly-rated corporations. The terms on these notes vary, but for example, they might have a 40-year maturity, with 30 years until first call. (A call gives the issuer the right to redeem the note prematurely.)

ESOP notes usually pay interest equivalent to the yields on short-term securities. Thus, yields are scant now. However, the banks and brokerage firms selling these notes may offer to let you borrow 80% or 90% of the face value of your ESOP notes, so you can reinvest elsewhere.

Example 2: Bart Rogers clears \$2 million from the sale of his company and defers the tax on the gain by investing \$2 million in an ESOP note. He then borrows \$1.8 million, using the ESOP note to secure the loan. Bart invests that \$1.8 million in a diversified portfolio of stocks and bonds.

In this example, Bart still owns the ESOP note, which is the QRP. Consequently, he maintains his tax deferral. Meanwhile, Bart can trade or redeem the stocks and bonds he has purchased with the borrowed funds without triggering the deferred income tax. If Bart wishes, he can use some of the borrowed money for personal expenses. The net cost of the ESOP note may be modest, compared with the value of the tax deferral.

If Bart dies while still holding the long-term ESOP note, his heirs will inherit it. Assuming that current tax law still applies at that time, the heirs will get a basis step-up; therefore, no one will ever owe capital gains tax on the sale of Bart's company. Our office can help you decide if an ESOP can fit into your succession plan for your business. ■

Keep Track of Noncash Contributions

Throughout the year, you probably make multiple donations of items other than cash. You might give used furniture to Goodwill, for example, or donate a pre-flat screen TV to a homeless shelter. Such contributions may cut your tax bill if you itemize deductions on your tax return, but you need to proceed carefully.

Most important, you should get a receipt for all noncash contributions. The receipt will show that you actually gave books, clothing, furniture, or whatever to a specific charity on a given date.

Valuing your deduction can be tricky. The tax law says that you are entitled to a deduction for the fair market value of each item. But what is the fair market value of a used computer or an old lamp?

Setting the price

In some cases, the fair market value is simple to determine.

Example 1: Jill Warner buys flowers every week and has them delivered to her church for display. Jill receives no reimbursement and does not take the flowers home after the services. Jill can deduct the amounts she spends on the flowers, which is the fair market value.

At Christmas, Jill spends \$200 on toys and donates them, still in their boxes, to a charity that distributes the toys to needy children. Again, the price that Jill paid for the toys is the fair market value because they were unused and donated immediately. She can deduct the \$200 she spent.

Donations of used goods, though, generally are more difficult to value. One approach is to check websites, such as the Salvation Army's, which

provides a valuation guide at www.satruck.org/donation-value-guide.

For example, a working color TV might be valued anywhere from \$75 to \$225, according to the Salvation Army's guide. The value of a man's raincoat on this list might be between \$5 and \$20. (A Salvation Army receipt will have a more extensive valuation guide on the back, listing items ranging from adding machines to wigs.)

You also might value used items by going to online sites such as eBay and Craigslist to see what used items sell for. Alternatively, you can price goods at a thrift shop. In any case, you should record your efforts to find the fair market value of the items you donate, in case your deductions are questioned.

Under the tax code, you generally can't deduct donations of used household goods or clothing unless the items are in "good used condition or better." The IRS doesn't define that term precisely, but it probably means that an item can be used as-is by a recipient; junk or trash won't qualify. You might want to take photos of items you donate to show their condition.

Trusted Advice

Proof Positive

- ✓ To support a deduction for cash or noncash contributions equaling \$250 or more, you must have a written acknowledgment from the charity that shows the amount of cash or a description of the property contributed, and the value of any goods or services provided by the charity in return for the contribution, on or by the earlier of either the date you file your return for the year of contribution or the due date (plus extensions) for the return.
- ✓ If your total deduction for noncash contributions for a year is over \$500, you must attach IRS Form 8283 to your tax return.
- ✓ If you donate an item or a group of similar items valued at more than \$5,000, you must complete Section B of Form 8283, which generally requires a qualified appraisal.
- ✓ If you donate noncash items that have increased in value, such as works of art, special rules determine the amount you can deduct.

Did You Know?

Mutual funds holding long-term government bonds had an average return of 33.45% in 2011. Among dozens of mutual fund categories, no other category returned as much as 12% last year.

Source: Morningstar

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Going private

In recent years, many charities have solicited auto donations. Often, they implied that any car would be accepted and that donors would

enjoy better financial results, after tax, than they'd realize from a sale or trade-in.

The IRS responded to such practices by issuing reminders and warnings about vehicle donations. IRS Publication 561, "Determining the Value of Donated Property," includes a section specifically devoted to donations of cars, boats, and aircraft. It says that the fair market value of a donated vehicle is the price listed in a used vehicle pricing guide for a private

party sale, not the dealer's retail price. What's more, that price is valid only if the guide lists a private sales price for a vehicle that is the same make, model, and year and sold in the same area; in the same condition; and with similar options, accessories, and warranties as the donated vehicle.

Example 2: Luke Barnes donates a car in poor condition to charity. A used car guide lists the dealer retail value for a similar car in poor condition at \$1,500. However, the guide also shows the price for a private party sale of the car at \$700. Luke can take a \$700 tax deduction for donating the car. ■

TAX CALENDAR

APRIL 2012

April 17

Individuals. File a 2011 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868. Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2012 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2012 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of \$1,700 or more in 2011 to a household employee, file Schedule H (Form 1040) with your income tax return, and report any household employment taxes. Report any federal unemployment tax on Schedule H if you paid total cash wages of \$1,000 or more in any calendar quarter of 2010 or 2011 to household employees. Also, report any income tax you withheld for your household employees.

Partnerships. File a 2011 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or

a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then, file Form 1065 by September 17.

Electing large partnerships. File a 2011 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then, file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2012.

MAY 2012

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.