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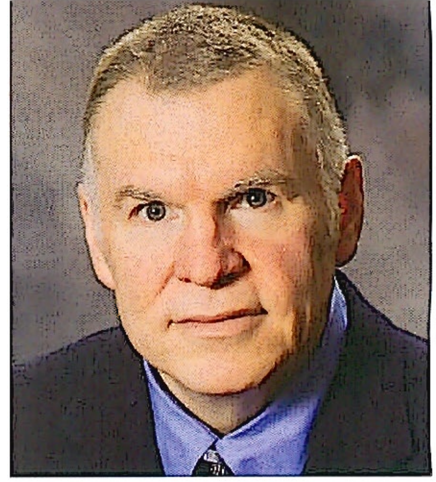

End Game

Major tax relief provisions are set to expire December 31. It's time to consider your options. BY DAN WRIGHT

TAX LEGISLATION SIGNED INTO law in 2001 and 2003 significantly lowered the effective tax rates for many business owners. These changes are informally referred to as the "Bush era tax cuts." Much of the tax relief provided by these provisions (and subsequent extender legislation) will sunset at the end of this year unless Congress once again provides extended relief. This change leaves business owners facing a potentially higher federal tax burden, with little guidance available as to what the rates/rules will be. Most commentators project that Congress may be too polarized to agree on any substantial tax relief extension in the near future, and that the political exchange occurring during this presidential election year will further exacerbate the stalemate.

Many expiring provisions have the potential to be economic game changers, including:

1. The highest individual rate bracket will return to 39.6 percent (the rate for the highest bracket is now 35 percent).
2. The top capital gains rate will return to 20 percent (currently 15 percent).
3. Dividends will be taxed at ordinary income tax rates (as high as 39.6 percent). The current rate for most business owners is 15 percent.

Faced with the prospect of these expiring provisions, here are a few guidelines business owners can focus on between now and the end of the year.

Cautiously consider changing status to a C corporation. Many business owners who have previously elected pass-through tax status for their business entities (i.e., S corporations or partnerships) are wondering if changing the entity status to a C corporation should be considered. Their reasoning: Individual tax rates will go higher due to the expiration of the tax cuts and corporate tax rates will go lower. Corporate tax rates as low as 25 to 28 percent have been suggested by campaigning politicians from both parties. However, many doubt that the lower rates will become law because of the other fiscal challenges afoot. If corporate rates drop and the highest tax bracket rate goes to 39.6 percent or more, electing to be treated as a C corporation may warrant consideration.

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Many factors should be considered before effecting an entity tax status change. For instance, if you are planning for an exit event in the near term, changing to C corporation status could reduce deal negotiation flexibility and may subject taxable proceeds from a sale of assets to a much higher effective tax rate. If you are not planning for an exit in the near future but expect to realize substantial levels of profits flowing through the business from regular operations, retaining a single pass-through tax rate structure may still be more efficient, despite rate changes.

Consider making 2012 dividend distributions. A difficult lending environment has caused many businesses to increase cash holdings as a safety net or to fund additional business growth. However, as the economy improves and other sources of cash become available, business owners should consider distributing any unnecessary cash holdings before year end. This can be done by making distributions to owners. In some cases, this type of cash transfer will be taxable. However, compare a combined 43.4 percent dividend tax rate (39.6 percent and the new 3.8 percent Medicare tax) that may apply post-2012 to the current rate of 15 percent. This year may be the last short-term opportunity to move cash out to owners at a rate as low as 15 percent.

Increase retirement plan deferrals. Another cash reduction strategy is to enhance retirement benefit packages. Many business owners fail to take full advantage of the tax deferrals available through maximizing retirement benefits. This can be another tax-effective way to reduce cash levels and provide additional deductions to the company, while creating a more loyal workforce as the labor market improves.

Replace old equipment in 2012. Finally, consider using cash to make additional capital improvements before the end of the year. Replacing older assets and expanding your asset base often leads to higher levels of productivity. Current year depreciation rules allow highly accelerated depreciation deductions. However, some acceleration rules are also set to expire at the end of 2012.

Regardless of your business situation, you will likely find post-2012 tax planning difficult due to election-year politics and the uncertainty regarding the fate of the expiring tax relief provisions. You should plan with caution and be extra vigilant of new tax developments as we approach year end. SB

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