

Planning for Tax Changes Affecting Businesses and Business Owners

Several recent tax changes, both in the state of Wisconsin and at the federal level, impact businesses and business owners. The following items highlight certain key changes and potential opportunities for businesses and business owners.

Federal Changes

Built-in Gains Holding Period Decreases. Effective January 1, 2009, the recognition period for S corporation built-in gains decreased from ten years to seven years for 2009 and 2010. This affects corporations in their eighth to tenth year since their S election.

Comment: Completing business sale transactions in 2009 and 2010 could result in substantial tax savings for owners of S corporations. Some owners will not have to wait until the expiration of the full ten-year period after an S election to avoid the onerous built-in gains tax.

Conversion of Traditional IRA to Roth IRA. Roth IRAs provide tax benefits not available with traditional IRAs: (1) qualified distributions from Roth IRAs are not taxable; (2) Roth IRAs have no required minimum distribution rules; (3) using a Roth IRA might keep taxpayers in a lower tax bracket and does not change social security payment tax calculations or deductions based on adjusted gross income.

The IRS eliminated adjusted gross income and filing status limits on conversion from a traditional IRA to a Roth IRA effective in 2010. The IRS treats conversion as a taxable distribution, but does not tax future account value appreciation. Taxpayers may elect to defer the tax on a 2010 conversion to 2011 and 2012.

Comment: Whether or not to convert all or part of a traditional IRA to a Roth IRA is complicated and should not be undertaken without professional advice. However, in the right circumstances, a conversion can result in significant long-term tax savings.

Increased Federal Tax Rates. Current ordinary income and capital gain/dividend tax rates are scheduled to automatically increase beginning in 2011 without congressional action.

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The current administration has indicated a desire to allow the rates to increase for married taxpayers earning over \$250,000, and such increase could occur before 2011.

Comment: High income taxpayers may benefit from accelerating income (or deferring deductions) in some cases. This is opposite from usual planning.

Comment: Changing rates also impact choice of entity. Differences between corporate and individual tax rates are a key factor in deciding between a flow-through entity and a corporation. Closely held C corporations with significant cash reserves might consider paying a dividend in 2009 to take advantage of low rates.

Comment: Wisconsin executives might consider deferring more of their compensation under nonqualified plans, especially if the payouts under the plans are at least ten years (or life) and the executive intends to become a resident of a state with no income tax, such as Florida.

State of Wisconsin Changes

Sales and Use Tax—Disregarded Entities. Beginning July 1, 2009, single-member LLCs that are disregarded for federal and Wisconsin income tax purposes are also disregarded for Wisconsin sales/use tax purposes.

Comment: Taxpayers who have set up single-member LLCs as transportation subsidiaries, or to otherwise minimize sales/use tax liabilities, should seek consultation on ways to restructure the entity to preserve existing tax benefits.

Sales Tax Amnesty Program. As part of joining the Streamlined Sales Tax Project, Wisconsin has enacted a sales tax amnesty program, which is available until September 30, 2010. Eligible sellers who register under this amnesty program will not be liable for any uncollected Wisconsin sales tax on sales made prior to the registration. Taxpayers may benefit from a reverse sales tax audit to determine the potential benefit of this sales tax amnesty program.

Combined Reporting. Wisconsin recently changed from a separate company reporting state to a combined reporting state for state income and franchise tax purposes. The change applies retroactively for 2009, but only to C corporations. Under the new combined reporting rules, companies with common attributes (assessed by three tests) must aggregate their income and losses. Combined reporting may require a corporation, itself operating only outside Wisconsin, to file in Wisconsin where its combined group members are operating, thus

increasing the number of filings, and complexity of filings, for each entity in the group. Combined reporting may save taxes in some cases and increase taxes in others. Taxpayers are encouraged to seek counsel from seasoned state tax planning practitioners to minimize state tax liability under these new rules.

Related Entity Addback Changes. Taxpayers have attempted to decrease Wisconsin income/franchise tax by paying management fees, royalties, or similar expenses to related entities in low tax states (which entities often hold intangible assets). Wisconsin has expanded its related entity addback rule to include intangible expenses and management fees, so taxpayers generally may not deduct these expenses for Wisconsin purposes.

Unfortunately, the law is drafted in a broad way and would cover otherwise legitimate expenses paid to related entities, such as rent. The law specifies that entities may deduct interest expenses, rent expenses, intangible expenses and management fees under some situations, as long as certain requirements are met, including: 1) if the payment was a reimbursement of expenses paid to an unrelated entity; 2) if the related entity was subject to tax in any jurisdiction on the income; or 3) if the entity did not make the payment for tax avoidance purposes. Entities which believe these expanded rules may apply to their circumstances should discuss the details of their situation with a [tax professional](#).

Other Notable Changes

Bonus Depreciation and Enhanced Small Business Expensing Extended for 2009. Bonus depreciation and enhanced small business expensing allow certain taxpayers to recover and write off a larger portion of their 2008 and 2009 capital expenditures. Taxpayers may combine these incentives with the extended net operating loss carryback to increase refunds. (Federal)

Net Operating Loss Carryback Increases. Typically, taxpayers can carry net operating losses back two years and forward twenty. Eligible small businesses can elect that applicable 2008 net operating losses apply retroactively up to five years. (Federal)

Capital Gains Exclusion. Wisconsin taxpayers are now subject to a reduced exclusion for capital gains. Previously, Wisconsin allowed taxpayers to exclude 60% of their net long-term capital gains from income. Beginning on January 1, 2009, taxpayers can only exclude 30%, which effectively increases Wisconsin tax on capital gains. (State)



State Tax Rate Increase. The highest individual income tax rate in Wisconsin increased from 6.75% to 7.75% on income in excess of \$300,000 for married filing jointly taxpayers and \$225,000 for single taxpayers. These changes directly affect flow-through entities since the income is generally not picked up by the entity but instead flows through to the individual and is taxed at the individual's income tax rate. *(State)*

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