

May/June 2005

TAX IMPACT

IN THIS ISSUE

THE PRODUCTION DEDUCTION

Congress scraps ETI exclusion in favor of new manufacturing tax break

AVERT ESTATE TAX DISPUTES WITH A BUY-SELL AGREEMENT

A FAIRY TALE COME TRUE?

Strategies for shifting income to your children

TAX TIPS

Health Savings Account contributions, day camp tax relief, and more ...



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THE PRODUCTION DEDUCTION

Congress scraps ETI exclusion in favor of new manufacturing tax break

After a series of adverse rulings by the World Trade Organization (WTO), Congress has curtailed its efforts to benefit exporters and instead provided a tax deduction for all manufacturers — whether they export or not.

Last year's American Jobs Creation Act (AJCA) repealed the extraterritorial income (ETI) exclusion and established the new tax relief. The manufacturing deduction isn't just for traditional manufacturers. It's also available to eligible construction contractors, engineers, architects, software developers, film producers, energy producers, farmers and agricultural processors.

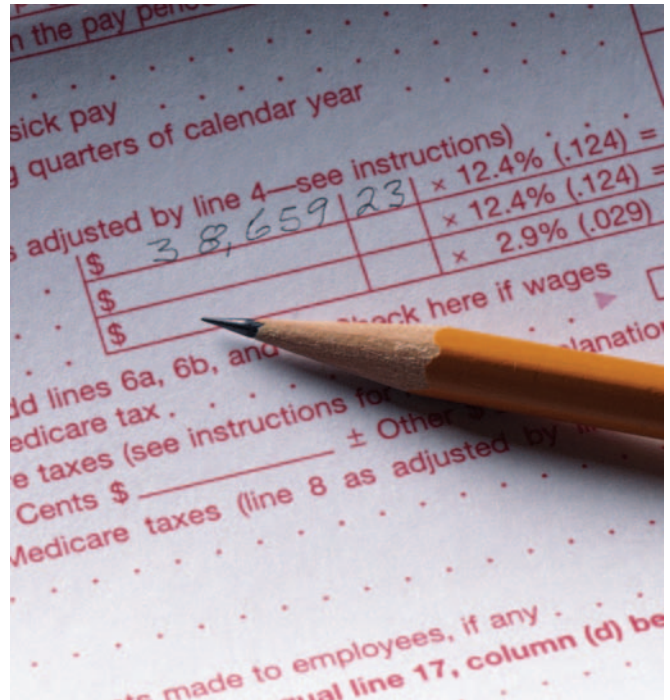
Plus, because the ETI exclusion is being phased out while the manufacturing deduction is being phased in, some taxpayers will enjoy dual benefits in 2005 and 2006.

BENEFITING FROM THE ETI EXCLUSION BEFORE IT EXPIRES

After two failed attempts to improve the balance of trade and to assist exporters through tax deferrals or exemptions for foreign trade income failed to pass muster with the WTO, the United States created the ETI exclusion in 2000. The ETI exclusion allows some taxpayers to exclude from gross income up to 30% of qualified foreign trade income. Eligible taxpayers include:

- ⊙ Domestic corporations,
- ⊙ U.S. citizens or residents,
- ⊙ Foreign corporations that elect to be taxed as domestic corporations, and
- ⊙ Partnerships and other pass-through entities, provided all of their owners fall into one of the above categories.

As it had previously responded to U.S. export tax regimes, the European Union (EU) quickly launched a challenge against the ETI exclusion. In 2002, the WTO again ruled for the EU, this time authorizing up to \$4 billion a year in retaliatory sanctions against U.S. exports.



The AJCA phases out the ETI exclusion over three years, allowing taxpayers to claim 100% of their ETI benefits in 2004, 80% in 2005 and 60% in 2006. The exclusion will be eliminated starting in 2007, but the full exclusion will continue to apply to current binding contracts that were in effect on Sept. 17, 2003.

Keep in mind, the act permits foreign corporations that elected to be treated as domestic corporations for ETI purposes to revoke that election before Oct. 22, 2005, without having to recognize gain or loss.

MAXIMIZING THE NEW DEDUCTION

The new manufacturing deduction is phased in between now and 2010. It permits eligible taxpayers to deduct a specified percentage of the lesser of: 1) their income from “qualified production activities,” or 2) their taxable income for the year. The deduction may not exceed 50% of the W-2 wages a taxpayer pays during the year.

The applicable percentage is 3% in 2005 and 2006, 6% from 2007 through 2009, and 9% in 2010 and

thereafter. Once it reaches full strength, the deduction will lower the effective marginal tax rate on qualifying income from 35% to 31.85%.

Qualified income is calculated by taking gross receipts from domestic production and subtracting the cost of goods sold and other allocable costs, deductions, expenses and losses. Domestic production gross receipts are those derived from any lease, rental, license, sale, exchange or other disposition of:

- ⊗ Qualifying production property (including tangible personal property, computer software and certain sound recordings) manufactured, produced, grown or extracted by the taxpayer in whole or in significant part in the United States,
- ⊗ Qualified films produced by the taxpayer, or
- ⊗ Electricity, natural gas or potable water produced by the taxpayer in the United States.

They also include receipts from construction and engineering or architectural services performed in the United States.

Two significant exceptions are receipts from the sale of food and beverages prepared by taxpayers at retail establishments, and the transmission or distribution of electricity, natural gas and potable water.

NAVIGATING OPPORTUNITIES AND CHALLENGES

The new manufacturing deduction offers eligible businesses an opportunity to reduce their tax burden. It also presents taxpayers with some thorny challenges, such as determining which activities qualify for the deduction,

calculating eligible income, and allocating costs, deductions, expenses and losses.

Fortunately, the IRS recently issued temporary guidelines that taxpayers can use until it issues formal regulations. Among other things, the guidelines define key terms, such as “in significant part within the United States.” For example, packaging, repackaging, labeling and minor assembly operations don’t count for purposes of the “significant part” test. The guidelines also outline acceptable methods for allocating cost of goods sold and other deductions.

The new manufacturing deduction is available to eligible construction contractors, engineers, architects, software developers, film producers, energy producers, farmers and agricultural processors.

LOOKING MORE CLOSELY

The manufacturing deduction provides the companies that already qualify with a potentially significant tax break. But the rules are complex and it’s likely the IRS will issue additional guidance. So be sure to take a closer look at whether you might qualify and what you need to do to maximize your tax savings. 📄

PHASEOUT OF ETI EXCLUSION AND PHASEIN OF MANUFACTURING DEDUCTION

During 2005 and 2006, eligible taxpayers will be able to claim both the extraterritorial income (ETI) exclusion and the manufacturing deduction.

	2004	2005	2006	2007	2008	2009	2010
ETI exclusion phaseout (percentage benefit allowed)	100%	80%	60%	0%	0%	0%	0%
Manufacturing deduction phasein (applicable percentage of qualified income)	0%	3%	3%	6%	6%	6%	9%

AVERT ESTATE TAX DISPUTES WITH A BUY-SELL AGREEMENT

If you own a family business, the last thing you want is for your family to become embroiled in a dispute with the IRS over the value of your shares. Fortunately, a well-constructed buy-sell agreement can help establish the value of your ownership interest for gift and estate tax purposes, allowing your loved ones to concentrate on managing family and business affairs.

HOW THE AGREEMENTS WORK

A buy-sell agreement is a contract among business owners that sets forth buyout procedures in the event of death, disability, disputes, financial problems, retirement and other specified triggering events. It is designed so that it either requires or, through a right of first refusal or other mechanism, permits the company or the remaining shareholders to buy your stock at a specified price based on set valuation guidelines and purchase terms. By establishing them in advance, a buy-sell agreement helps ensure that the stock changes hands in an orderly fashion.

Under the right circumstances, a buy-sell agreement can also set the value of your shares for gift and estate tax purposes, allowing you to better plan for this tax liability. To achieve this objective, however, your agreement must



meet a number of requirements. If it doesn't, the IRS may dispute your valuation and impose additional taxes and, perhaps, penalties.

Buy-sell agreements provide other benefits as well, including:

Keeping the business in the family. A buy-sell agreement allows family members to retain control of the company and prevents unwanted persons — such as a divorced owner's spouse — from snatching an ownership interest.

If the buy-sell agreement sets a fixed purchase price — even if reasonable at the time — it will be very difficult to argue the agreement's terms are similar to arm's-length arrangements.

Creating a market for otherwise illiquid shares. This can be critical to a deceased or disabled shareholder's heirs or to shareholders with noncontrolling interests.

HOW TO DESIGN

A WATERTIGHT AGREEMENT

To avoid estate tax surprises, design your buy-sell agreement carefully with the help of your tax advisors. Pay close attention to Internal Revenue Code Section 2703, which provides that a buy-sell agreement can be used to set your stock's estate tax value if it:

- ⊙ Is a bona fide business arrangement,
- ⊙ Is not a device to transfer property to your family for less than adequate consideration, and
- ⊙ Has terms that are comparable to similar arrangements in an arm's-length transaction (an arrangement where you sell the business for the same price as you would sell to an unrelated buyer).

IRS regulations contain a safe harbor: If nonfamily shareholders own more than 50% of your company and are

subject to the same rights and restrictions as you and your family, the IRS will presume your buy-sell agreement complies with Sec. 2703. The IRS can overcome this presumption, however, by showing that the agreement is a testamentary device (a tool to transfer shares to the “natural objects of your bounty” for less than an adequate and full consideration).

Sec. 2703’s legislative history indicates that, in addition to the above, a buy-sell agreement must also comply with existing case law. That means the agreement must:

- ⊗ Set a purchase price that’s either fixed or determined according to a formula, provided the price is reasonable when you enter into the agreement,
- ⊗ Require your estate or beneficiaries to sell the shares at the specified price, either automatically or at the purchaser’s option, and
- ⊗ Restrict shareholders’ disposition of their shares during their lifetimes and at death.

Keep in mind that if the agreement sets a fixed purchase price — even if reasonable at the time — it will be very difficult to argue the agreement’s terms are similar to arm’s-length arrangements.

WHAT TO EXPECT

Even if your buy-sell agreement has legitimate business purposes, it won’t support your stock’s estate tax value if the IRS has determined that the agreement is merely a device for transferring the stock to your family at

6 WAYS TO PROTECT YOUR BUY-SELL AGREEMENT


The Tax Court’s opinion in *Estate of True*, which was affirmed by the Tenth Circuit Court of Appeals last December, suggests these ways to insulate your buy-sell agreement against an IRS attack:

1. To support the position that the buy-sell agreement is comparable to arm’s-length transactions, the shareholders should negotiate its terms. If children are involved, they should be provided with independent legal or accounting advice.
2. Consult a professional business valuator to design the price formula.
3. Don’t structure the buy-sell agreement or establish a price formula without a contemporaneous appraisal of your business.
4. Be sure the buy-sell agreement provides for periodic review and adjustment of the price formula.
5. Make the agreement when you’re in good health.
6. Consistently enforce the agreement’s terms.

depressed estate tax values. Fortunately, you can use a number of strategies to avoid this result. (See “6 ways to protect your buy-sell agreement” above.) Keep these tips in mind as you create or modify your buy-sell agreement. 📖

A FAIRY TALE COME TRUE?

Strategies for shifting income to your children

 Once upon a time, parents could save a lot in taxes by shifting income to their kids. They would transfer stock or other taxable investments to a custodial account in the child’s name and the earnings would be taxed at the child’s lower tax rate. Then Congress passed the “kiddie tax,” making it harder to benefit from this strategy. Still, if you do a little planning, you can implement other strategies — such as hiring your kids or opening a 529 plan for them — to reduce your family’s tax bite.

THE KIDDIE TAX

The kiddie tax eliminated the tax advantages of shifting income to children under 14. This year, their first \$800 in

unearned income (such as interest, dividends and capital gains) is tax-free. Their next \$800 is taxed at their rate, usually 10% or 15%. But any unearned income over \$1,600 is taxed at their parents’ marginal rate.

For children age 14 or older, unearned income is taxed at their own rates. But the benefits are still limited, especially now that qualified dividends and long-term capital gains are taxed at a top rate of only 15% (5% for the two lowest tax brackets).

Suppose you give your 14-year-old \$100,000 in stock earning an 8% rate of return. (You must file a gift tax

return, which will use some of your \$1 million lifetime gift tax exemption.) If you transfer the stock to a custodial account under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act, you can retain control until your child reaches the age of majority — age 18 or 21 depending on your state's law.

The stock earns \$8,000 a year in dividends and long-term capital gains, for a tax of \$1,200 at your rates (15%). Assuming your child is in the 15% tax bracket, the income would be taxed at a 5% rate, for a tax of \$400. In other words, you save \$800 in taxes. But you may not want to part with \$100,000 in assets that your child will have unrestricted access to in a few years for this small amount of tax savings.

HIRING YOUR KIDS

If you're a business owner, hiring your kids to work in your company can allow you to shift income while yielding greater tax benefits. When you employ your children, you don't have to worry about the kiddie tax, which applies only to *unearned* income. Plus, you can deduct your children's wages as a business expense, and if they're under age 18 and your business is unincorporated, you won't have to pay Social Security, Medicare or unemployment taxes.

Your kids are also entitled to a standard deduction (currently \$5,000), which means their first \$5,000 in earned income will be tax-free.

Let's look at an example. Aurora has three children, Cindy, 14, Ariel, 15, and Belle, 16. She hires all three to work part-time in her unincorporated textile business. Cindy sweeps the floors, Ariel answers the phones and Belle helps keep the books.

Aurora pays each child \$8,000 per year, contributing \$3,000 of that amount to IRAs she has set up for them. Each child is entitled to the \$5,000 standard deduction and a \$3,000 deduction for the IRA contribution. The entire \$8,000 is federal-tax free, and Aurora deducts \$24,000 in wages for a tax savings of \$8,400, assuming she's in the 35% income tax bracket. Alternatively, Aurora could contribute the \$3,000 to Roth IRAs. The kids would have to pay income tax on that amount, but the funds could grow tax-free for decades.

When hiring your kids, be sure that they do real work and that their compensation is reasonable. If you pay your teenager \$50,000 a year for part-time clerical work, the IRS may hit you with back taxes and penalties.

ALSO REAP ESTATE TAX BENEFITS WITH 529 PLANS

In addition to income tax savings, 529 plans offer estate planning benefits. Unlike other estate planning vehicles, you maintain control over the funds even though contributions and earnings are removed from your taxable estate. These plans give you a great deal of flexibility. You can change beneficiaries to other family members (though it may be considered a gift), roll the funds into a different 529 plan without adverse tax consequences and even take your money back — though growth will be subject to tax and a penalty.

529 contributions qualify for the \$11,000 annual gift tax exclusion (\$22,000 if you split gifts with your spouse). You can even bunch five years' worth of exclusions into one year and contribute \$55,000 (\$110,000 with gift-splitting) up front, but you must file a gift tax return in the year of the gift. If you die before the five years, the remaining years' gifts will be included in your estate.

529 PLANS

If higher education is in your children's future, investing in a 529 plan may be your best option for shifting income. These savings plans allow you to make significant cash contributions to a tax-advantaged investment account that's similar to a Roth IRA.

Your contributions aren't deductible, but the funds grow on a tax-deferred basis and distributions are tax-free if the beneficiary uses them to pay for qualified higher education expenses (including tuition, fees, books, supplies, equipment, and room and board). Nonqualified distributions are subject to income tax plus a 10% penalty.

Remember that some of the 529 plan's advantages are set to expire at the end of 2010, unless Congress extends them. For example, starting in 2011, distributions used for qualified higher education expenses will be taxed at the beneficiary's tax rate, which will likely be lower than your own.

TAX STRATEGIES WITH A HAPPY ENDING

Unfortunately, there is no magic wand to reduce your tax bill. Shifting income, employing your children in your business and opening a 529 plan are just a few strategies that can give you a happy ending. 📖


TAX TIPS

GET TAX RELIEF FROM SUMMER DAY CAMP

Like many parents, you may send your children to day camp during the summer. But did you know you can receive a tax break? Day camp is a qualified expense under the Child and Dependent Care credit,



which is worth 20% of qualifying expenses (more if your income is less than \$43,000), subject to a cap. In 2005, the maximum expense allowed is \$6,000 for two or more qualifying persons with a limit of \$3,000 for one qualifying person.


Although overnight camp costs do not qualify for the credit, the cost of having a sitter watch your children in your home while you and your spouse work, or look for work, may. 

SHARING YOUR GAINS

To defer capital gains taxes, you can deduct charitable contributions of appreciated long-term stock by creating a charitable remainder trust (CRT). A CRT provides you with an annual income stream, plus it can sell the securities.

The benefit? You incur no capital gains taxes at the time of the sale. In effect, you receive an annuity based on the security's fair market value at the contribution date and pay taxes only as you receive distributions. You also can receive a current income tax deduction for

the remainder expected to benefit the charity, as determined by IRS tables.


By funding a CRT at your death, you can reap estate tax benefits. Income from the trust will go to a beneficiary of your choosing (rather than to you). When the trust term ends or the beneficiary dies, the remainder will pass to charity. Because you will be making a partial charitable donation at the time of your death, your estate will receive a deduction for a portion of the trust's value. 

HSA CONTRIBUTIONS MADE BY PARTNERSHIPS AND S CORPORATIONS

Contributions made by a partnership or S corporation to a partner's or shareholder's Health Savings Account (HSA) are generally treated as payments to the individual and included in his or her gross income. Therefore, the IRS considers the contributions as made by the individual partners or shareholders and allows them to be an above-the-line deduction on their individual income tax returns.

Partnerships can approach contributions to partners' HSAs in two ways. One approach is to treat them as distributions to the partner. Contributions are not deductible by the partnership and aren't included in the partner's self-employment earnings. But if contributions are for services rendered, you can treat them as guaranteed payments. Doing so allows the partnership to deduct the amount. The contributions will be included in the partner's net self-employment earnings.



Meanwhile, contributions made on behalf of S corporation shareholder employees who own 2% or more of the stock are treated as wages and are not subject to payroll tax. The business can deduct the cost of the payment. 

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