

# TAXOLUTIONS



►► *ideas on taxes*

## CONGRESS APPROVES TAX INCENTIVES TO HIRE VETERANS

After an extended campaign to persuade Congress to enact his administration's proposals for job creation, on November 21, 2011, President Obama signed into law the 3% Withholding Repeal and Job Creation Act. This will provide tax incentives for employers to hire military veterans, especially those with service-related disabilities, and repeals the controversial 3% withholding on government contractors. The bill passed with overwhelming bipartisan support.

Prior to voting on the repeal of the 3% withholding, which had been approved by the House, the Senate added as an amendment the Vow to Hire Heroes Act of 2011, a measure that provides tax credits to employers who hire military veterans. The new law expands the Work Opportunity Tax Credit, which rewards employers for hiring employees from certain targeted groups, by the following: creating a new tax credit of up to \$5,600 for hiring veterans who have been unemployed for more than six months; up to \$2,400 for hiring veterans who have been unemployed for more than four weeks, but less than six months; and up to \$9,600 for hiring veterans with service-related disabilities who have been unemployed for more than six months, as well as expanded

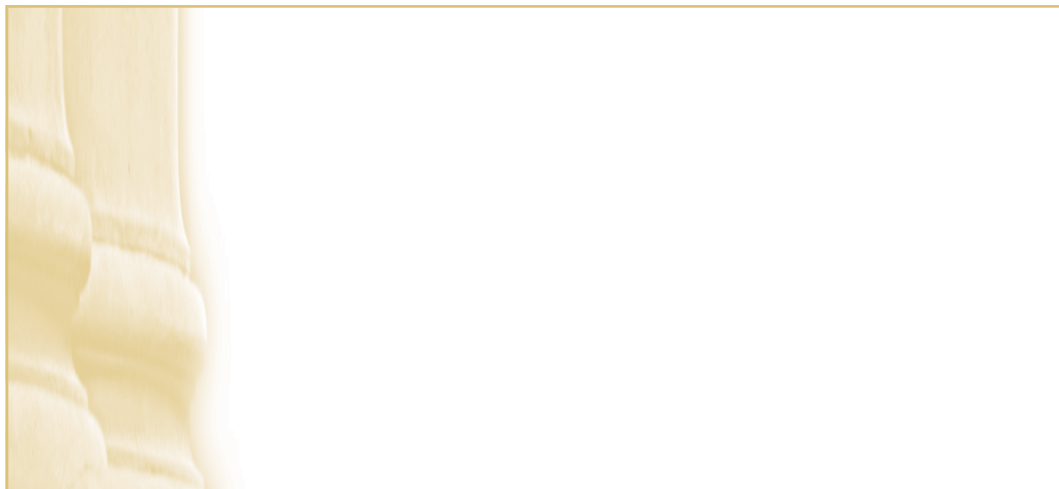
training and educational opportunities for all veterans. These credits may be applied to veterans who start work between November 21, 2011 and December 31, 2012. The \$1.6 billion cost of these provisions is offset by delaying scheduled fee reductions on mortgage applications for loans guaranteed by the U.S. Department of Veterans Affairs (VA).

Observing that the unemployment rate among veterans is considerably higher than that of the general public, Sen. Max Baucus remarked, "Today's vote is a win for our economy, a win for bipartisanship, and most importantly the right thing to do for our veterans. This bill will make it easier for businesses to hire

veterans and help make veterans more competitive in the job market."

The incentives for hiring veterans are the first proposals from the American Jobs Act, a \$447-billion plan presented by President Obama at a joint session of Congress on September 8. The package also includes a reduction and suspension of payroll taxes for qualifying employers and medium- to low-income employees; an extension of unemployment benefits; a jobs tax credit for the long-term unemployed; an expansion of opportunities for low-income youth and adults; new spending on infrastructure and wireless projects; funding to protect the jobs of teachers and first responders;

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## ARE LEGAL FEES TAX-DEDUCTIBLE EXPENSES?

While U.S. tax law does not expressly provide for deductions of legal fees, amounts paid for legal or other professional services may be deductible by businesses and individual taxpayers under certain circumstances, especially if the legal services are related to business or income-producing investment activities.

Generally, attorneys' fees are not tax deductible if they are incurred in resolving personal or family matters, such as divorce and custody cases, legal disputes involving wills and family inheritance, or criminal or civil lawsuits not related to work. Attorneys' fees may, however, be deductible as business expenses if they are paid or incurred in a trade or business. Private individuals may also be able to deduct legal fees incurred in the course of obtaining advice on a tax or investment matter as investment expenses, provided the activity is intended to produce taxable income. In short, to deduct legal fees, the taxpayer must usually show that the expenses are connected to the operation of a trade or business, to an investment or profit-making activity, or to the payment of taxes.

When seeking to deduct attorneys' fees as a business or investment expense, the taxpayer must also be able to demonstrate that expenditure is "ordinary and necessary," and "reasonable in amount." The fees must be paid or incurred during the taxable year in which the taxpayer seeks to deduct them, and be paid by the person who benefited from the services rendered.

Businesses, including corporations, LLCs, partnerships, and proprietorships, can deduct most legal and professional expenses incurred while engaging in business or trade. However, certain fees, such as those related to the sale of a business, must be capitalized and added to the basis of assets. An employee may deduct legal fees related to performing or retaining his job, such as fees paid for defense against criminal charges or disciplinary or licensing proceedings

arising out of business activities, or when involved in a class-action lawsuit. Employees must, however, deduct legal expenses as miscellaneous itemized deductions, which limits deducting only the amount over 2% of their adjusted gross income (AGI). Taxpayers subject to the alternative minimum tax (AMT) are not permitted to claim miscellaneous itemized deductions, including legal fees.



In some cases, taxpayers are permitted to claim legal expenses, including investing, incurred in connection with income-producing activities as a miscellaneous itemized deduction. To qualify as deductible, the fees must be paid or incurred for the production or collection of taxable income, or for the management, conservation, or maintenance of property held for the production of taxable income. Generally, legal fees and other expenses paid for the management or conservation of property held in connection with a hobby or recreational activity, or as the taxpayer's primary residence, are not deductible. If, however, the taxpayer vacates his home and turns the residence into a rental property, legal expenses incurred in managing the house as a rental property are deductible. Moreover, some investment legal fees must be capitalized to the basis of the assets, such as legal fees for the purchase of investment property, or for the resolution of certain types of disputes involving the property.

The Internal Revenue Code typically does not allow individuals to deduct fees paid for legal and other professional advice on personal matters. However, legal expenses incurred in slander lawsuits involving the taxpayer's business reputation could count as a business or investment expense. In addition, individuals can usually claim legal expenses they incur in connection with the determination, collection, or refund of any

tax as a miscellaneous itemized deduction. For example, taxpayers can deduct legal fees incurred for personal tax preparation or planning, or in seeking advice on any tax-related issue, including the resolution of tax disputes, representation in an audit, or the payment of tax-deductible alimony. Recently, the IRS has also permitted individuals involved in employment discrimination lawsuits to deduct attorneys' fees or court costs as an adjustment to income, rather than as a miscellaneous itemized deduction.

If a transaction in which a legal fee is incurred is attributable partly to a deductible business or investment activity and partly to a non-deductible activity, such as personal or capital expenditures, the taxpayer can claim a deduction for the portion of the fees that are deductible. When seeking the advice of an attorney, the taxpayer may wish to request that fees for the deductible and non-deductible legal services being provided are identified on the bill. ■

## THE TAX CONSEQUENCES OF SELLING A BUSINESS

**B**usiness owners who are considering selling their company should take into account the taxes they will owe before putting the “For Sale” sign up. When a sale produces income, owners have to pay taxes on at least part of their gains from the sale. How these gains are taxed depends in large part on the structure of the business, whether the business is being sold as a set of assets or as an entity, as well as the type of assets being sold.

The IRS generally views a business as a collection of assets, including real property, equipment, inventory, and goodwill. The gain or loss on the sale of different categories of business assets are taxed differently. When they are sold, the assets must be classified for IRS purposes as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. Under the Internal Revenue Code, sellers and buyers must assign a specific value to each asset or groups of similar assets, and report a gain or a loss from the sale of each asset to the IRS. The sale of capital assets results in a capital gain or loss, the sale of real property or depreciable property used in the business and held longer than one year results in a gain or loss from a Section 1231 transaction, and the sale of inventory results in ordinary income or loss.

The tax consequences of a sale also depend on the structure of the business. Because sole proprietorships, partnerships, and limited liability companies (LLCs) are “pass-through” entities, owners of these companies enjoy a degree of flexibility in negotiating an asset sale. C corporations can sell both stocks and assets, but, unlike pass-through entities, a C corporation is taxed twice when its assets are sold. The company pays the corporate

tax rate on any gains realized from the sale of the assets, and the company’s individual shareholders pay capital gains taxes when they receive distributions from the liquidation of the corporation. But when a C corporation sells its stock, the seller pays only capital gains taxes on the profit from the sale.

Meanwhile, in purchasing the stock, the buyer is acquiring the company as an entity, including any of the business’s existing liabilities. If, instead of purchasing the stock, the buyer acquires the company’s assets, the buyer receives a new tax basis in the assets, and higher depreciation and amortization deductions in the future. So, buyers are more likely to want to acquire the assets of a company rather than the stock, while the seller may prefer to sell the company as an entity. Because a stock sale usually results in a lower overall total tax bill than an asset sale, the seller may wish to consider adjusting the purchase price in order to persuade the buyer to

accept a stock transaction rather than an asset sale.

S corporations are taxed in a manner more similar to that of partnerships than of C corporations, and thereby avoid this double taxation. The income or losses of an S corporation flow through to the shareholders, who pay taxes on this income at their individual income tax rates. Therefore, no second taxation occurs when an S corporation sells its assets. To discourage C corporations from changing to the S status shortly before a sale, a company must have been an S corporation for a certain amount of time prior to the sale to qualify for all of the tax advantages.

Since selling a business can be a complex undertaking, business owners should meet with legal and tax professionals beforehand to discuss strategies for making the company attractive to buyers, while minimizing their own tax liabilities. ■



## Low Uptake on Small Business Health Care Tax Credit

Since March 2010, small businesses with fewer than 25 full-time employees with average wages of \$50,000 or less, and that pay at least 50% of the health care premiums for their employees, have been eligible for a tax credit of up to 35% of their premiums under the Patient Protection and Affordable Care Act of 2010 (PPACA). After 2013, this rises to 50%. The size of the credit each business receives depends on the number of employees and the average wage. The full tax credit is available only to employers with 10 or fewer employees who have average salaries of \$25,000 or less, and the credit phases out for businesses with 10–25 full-time employees with average wages of \$25,000–\$50,000. According to Congressional Budget Office (CBO) estimates, the credit will cost \$37 billion over 10 years, and could be claimed by as many as 4.4 million businesses and nonprofits.

Figures provided by the IRS indicated that 309,000 small business owners received \$435 million in tax credits through mid-October—less than the original CBO projection that taxpayers would claim up to \$2 billion in credit for tax year 2010.

Emily McMahon, acting assistant secretary for Tax Policy at the Treasury Department observed, “Businesses generally make decisions about providing health insurance before the start of the year. The Affordable Care Act passed in March of 2010, and some businesses may not have had the opportunity to make any needed adjustments to qualify for the credit for 2010. These businesses may be eligible to claim the credit on 2011 returns and beyond.”

But at a November 2011 hearing on the tax credit, Todd McCracken, president of the National Small Business Association (NSBA), pointed out that the credit is most valuable to very small businesses

with very low-wage employees, but these businesses are often unable to make use of the credit. He attributed this low uptake to the inability of many low-wage workers to pay their portion of the premium; the higher morbidity in the small group health insurance market; limited duration of non-refundable credit; and rising health care costs.

“This tax credit is only temporary—it expires after five years—and given the failure of PPACA to contain costs even those few small-businesses able to utilize this credit will be left without any kind of support and a very expensive benefit that is difficult to take away once they offer it to employees,” McCracken said. “Tax credits are neither the cure-all for small businesses’ health insurance woes nor a replacement for good policies on cost-containment that make health care more affordable.”

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and funding to modernize public education facilities. Bills that would have enacted portions of this plan failed to make it through Congress earlier.

The new law also repeals the 3% government contractor withholding requirement, a measure designed to discourage tax avoidance among contractors that never went into effect. As part of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), a 3% government withholding requirement was to be imposed on certain types of payments to contractors and other providers of services or property to Federal, state, and local governments. The government withholding had been scheduled to apply to payments made after December 31, 2010, but the implementation was delayed under the economic stimulus legislation, and again by the Internal Revenue Service (IRS), and had been due to go into effect on January 1, 2013.

Critics of the 3% withholding argued that it would pose considerable compliance problems for smaller government contractors. Patricia A. Thompson, chair of the tax executive committee of the American Institute of Certified Public Accountants (AICPA), supported a repeal, arguing that the withholding would force many contractors to pay for a costly reprogramming of their accounting and procurement systems. “In the absence of repeal,” Thompson said, “the withholding law will likely have a pronounced (but negative) impact on government contractors with low profit margins, potentially threatening their operations due to a tightening of cash flow.”

The Joint Committee on Taxation has estimated that the repeal of the withholding tax will cost \$11.2 billion over 10 years. To offset this cost, the new law alters the definition of modified adjusted gross income (AGI) to include

a portion of the individual’s Social Security benefits, which had previously been excluded, when calculating AGI for the purposes of determining eligibility for Medicaid, the Children’s Health Insurance Program, and for the premium assistance tax credit, which will become available as part of the Federal health care reform plan starting in 2014.

In addition, the law will permit the IRS to impose a continuous 100% levy against payment due on a provider of property sold or leased to the Federal government if the vendor has an unpaid Federal tax debt, and not just on vendors of goods and services. The legislation further provides the VA with the authority to obtain information from the IRS, and orders the Treasury Department to prepare a report on how the government can become more effective in collecting delinquent taxes owed by Federal contractors. ■