

Ideas for Your Success

Second Quarter 2009

Prepping for FIN 48 compliance

Chances are that most people have never heard of the accounting rule with the funny name: FIN 48. But it's been causing nightmares for many business owners for some time.

ABCs of FIN 48

Under Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), some organizations must disclose uncertain tax positions on their financial statements. The rule is causing sleepless nights among business owners because of concerns that the new disclosure requirements will increase their costs and affect their earnings.

The good news is that last fall FASB voted to postpone the effective date of FIN 48 for many private companies until periods beginning after Dec. 15, 2008. For them, this reprieve likely means that FIN 48 will affect only their calendar-year 2009 and later financial statements.

FIN 48 applies to all companies that prepare their financial statements according to Generally Accepted Accounting Principles (GAAP). The biggest impact has already been felt by public companies, which are required to follow GAAP in their SEC filings. But FIN 48 also applies to private companies that prepare GAAP-compliant financial statements to satisfy lenders, investors or other third parties.

Compliance requirements

To comply with the new rules, you need to review every tax position you've taken on your federal and state income tax returns. A tax "position" is virtually anything that results in a tax benefit, such as claiming a deduction, credit or exemption, or determining how certain income should be characterized.

For each tax position, you must determine whether it's "more likely than not" that the position would be sustained if it were challenged in an IRS audit. To make this determination, you'll need to consider the taxing



authority's policies, practices and prior rulings, and any relevant court decisions.

If a position fails the more-likely-than-not test, the tax benefit shouldn't be recognized on your financial statements. If it passes the test, then, according to FIN 48, you should recognize "the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority." The interpretation also requires specific financial statement disclosures regarding uncertain tax positions — whether you recognize the tax benefits or not.

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On your mark, get ready, sell

Planning is key to defer or reduce capital gains taxes when selling an appreciated asset

In today's difficult economic climate, it may be less likely that an asset will appreciate in value, but, fortunately, it still happens. And if you're lucky enough to have an asset's value increase, you'll, *unfortunately*, face a capital gains tax when you sell it. Thankfully, there are actions you can take before you realize the gain to defer, reduce or even avoid tax liability.

Time the sale

You generally won't realize a gain until you sell an asset. So *when* you sell an appreciated asset can affect the tax consequences.

First, gain on assets held for more than one year is subject to the long-term capital gains rate, as of this writing generally 15% for most types of assets. (Under the Obama administration and the new Congress, capital gains rates may change, so check with your tax advisor for the latest information.) Gain on assets held for less than a year, however, is considered short term and subject to the taxpayer's marginal income tax rate, which might be significantly higher than the long-term capital gains rate. So before selling an asset you've held for less than a year, consider the potential tax savings if you were to hold on to it until you pass the one-year mark.

Second, it's generally beneficial to defer taxes when possible. So as you approach year end, you may want to consider waiting until the beginning of the next year to sell an appreciated asset so you can defer the tax liability. Or,

if you're selling real estate, consider selling this year but receiving installment payments in later years that will be taxed as they are received. But keep in mind that deferring taxes could have negative consequences if tax rates go up.

Consider state income tax

You must be prepared to owe a substantial amount of state income tax on the sale of an appreciated asset — unless you're a resident of a state with no individual income tax. Bear in mind, though, that any taxes you pay might reduce your federal income tax liability.

Because state income taxes are one of the itemized deductions subject to an adjusted gross income (AGI) limitation, you may not be able to deduct the entire expense.

You also must consider the alternative minimum tax (AMT), because state income taxes aren't deductible for AMT purposes. Only a careful projection for this year and next will tell how to best time a sale to minimize AMT consequences.

Reap more of your reward

It's important to keep in mind that you shouldn't make investment decisions based solely on tax consequences; there are many other important factors to consider. But where appropriate for your overall financial situation and goals, timing the sale of an asset and taking into account state income tax might enable you to reduce the amount of profit that must go to Uncle Sam.

Does your home office qualify for a deduction?

You've decided to go into business for yourself. You have a solid business plan and the necessary capital to get up and running, but where should you base yourself?



How about your home? If this option is feasible, you may be able to deduct some home office expenses. Your workspace doesn't have to be an actual office, only a defined space you use for business. According to the IRS, your workspace must meet four tests to qualify for the home-office deduction:

- 1. Exclusive use.** Your home office space must be used for only your trade or business. No personal use of the area is allowed.
- 2. Regular use.** You must use the area regularly and on a continuous basis.
- 3. Trade or business use.** You must use the area in connection with a trade or business.

4. Place of business. The area must be your principal place of business or the place where you regularly meet or deal with customers. Using the space for administrative or management functions typically qualifies too, even if a significant portion of your work is done in the field.

If your home office qualifies for the home-office deduction, work with your tax advisor to calculate how much you can deduct. (Bear in mind that this deduction will affect this year's tax filing and next year's tax planning.)

Begin by listing your expenses. If you're self-employed, you can deduct 100% of expenses directly related to the home-office space, including your telephone line and utilities (if you have separate hookups), painting and repairs, and the cost of an insurance rider on your homeowner's policy.

You can deduct only the portion of home-related expenses that pertain to your home office, not the full amount that applies to your entire residence.

Uncertainty requires flexibility 3 estate planning strategies to consider

Flexibility generally is a positive attribute, allowing for an easier accommodation to change. Building flexibility into your estate plan is a must because changes to the estate tax laws are likely this year.

Facts and predictions

During the last several years, exemption amounts have increased while tax rates have dropped. As of this writing, the estate tax is scheduled to disappear in 2010, only to reappear in 2011, when the estate and generation-skipping transfer tax exemptions are scheduled to fall and gift, estate and GST tax rates are scheduled to return to their 2001 levels, with the maximum rate increasing to 55%.

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During the last several years, exemption amounts have increased while tax rates have dropped.”

But lawmakers are expected to take action this year to preserve the estate tax — perhaps they will even have done so by the time you’re reading this article. (Contact your estate planning advisor for the latest information.) Let’s take a closer look at three techniques that may help minimize any negative impact of estate tax law changes on your estate plan.

1. Give gifts

One of the most basic estate planning strategies also can be one of the most effective in terms of flexibility. The annual gift tax exclusion allows you to give up to \$13,000 (up from \$12,000 in 2008) to an unlimited number of recipients free of gift tax and without using any of your \$1 million lifetime gift tax exemption. So, for example, if you have three children and five grandchildren, you and your spouse jointly could make tax-free gifts to them of up to \$208,000 per year.

These gifts shrink the size of your taxable estate, resulting in substantial savings in the event of an estate tax increase. But even if estate tax rates go down and the exemption amount goes up, a gifting strategy can’t hurt from a gift and estate tax perspective, because there’s no gift or estate tax cost.

2. Use qualified disclaimers

A qualified disclaimer is a refusal by your beneficiary to accept an interest in property. It’s considered “qualified”

if it’s in writing, is delivered within a specified time period and meets certain other requirements. The disclaimed property then passes to a contingent beneficiary according to the terms of your will or trust.

If your estate plan is designed properly, your spouse or other beneficiaries can use qualified disclaimers to achieve the best tax results depending on the financial circumstances and applicable estate tax laws at the time.

3. Create a GRAT

If it seems likely that estate tax law changes could mean a large estate tax bill for your family, a grantor-retained annuity trust (GRAT) may be the answer. It allows you to remove substantial amounts of wealth from your estate, together with any future appreciation in value, while retaining an income stream. At the end of the trust term, the assets are transferred to your children or other beneficiaries tax free.

Keep in mind that there are a few disadvantages to this strategy. First, it works only if you outlive the trust term, so the term shouldn’t be too long. Second, the initial contribution of assets to the trust is subject to gift tax if it exceeds your available gift tax exemption — an unnecessary expense if the estate tax is ultimately repealed or the exemption amount is increased beyond the size of your estate. Fortunately, IRS regulations allow you to structure a GRAT in a way that minimizes (or, in some cases, eliminates) gift taxes.

Be prepared

With a range of new estate tax law possibilities in mind — from no estate tax to the lowest exemption amount and highest tax rate in a decade — review your situation with your estate planning advisor and explore techniques for building flexibility into your estate plan. The right approach depends on your particular circumstances.



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When making the decision to extend the compliance deadline, FASB took into account that pass-through entities — such as partnerships, S corporations and limited liability companies (LLCs) — haven't been adequately defined for FIN 48 purposes. In fact, partnerships and LLCs can have multiple pass-through entities, thus making it difficult to determine which entity is liable for taxes. FASB expects to finalize and issue an FASB Staff Position (FSP) that offers guidance for pass-through entities and provide amendments to the existing disclosure requirements for nonpublic entities in early 2009.

Don't procrastinate!

Even though FASB's decision to postpone its compliance deadline is good news for many private companies, it doesn't mean you should put off your planning for FIN 48. Consult with your tax and financial advisors to evaluate the potential impact of FIN 48 on your financial statements and to ensure that procedures are in place to gather the information FIN 48 will require.

FIN 48 and state taxes

When working to comply with Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), it can be particularly challenging to account for state business income and franchise taxes. Tax liability in a particular state depends on whether your business has a sufficient physical or economic connection, or "nexus," with that state. Each state has its own rules regarding the level of business activity within its borders that will trigger its tax laws.

Under FIN 48, you must not only analyze your tax positions for every state in which you file a return, but also evaluate any decisions *not to file* a return in a state where you do business. If there's uncertainty over whether you're required to file, you may have to reflect some of the potential tax liability on your financial statements.

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