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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

June 2012

Corporate Minutes Can Provide Timely Assistance

If you're a business owner with a company structured as a corporation, certain formalities must be followed. For instance, you must hold regular meetings of shareholders and directors. At these meetings, you should formally document important company decisions. Without thorough minutes, your company could lose its status as a corporation, and shareholders might lose the limited liability that corporations can provide.

Accurate minutes may protect the company and key individuals from future litigation. If the minutes show valid reasons for taking certain actions, unhappy shareholders or employees may be discouraged from pursuing lawsuits if those actions yield poor results. In addition, you, as a business owner, may avoid potential tax traps by keeping good minutes.

Debt versus equity

You probably contributed cash to your company at its creation or at a later date. Were those contributions debt or equity? You may prefer to have your contributions classified as debt because money you receive from the company in the future may be treated as tax-deductible interest payments on the debt. If your contribution is classified as equity, the payments you receive may be treated as nondeductible dividends. Although qualified dividend income currently is taxed at low rates, which may be attractive to the owner, there's no guarantee that this will continue in the future (especially for high-income taxpayers).

If you prefer your contributions to be treated as debt, you should make sure your corporate minutes state that you have made a loan to your company. Your minutes might explain that banks are reluctant to lend to small businesses in a slow economy, so you are stepping in with a needed loan.

You should execute a formal loan agreement between yourself and the

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What's Inside

Hedges Trimmed

Assets managed by U.S. hedge funds with $1 billion or more rose 3% last year to $1.34 trillion but are still below the $1.68 trillion managed in mid-2008.

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company, stating the interest rate and the repayment terms. Record the loan details in your corporate minutes. At future meetings, make sure the minutes state that the loan terms are being observed or give reasons why you and your company have decided to restructure the loan.

Regardless of whether you make a loan to your company, you may decide to borrow from the business once it begins to generate positive cash flow. Loan proceeds aren't subject to income tax. Again, by drawing up and following a formal loan agreement, backed up by an explanation in the corporate meetings, you may be able to protect yourself from an IRS assertion that you have actually received taxable compensation or dividends.

Reasonable compensation

If you own a young business, you may be taking only a modest salary. The same might be true even if you own an established company in a slow economy. By doing so, you're leaving more cash in the company to finance its growth or survival. Such actions are common, but you could suffer adverse tax consequence as a result.

Example: For years, Sheila Turner nursed her business to health, taking just enough salary to pay her basic living expenses. In 2012, her company is thriving, so Sheila raises her annual compensation from $40,000 to $240,000.

If the IRS audits the tax return filed by Sheila's corporation, an examiner might contend that Sheila's huge increase in compensation was unreasonable. The IRS agent could conclude that $120,000 was ample compensation, for someone running this type of company, while recasting the other $120,000 paid to Sheila as a nondeductible dividend.

In this situation, Sheila could use comprehensive corporate minutes as a defense. Suppose that the company's minutes, dating back to 2008, state that Sheila had taken a lower-than-justified salary in order to help the company survive in troubled times. The minutes might show that the corporation's directors had agreed, at periodic meetings, that Sheila would be entitled to higher compensation once the company prospered.

In this scenario, Sheila could produce the historic corporate minutes to show an IRS agent that her reported salary was reasonable. Therefore, you should make sure that your company's minutes note that you are taking a below-market salary, when that's the case; such minutes might support corporate tax deductions for generous compensation in the future. ■

Trusted Advice

Cash Cache

- In addition to corporate income tax, a corporation may owe an additional 15% tax on accumulated taxable income over $250,000, or over $150,000 for personal service corporations, such as consulting firms and medical practices.
- Your corporate minutes can reduce the threat of this surtax.
- In those minutes, you can explain why you are holding onto large amounts of cash. You might say that you are planning to expand the business or ride out a recession.
- Go beyond a bare statement of facts in your minutes. If you are planning to build a warehouse, for example, you might attach a copy of a proposal from a contractor to illustrate the likely costs.

Municipal Bond Refundings May Offer Safe Tax-Exempt Income

If you keep cash in a bank account or a money market fund, you're certainly aware of the low interest rates that prevail today. Those rates are having an impact on municipal bond investments, too. Although interest rates are down, lowering yields to investors, so-called municipal bond "refundings" are up. As a result, you may be able to earn relatively high tax-exempt income with little risk of default.

Reduced borrowing costs

Municipal bond issuers can borrow at today's low interest rates. In a refunding, the money from the newly issued municipal bond will enable payment of the debt service on an issuer's older, higher yielding bonds, as explained later. Eventually, old bonds will be redeemed and essentially replaced by newer, lower yielding bonds, which can save money for the state and local government agencies that issue municipal bonds.

Recently, *Barron's* reported that nearly 60% of the money raised by issuing municipal bonds in 2012 has come from refunding transactions.

Earlier in this century, annual refundings have ranged from 31% to 47% of total issuance, so based on that, refundings have surged this year. For example, Bellevue, Washington, has refunded bonds issued for the remodeling of its city hall. That move dropped the average interest rate on such bonds from 5.2% to about 3.5%. City officials in Bellevue said the refunding is expected to save the city more than $9 million over the next 30 years.

Impact on investors

After a municipal bond refunding, the issuer uses the proceeds of the new issue to purchase highly rated collateral, such as U.S. Treasury bonds, and places that collateral into an escrow account. Generally, the bonds purchased as collateral are set to mature at the first "call date" of the original bonds.

Example: A city issued municipal bonds several years ago with a 5% interest rate. The bonds were set to mature in 2024, but the earliest call date was 2014. That is, these bonds can be redeemed prematurely in 2014.

Now that interest rates have fallen, the city issues new bonds with a 3.5% interest rate, which will be less expensive. The money raised from this new issue is used to buy Treasuries that mature in 2014. The Treasuries are placed in an escrow account, securing the interest payments and the redemption of the older bonds.

In this example, the older bonds have been "prerefunded." They won't be redeemed until 2014, but the mechanism for paying the debt service and returning principal to investors already is in place. Consequently, investors who own these bonds typically have little risk of default.

Often, investors who buy prerefunded municipal bonds receive relatively high yields from the date of purchase to the call date. If Treasury notes maturing in 2014 yield 2%, for instance, prerefunded municipal bonds may yield upwards of 3% until the scheduled call in 2014. Moreover, the interest on Treasuries is subject to federal income tax, but municipal bond interest is usually tax-exempt.

Therefore, conservative investors seeking a place to hold cash in the short term may want to consider prerefunded municipal bonds, which are offered by many brokerage firms. Our office can help you determine the tax consequences of specific issues. ■

Pros and Cons of Living Trusts

Estate planning often involves the use of trusts, which come in two basic forms: revocable and irrevocable. As these names suggest, trusts may be permanent or not-so-permanent. If you create a revocable trust and transfer assets into it, you can change your mind and terminate the trust, reclaiming ownership of the assets that were in the trust.

An irrevocable trust can be established in your lifetime or after your death, as per your instructions. A revocable trust, on the other hand, can be established only while you're alive. Therefore, revocable trusts may be called "living trusts," and they have become increasingly popular.

Deflate probate

Living trusts have been promoted as a means to bypass probate at your death. In some circumstances, the probate process may be time-consuming and expensive.

Example 1: Annette Dawson dies with many assets held in her own name, including real estate, bank accounts, and securities. Those assets go to her three children, according to Annette's will. The executor of Annette's estate must prove to a local court that Annette has left a valid will, identify the assets that pass under her will, value those assets, pay any debts and taxes, and see that the remaining assets are properly distributed. (If Annette had died without a will, her assets would have gone through probate anyway and been distributed under state law.)

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The entire proceedings can take a little or a great deal of time, depending on state law and the size of the decedent's estate. An estate going through probate typically will owe legal and court fees, which may be substantial.

Example 2: Beth Emerson, Annette's sister, has similar assets. However, Beth has created a living trust and transferred her assets into that trust. Beth dies in the same state as Annette.

Any items that Beth has not transferred to her living trust will have to go through probate. However, assets held in trust don't go through probate. The assets that Beth transferred to her living trust will avoid probate and can either stay in trust or pass to other parties at her death, according to the trust terms Beth had specified.

From one pocket to another

Creating a living trust can spare your heirs some time and money in the future. What's more, you can remain in control of your living trust. You can collect any investment income generated by your trust assets; you can sell them and replace them with other assets, if you like. In addition, you can revoke a revocable trust if you become unhappy with the arrangement. Then the assets will move from the trust back into your own name.

A revocable trust can provide another valuable benefit: you can use it as a form of incapacity protection.

Example 3: When Beth creates her living trust, she names her son Rick as successor trustee. If Beth loses the ability to manage the trust assets, Rick will replace her as trustee. Then Rick will manage those assets on Beth's behalf. Beth's family won't need to petition a court to appoint a guardian to manage the assets held in the trust.

Paying the price

If those are the advantages of a living trust, what are the drawbacks? You'll probably pay legal fees to create the trust, and you will have to retitle your assets to the trust. If you don't take the time to move assets into a living trust, the assets you leave out won't get the benefits of probate avoidance and incapacity protection.

Additionally, depending on your situation, you may not need a living trust to avoid or minimize probate at your death. Assets such as IRAs, other retirement plans, annuities, and life insurance proceeds pass directly to a named beneficiary without going through probate. The same is true for bank and investment accounts with a payable-on-death or transfer-on-death designation. If you hold property titled in joint tenancy with right of survivorship, your co-owner will inherit your share automatically, without probate.

Weigh the merits and drawbacks carefully before deciding if a revocable trust can offer value to you and your loved ones. ■

Did You Know?

It is estimated that the total amount of gold ever mined, worldwide, would fit into 60 tractor trailers. In comparison, 6,000 times as much iron is produced each year.

Source: American Museum of Natural History

TAX CALENDAR

JUNE 2012

June 15

Individuals. If you are not paying your 2012 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2012 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2011. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2012.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

JULY 2012

July 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

July 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2012. Deposit any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2011.

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