

PERSPECTIVES



Dear Clients and Friends,

I can't believe it's almost year end.

That being said, we still don't have

resolution on income tax rates for 2011 nor on estate tax law for 2010 or 2011. The results of the November election show our government that there is much opposition to the current administration. We now have a lame duck Congress who have set in motion negotiations for enacting compromises in the tax law before year end. We will keep you posted once legislation has passed.

The economy continues to show signs of strengthening one week, then pulling back the following week. The high unemployment rate is interpreted by one analyst as being good, and by another as being bad. Bonds are getting negative press by some, yet others feel they're still the best investment. The media causes much of this confusion, and has a direct impact on the volatility of the financial markets. I know it may sound redundant from previous columns, but I continue to be cautiously optimistic and advise you to do so.

On the homefront, our renovation is proceeding along nicely. We are now entering our third and final phase, which should last about five weeks. Our goal is to have construction completed by the first week of January. We have been living through dirt and dust, and shifting people into temporary work areas as we progress. Fortunately, we were well organized thanks to our partner/construction manager Tony Pentz. I have now been relocated and am working out of boxes.

On behalf of everyone at the firm, I thank you for your continued support and your confidence in us. We wish you and your families a good holiday season and a happy and healthy new year.

*Very truly yours,
Michael S. Lewis, CPA
Managing Partner*

Take Care When Mixing Business With Pleasure

How to Substantiate Entertainment Expenses

Anthony Pentz, CPA, MST

Entertainment and recreation have a genuine and accepted role to play in the world of business. And while the IRS and courts scrutinize tax deductions for these activities, they also recognize that professionals conduct legitimate business over lunch, dinner, drinks, and even on the golf course. The key to deducting these expenses is to understand the rules and pay close attention to substantiation requirements, allowing yourself to successfully mix business and pleasure without giving up the tax benefits.

Supporting your entertainment expenses

Generally, your company can deduct "ordinary and necessary" business expenses. But the tax code imposes additional requirements on entertainment expenses. To support an entertainment expense deduction, you must be able to show that:

- The expense is directly related to or associated with the active conduct of your business—an expense may be "associated" with your company if

the entertainment directly precedes or follows a "substantial and bona fide business discussion";

- The deduction is adequately substantiated by records (or other evidence) that establish the amount, time, place, and business purpose of the expense, as well as the business relationship of the parties involved;
- You had "more than a general expectation" of gaining a business benefit from the entertainment;
- You engaged in some business activity, other than the entertainment, such as a meeting, negotiation, discussion, or other bona fide business transaction;
- The "principal character or aspect" of the combined business and entertainment was business; and
- The expense was attributable to you, your employees, or others involved in conducting business.

As with anything, the greater level of documentation you keep regarding any of the above, the more likely you will be able to defend the deduction in the

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Understanding the Loan Approval Process

Michael Rutkowski, CPA

Applying for a bank loan can be a frustrating and mystifying experience for small business owners. Having a strong relationship with your banker and knowing how credit decisions are made can improve your chances of being approved for a loan when you need it. This article serves as a brief guide to the dynamics between you and the banker that will help you understand the process from both sides.

The Banker's Point of View

A banker has three main priorities when extending a loan: To recoup the principal of the loan, to earn a reasonable rate of interest on the loan, and to help you to prosper in the hopes you will eventually conduct more business with them. The first—ability to recoup the principal—is paramount. Bankers are not in the risk business.

The Business Owner's Point of View

As the business owner, your role is to provide the banker with as many reasons to feel safe as possible. The approval process typically begins with you submitting a financing proposal—a statement of what you need, why you need it, when you need it, and how you plan to repay it. This document should also include information such as up-to-date balance sheets, cash-flow pro formas, and projected income statements. All banks have standard forms to help you prepare your proposal, but using your own business plan increases your credibility in the mind of the banker and gets the process off to a good start.

The Seven C's of Credit

Of course, credit is the driving factor behind a banker's decision. Here are "Seven C's of Credit" to think about as you

apply for a loan:

- **Character:** When applying for a loan, your character judgement is largely based on your past credit performance. Personal credit histories as well as business credit histories will be reviewed.
- **Capacity for debt:** This is figured on the amount of debt load your business can support. The debt-to-net-worth (debt/net worth) ratio is often used to justify a credit decision.
- **Creating value:** Suppose your business plan shows that the loan will increase earnings and lead to a swift reduction in the debt/net worth ratio. Your chances of a positive answer would increase.
- **Conditions:** If the bank believes that a worsening recession or even a depression is coming, it won't extend credit easily. Demonstrating your belief that business is on the rise can help.
- **Collateral:** Collateral is used only as a secondary source of loan repayment; banks prefer that the loan be repaid from operating profits and inventory. They have a vested interest in you becoming a bigger, better borrower and depositor.
- **Credibility:** How well do you know your business? How detailed are your plans? A business plan helps you answer the banker's questions without hesitation, sending your credibility rating soaring.
- **Contingency plan:** Those extending loans like to see that you're examining all possibilities, not just the outcome you want. A contingency plan is a short, worst-case business plan that examines the options that would be open to the

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Combined New Jersey and New York Sales Tax Returns are Coming to an End

Michael Rutkowski, CPA

Filing sales tax returns in both New Jersey and New York will soon become a little more complicated, as the agreement allowing the combination of sales tax information onto one form is ending. Here are the forms and due dates you will need to file after the 1986 Reciprocal Agreement between New Jersey and New York ends:

New Jersey vendors: New Jersey sales tax returns must be reported on a quarterly basis, using Form ST-50, even if no sales tax balance is owed. If New Jersey sales tax owed exceeds \$500 for the first and/or second month of the calendar quarter, Form ST-51 must be filed and the sales tax owed must be remitted. Both returns must be filed by the 20th day following the end of the respective period.

Currently, New Jersey based businesses are able to file New York sales and use taxes using Form ST-20 on a quarterly basis or ST-21 on a monthly basis. Going forward, New York sales and use taxes will be reported on Form ST-100. The first period to file ST-100 after the end of the 1986 Reciprocal Agreement will be for the partial period January 1, 2011 through February 28, 2011, with a due date of March 21, 2011.

New York vendors: New York based monthly and quarterly filers will stop using Form ST-810.4 and Form ST-101.4 to file New Jersey sales and use taxes after November 2010 and will file New Jersey sales and use tax returns starting December 2010 with a due date of January 20, 2011. New York vendors who file on an annual basis will start filing New Jersey sales and use tax returns for the period of January 1, 2011 through March 31, 2011 with a due date of April 20, 2011. As noted earlier, New York based vendors will report New Jersey sales and use taxes using forms ST-50 and ST-51.

If you need guidance on how these changes impact you, please contact your MT&L advisor. ■

Plan Now to Maximize Deductions for Equipment Purchases

Shane Orbach, CPA, MST

On Sept. 27, President Obama signed into law the Small Business Jobs Act (SBJA), reinstating the 50 percent depreciation bonus for 2010 and increasing Section 179 expensing limits to \$500,000 for both 2010 and 2011. In addition, the Act increases the phase-out threshold to \$2 million. Without the SBJA, the expensing limit for Section 179 property would have been \$250,000 for 2010 and \$25,000 for 2011. This legislation can make purchasing needed equipment more affordable.

Depreciation 101

Ordinarily, when you buy equipment and other assets for your business, you're required to depreciate the costs over several years for tax purposes. Section 179 allows you to "expense" as much as 100 percent of the cost of a qualified asset in the year you place it in service.

The amount you can expense under Section 179 is subject to an annual limit, which is phased out on a dollar-for-dollar basis when your total investment in Section 179 property exceeds the phase-out threshold. As a result of the SBJA, the \$500,000 limit is reduced by \$1 for every dollar of 2010 or 2011 qualified purchases that exceed \$2 million. So, for example, if you spend \$2.2 million on qualified property this year, the most you can expense is \$300,000. In addition, Section 179 limits expensing to a taxpayer's taxable income, so you can't use the election to generate a loss. If the taxable income limit prevents you from deducting all of your Section 179 expenses this year, you can carry over the unused deductions to future years. However, you may be better off forgoing some or all of the election this year and using ordinary or bonus depreciation deductions to generate a loss.

As mentioned above, the SBJA has also reinstated the 50 percent bonus depreciation that was available in 2009. Bonus depreciation allows you to accelerate your depreciation

deduction for a qualified asset by taking more of it in the year of purchase, in this case 50 percent of an eligible asset's adjusted basis.

Bonus depreciation is not subject to any asset purchase limits, so businesses ineligible for Section 179 expensing can take advantage of it. Furthermore, businesses that qualify for Section 179 expensing can take bonus depreciation on asset purchases in excess of the \$500,000 Section 179 limit. (Of course, they have to keep in mind the \$2 million Section 179 phase-out threshold.)

Timing purchases

A tax rule of thumb advises that you should take as many deductions as possible in the current year and defer as much income as possible to later years. So if cash flow permits, accelerating purchases into 2010 and 2011 in order to take advantage of the SBJA can make sense.

But like all rules, there are exceptions. For example, if you anticipate being in a higher income tax bracket in future years, you may be better off holding off on asset purchases—even if it means you'll be subject to lower Section 179 expensing limits and no bonus depreciation. Why? Because deductions save more tax dollars when you're paying tax at a higher rate. For example, a \$10,000 deduction saves \$2,800 in taxes if you're being taxed at the 28 percent rate, but it saves \$3,500 if you're being taxed at the 35 percent rate. With the current political uncertainty surrounding future tax rates, this scenario should be given its due consideration.

You can be assured that we are diligently monitoring Congress and will issue updated information as needed. In the meantime, please contact your MT&L advisor if you have any questions or concerns about how to get the best tax result from your asset purchases and depreciation-related deductions. ■

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Understanding the Loan Approval Process

business should adverse conditions arise. A contingency plan shows preparedness and prevents panic (both yours and your banker's).

Reasons for Rejection

Even after paying careful attention to all of these items, it is inevitable that some credit requests will be denied. So why do bankers turn down loan applications? Except for bank credit policy reasons or banking law, applications are rejected for the following credit-related reasons:

- Too little owner's equity
- Poor earnings record
- Questionable management
- Low-quality collateral
- Slow/past-due trade or loan payment record

- Inadequate accounting system
- Startup or new company
- Poor moral risk

Establishing more than one banking relationship, being honest with your banker, and knowing the kind of credit you need are all things that can help you in any type of loan approval process. Please contact your MT&L advisor for more information about financing your business. ■

*Wishing You A Happy Holiday
Season & A Prosperous New Year!*

An Inside Look

Employee News

Congratulations to **Shane Orbach** and his wife Ana on their first child, Isabella Grace, born on October 25.

Congratulations to **Jason Doughty** for obtaining his CPA designation.

Michael A. Weber participated in the Juvenile Diabetes Research Foundation International's Walk to Cure Diabetes on October 3 in North Branch, NJ.

Lia Copeland participated in the American Cancer Society's Making Strides Against Breast Cancer Walk on October 17 in Parsippany, NJ, raising \$1,175 and walking 3.1 miles.

Firm News

Andrew Fink co-presented a seminar on October 29 to the NJSCPA Estate, Trust, & Gift Tax Committee, titled "Special Needs Planning and Incentive Trusts: What You Need to Know to Help Your Clients."

Shane Orbach spoke at the Commercial Food Equipment Service Association Region 5 Conference on November 12. His topic was "Preparation for Multijurisdictional Sales and Use Tax Audits."

MT&L is pleased to welcome **Meghan Flinn, CPA** to the firm. Meghan joins us as an Audit Senior.

MT&L sponsored the Washington Institute for Near East Policy dinner, honoring Tony Blair.

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Take Care When Mixing Business With Pleasure

How to Substantiate Entertainment Expenses

event of an audit. Also, keep in mind, otherwise allowable deductions for meals and entertainment are reduced by 50 percent in most cases, although certain situations do allow for full deduction.

Case Study: *Townsend Industries Inc. v. United States*

Townsend Industries Inc. v. United States provides some important lessons for businesses that wish to deduct entertainment expenses.

Every summer, Townsend gathered its independent sales representatives for a two-day meeting at its headquarters. Following the meeting, Townsend sponsored a four-day, expense-paid fishing trip for its sales reps and factory employees. Employees were encouraged, but not required, to attend. Although business discussions were conducted on an ongoing basis and one dinner meeting was held, workers were generally free to do as they pleased during the trip.

The IRS challenged Townsend's treatment of the trip expenses, contending they constituted wages that were subject to employment and income taxes. The district court agreed, finding: 1) the "fishing trips were not an ordinary

and necessary business expense in light of the lax attendance policy for the trip," 2) there was "a disconnect between the sales meeting and the fishing trip," and 3) the company had no more than a general expectation to derive uncertain future benefits from the trips.

The court also found Townsend failed to meet substantiation requirements, citing the company's lack of contemporaneous, written records detailing how the expense was business related.

The appellate court disagreed, ruling that, despite the lack of contemporaneous records, trial testimony clearly established the fishing trips had a legitimate business purpose. Even though the trips were voluntary, employees "felt an obligation to attend, and some felt it was part of their job." Moreover, there was "extensive trial testimony" regarding specific business issues discussed and problems solved during the trips.

Although *Townsend* confirms the deductibility of travel and entertainment expenses for legitimate business purposes, the case also highlights the importance of substantiating these expenses with detailed records.

For guidance on how your company should be documenting its entertainment expenses, contact your MT&L advisor. ■

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The Small Business Jobs Act of 2010

William Schwarz, CPA, MST

On September 27, 2010 President Obama signed the Small Business Jobs Act of 2010, which contains valuable individual and business tax incentives. Many of the \$12 billion tax incentives are temporary, so taxpayers have only a short window in which to take advantage of them. Others are permanent, but require careful planning to maximize the tax benefits. This article highlights the tax incentives and revenue raisers in the new law.

Although the new law is labeled a "small business bill," it is actually much more. The new law includes a number of provisions targeted to small businesses and investors in small businesses, such as 100 percent exclusion of gain on qualified small business stock, an increase in the amount allowed as a deduction for start-up expenditures, and more. Other provisions may benefit businesses of all sizes, such as extended bonus depreciation and extended and doubled Code Section 179 expensing. Many individuals will benefit from a new rule allowing rollovers from elective deferral plans to Roth designated accounts, along with other retirement savings incentives. Self-employed individuals benefit from a temporary deduction for health insurance costs in computing self-employment income.

To ensure passage of the bill, supporters had to find revenue raisers to pay for the tax incentives. The largest revenue raiser designed to force greater disclosure of taxable income is a new information reporting requirement for rental property expenses, which is projected to raise \$2.5 billion over 10 years. The new law also increases information return penalties.

General Business Provisions

Bonus Depreciation: The new law extends a popular business tax incentive referred to as "bonus depreciation." This incentive allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis for qualified property placed in service. The new law extends bonus depreciation for qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain longer-lived property and transportation property). The new law also includes a special long-term accounting rule for bonus depreciation.

Depreciation on Passenger Autos: The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year they are used in a business by \$8,000 for automobiles that qualify and for which the taxpayer does not elect out of the additional first-year deduction. For 2010, therefore, maximum first-year depreciation for passenger automobiles is \$11,060.

Code Section 179 Expensing: The new law increases the maximum amount a taxpayer may expense under Code Section 179 to \$500,000 and raises the phase-out threshold to \$2 million. It also allows taxpayers to expense qualified leasehold investment property, qualified restaurant property, and qualified retail improvement property. For detailed information on these rules, read Shane Orbach's article inside this issue.

Start-up Expenditures: A certain amount of qualified business start-up expenses may be deductible in the tax year in which the active trade or business begins. The new law increases the amount of start-up expenditures that a taxpayer may elect to deduct from \$5,000 to \$10,000 for tax years beginning in 2010. It also increases the deduction phase-out threshold so that the \$10,000 is reduced, but not below zero, by the amount by which the cumulative cost of qualified start-up expenses exceeds \$60,000.

S Corporation Built-in Gains Tax: A C corporation that converts to an S corporation generally must hold appreciated assets for 10 years following the conversion or, if disposed of earlier, pay tax on the appreciation at the highest corporate level rate (currently 35 percent). The American Recovery and Reinvestment Act of 2009 temporarily shortened the usual 10-year holding period to seven years for dispositions in tax years beginning in 2009 and 2010. The new law further shortens the holding period to five years in the case of any tax year beginning in 2011, if the fifth year in the recognition period precedes the tax year beginning in 2011.

Cell Phones: Previously, cell phones were classified as "listed property." No deduction is allowed for "listed property" unless a taxpayer adequately substantiates the expense and business usage of the property. The new law removes cell phones from the definition of listed property for tax years beginning after December 31, 2009.

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The Small Business Jobs Act of 2010

Small Business Provisions

Small Business Stock: To encourage investment in small businesses, the American Recovery and Reinvestment Act of 2009 temporarily increased the percentage exclusion for qualified small business stock acquired after February 17, 2009 and before January 1, 2011 to 75 percent. The new law raises the exclusion to 100 percent for qualified stock issued after the date of enactment and before January 1, 2011. The stock must be acquired at original issue from a qualified small business and held for at least five years.

General Business Credit: The new law extends the carryback period for eligible small business credits from one to five years. Eligible small business credits are defined for purposes of the new law as the sum of the general business credits determined for the tax year with respect to an eligible small business. An eligible small business is a corporation whose stock is not publicly traded, a partnership, or a sole proprietorship. Additionally, the average annual gross receipts of the entity for the prior three tax year periods cannot exceed \$50 million. The extended carryback provision is effective for credits determined in the taxpayer's first tax year beginning after December 31, 2009.

Provisions for Individuals

Retirement Savings: The new law includes several provisions to encourage retirement savings. With many employees now saving for retirement using 401(k) plans, the new law provides a major Roth conversion option. Under the new law, if a 401(k), 403(b), or governmental 457(b) plan sets up a qualified designated Roth contribution program, a distribution to an employee or surviving spouse from a non-designated Roth account under a plan may be rolled over to a designated Roth account within the same plan. If an amount is rolled over in 2010, the new law helps ease that tax liability by treating the taxable converted amount as included ratably in income in equal amounts for 2011 and 2012 unless the taxpayer elects otherwise. The designated Roth provisions in the new law are effective for distributions made after the date of enactment.

Self-employment: Individuals who are self-employed may claim a deduction for qualified health insurance costs for income tax purposes. For self-employment taxes, the self-employed individual cannot deduct any health insurance costs. The new law allows the deduction for the cost of health insurance in calculating net earnings from

self-employment for purposes of self-employment (FICA) taxes. The provision is temporary and only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009.

Revenue Raisers

Rental Property Expense Payments: Third-party reporting has been shown to increase tax compliance and in recent years Congress has passed a number of new information reporting requirements. The new law imposes information reporting requirements on certain recipients of rental income from real estate. Rental income recipients making payments of \$600 or more to a service provider will file an information return with the IRS and the service provider. The reporting provision applies to payments made after December 31, 2010.

Information Return Penalties: The Tax Code provides penalties for failing to file information returns. The penalty is tiered and capped. The maximum amount of the penalty varies depending when the information return is filed and if the taxpayer is a qualified small business. The new law increases the penalty generally across-the-board and imposes new maximum penalty amounts. The new law also revises the penalty for failing to furnish a payee statement. The new penalty regime applies to information returns and payee statements required to be filed on or after January 1, 2011.

Income on Guarantees: Congress was unhappy with the Tax Court's decision in a case about source rules for income on guarantees, which held that since the guarantee fees were treated as payments for services, the foreign parent was not subject to U.S. tax on them. The new law treats them prospectively as interest payments, whose source is determined by the position of the payer.

As you can see, the new law is much more than a small business bill, although many small businesses and their owners will benefit greatly from its provisions. Many provisions within the new law are broad-based and far-reaching. Moreover, many of the tax incentives are temporary, requiring prompt action to take full advantage of them. Please contact your MT&L advisor to help you design a tax strategy that maximizes your benefits from the new law. ■