

October 27, 2008
ALERT: Tax issue roundup for fall 2008 –
Good communication with your tax professional
essential to effective and timely tax planning

As IRS enforcement and penalties continue to increase annually, it's more critical than ever to make sure your AGH tax professional has a clear understanding of the scope of your business activities. Tax code touches so many aspects of business that sometimes clients may not relay pertinent information because they aren't aware it has tax consequences. This alert serves as a **roundup of several areas in which tax issues are frequently overlooked, the economic environment may have an impact, or significant deadlines are nearing.**

International activities: Businesses need not have foreign subsidiaries or build facilities overseas to incur reporting requirements related to international tax – the threshold is much lower than you may think. **Two key questions help screen whether your organization needs to review international tax requirements more closely.** If the answer to EITHER of these questions is YES, you should plan to cover in more depth with your AGH tax advisor to understand the tax impact, even if it's "only" reporting rather than tax liability. Penalties for non-reporting can be steep.

- Do you engage in financial transactions in which funds originating in the U.S. are sent outside the U.S. OR funds originating outside the U.S. are sent into the country? Beyond major indicators such as purchasing a foreign business or foreign ownership of a U.S. business, other reportable activities include transactions such as paying vendors compensation for services provided outside the U.S., earning dividends, pensions or real property income such as rents.
- Are you exporting goods outside the U.S. and shipping them "FOB destination" – which means that the transfer of title for the goods occurs outside the U.S.? (As opposed to shipping "FOB shipping point," so that the transfer of title for the goods occurs in the U.S. at your shipping point.) If you are shipping FOB destination, the income from those goods will be sourced to the foreign country and will affect how much foreign tax credit you may use. The relative benefit or liability depends on your tax structure.

Inventory valuation: Periods of significant inflation such as we're now experiencing are signals to review your inventory valuation methods to ensure they are still the most appropriate for your needs. Inventory valuation methods are rarely revisited once a method is selected, but they can represent an area of both significant risk and opportunity for you.

An area where errors are common is handling of obsolete or subnormal goods in inventory. **When a write-down of inventory occurs, there must be a defined and consistent process used in identification, valuation and documentation of the obsolete or subnormal goods.** In other words, the value assigned to the goods being written off should be supportable, not a guesstimate.

We recommend you **discuss your inventory valuation method with your tax advisor to consider the potential risks and benefits a change could deliver**, and to ensure that the method is consistent with that reported on your return.

State tax issues:

- As states seek to grow their revenues, they are increasingly aggressive in identifying and looking to tax businesses which may have established a presence within their borders. **If you receive a state tax nexus questionnaire, please review it with your tax advisor before completing it.** You may be able to manage or lower your state tax liability by making some key decisions before sending in the questionnaire.
- Tax credit opportunities are widely varied by state and requirements to qualify; they also change with some frequency. Unless we have already completed a formal state tax credit review, you should **make sure your tax advisor has a current list of all states in which you have a presence, and ask about potential areas of benefit.**

Tax reduction on foreign sales: Have your foreign sales increased? **If you're exporting \$2 million or more annually, you may benefit from formation of an Interest Charge Domestic Interest Sales Corporation, or IC-DISC.** Briefly, an exporter sets up an IC-DISC as a C corporation owned by the same shareholders as the exporting company, then pays the IC-DISC a commission to handle its export sales. The IC-DISC is generally exempt from federal taxes, with income taxed at the 15% capital gains rate when paid to shareholders instead of the 35% tax rate on ordinary income – resulting in a **permanent tax savings of up to 20% on the income.**

The timetable on this tax strategy could be running out if the 15% capital gains tax rate is allowed to expire at the end of 2010, so if you have significant export sales, the earlier you adopt this strategy, the longer you enjoy the tax savings.

Treatment of owners' health insurance on W-2 forms: In order for individuals who own two percent or more of an S corporation **to claim a deduction for health insurance premiums paid for or reimbursed by the S corporation, the insurance premium cost must be included in shareholder income on their W-2 form.** This income is subject to withholding, although not to FICA or Medicare taxes. If the premium costs are not documented on the W-2, they may not be deductible.

Deferred compensation: If you have a non-qualified deferred compensation plan in place, you must have been operating it in compliance with IRC Section 409A since the law changed, effective January 1, 2005 (unless grandfathered). However, the **deadline for having a formal written deferred compensation plan document in compliance with Section 409A is fast approaching – Dec. 31, 2008.** After several deadline extensions for plan documents in past years, it's unlikely the IRS will provide another extension. Plans not in compliance face serious penalties, which are paid by the employee, not the employer. There are some exemptions and exclusions, but unless an exclusion is specifically spelled out in Section 409A, the plan must be in compliance by the deadline.

NOTE: Pursuant to federal regulations imposed on practitioners who render tax advice ("Circular 230"), we are required to inform you that any discussion of tax matters contained herein is not intended or written to be tax advice, and cannot be relied upon as such, nor can it be used for the purpose of: (i) avoiding tax penalties that may be imposed by the IRS or states, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. If you seek definitive tax advice on a matter, please request a written tax memorandum from your AGH tax advisor.