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Special Tax Issue

LIFO Considerations, R&D Issues

By Stephen J. Talkowsky, CPA, JD, LLM, Tax Director

There are two popular inventory methods used today: LIFO and FIFO. Under the LIFO (last in, first out) inventory method, the goods sold in any given period are those most recently obtained, and the goods on hand at the end of the period are understood to be the earliest obtained. It represents a system which is the reverse of the FIFO (first in, first out) method. Fluctuations in the price of purchasing and processing the goods result in differences between the two methods.

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The major benefits of using the LIFO method are seen in periods of rising prices in which LIFO eliminates inventory profits, reduces federal income taxes and improves cash flow. LIFO can also result in lower values designated to inventories on the balance sheet, which could result in reduced personal property taxes if the local taxing authorities permit the use of LIFO. A lesser net income may also decrease expenses based on reported income, such as profit sharing and bonus plans. If a company does not want this result, it can add back LIFO adjustments when making such computations.

Incremental Research Credit

Note: The incremental research credit expired on December 31, 2005. It is believed that the credit will be extended.

The research credit can be claimed for qualified research expenditures (QREs) conducted as part of a taxpayer's trade or business. QREs are the sum of in-house research expenses and contract research expenses. In-house research expenses include: wages paid to an employee engaged in qualified research or in the direct supervision of qualified research, amounts paid for supplies used to conduct qualified research and amounts paid for the use of computers for the purpose of qualified research. Contract research expenses are 65 percent of amounts paid to persons other than employees for qualified research.

To learn more about inventory methods and the incremental research credit, please contact your local WS+B advisor.

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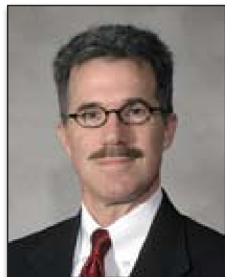
Tax Planning Ideas

Section 199 Manufacturing Deduction

By Carl H. Dobes, CPA, MST, Tax Shareholder



The American Jobs Creation Act of 2004, which is applicable to corporations, partnerships, other pass-through entities and individuals for taxable years beginning after December 31, 2004, provides a new qualified production activities deduction (QPAD) that applies to all taxpayers deriving income from qualified domestic production activities. This new deduction may include not only traditional manufacturers, but also handlers of agricultural products; software companies; film production companies; electric, gas and water companies; construction companies; and engineering and architectural firms.

The amount of the QPAD under the new Section 199 is a percentage of the lesser of the qualified production activities income of the taxpayer for the year or the taxable income (determined without regard to the effects of this deduction) for the tax year. The applicable percentages are 3 percent for the tax years beginning in 2005 or 2006; 6 percent for tax years beginning in 2007, 2008 or 2009; and 9 percent for tax years beginning in 2010 or subsequent years. However, the deduction cannot exceed 50 percent of the total wages and certain elective deferrals that a taxpayer reports on Forms W-2 (regardless of whether employees are engaged in qualifying production activities).

What constitutes a qualified production activity?

The following activities are qualified production activities eligible for claiming the deduction under Internal Revenue Code Section 199:

- Manufacturing based in the U.S.
- Selling, leasing or licensing items that have been manufactured in the U.S.
- Selling, leasing or licensing motion pictures that have been produced in the U.S.
- Construction services in the U.S., including building and renovation of residential and commercial properties
- Engineering and architectural services relating to a U.S.-based construction project
- Software development in the U.S., including the development of video games.

NJ Corporate Presence

The Lanco Case

By Anthony J. Nitti, CPA, MT, Tax Manager

In an opinion dated October 12, 2006, the New Jersey Supreme Court upheld a lower court's ruling that NJ could constitutionally impose a corporation business tax upon a foreign corporation that generated income through a licensing agreement with a company that conducted retail business in NJ, even though the foreign corporation had no physical presence in the state.

Specifically, the question before the Court was whether a Delaware Corporation (Lanco, Inc.), which had no physical presence in NJ, but generated income in the form of royalty payments through a licensing agreement with the company that had retail operations in NJ, could be constitutionally subject to NJ's corporation business tax.

The Court held that the U.S. Supreme Court's requirement for a business entity to be physically present in a taxing jurisdiction in order to establish the constitutionally required "substantial nexus" is limited to sales and use taxes and is not applicable to income tax. Accordingly, the Court ruled that NJ's corporation business tax may be constitutionally enforced to income derived by a foreign corporation's licensing fees attributable to NJ.

For more information on these important tax issues, contact your local WS+B advisor.

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Nonqualified Deferred Compensation

Proposed Regulations and Another Extension

By Kimberlee S. Phelan, CPA, MBA, Tax Shareholder

Section 409A, part of the American Jobs Creation Act of 2004, was the IRS's response to the corporate scandals of the early 2000s and, as is usually the case, has made such drastic and dynamic "tightening" of rules that every deferred compensation plan must be reviewed (and potentially changed) so that suffocation does not occur. Pre-2004 plans may be frozen and "grandfathered," but any deferrals after 2004 will have to meet new requirements. After two extensions, the deadline to review and revise plans is now December 31, 2007. Proposed regulations under Section 409A were issued in December 2005. As the final regulations are expected shortly, we do not anticipate that any further extensions will be granted. Thus, the time to review your plans is NOW!

The key provisions of Section 409A include:

Taxation. Under the new law, for deferred compensation to be excluded from gross income, the plan must meet distribution, acceleration of benefits and election requirements. If a plan fails to meet the requirements, all compensation earned and deferred must be included in income for the first tax year that the plan fails to meet the requirements. A *20 percent penalty* and interest will also be imposed on the amount required to be included in income.

Restrictions on distributions. Under the new law, a plan may not permit distributions earlier than separation from service, death, disability, a specified time (or pursuant to a fixed schedule), a change in control of a corporation (to the extent allowed by the IRS) or an occurrence of unforeseeable emergency. Additionally, key employees at public corporations generally may not receive their distributions earlier than six months after separation. Reducing benefits with a "haircut" (i.e., forfeiture of a portion of the account balance in exchange for access to the plan account) is not a distribution option.

Acceleration of benefits. A plan may not allow for the acceleration of benefits.

Requirements relating to the timing of deferral elections. Deferral elections generally must be made in the tax year preceding the year in which the services are performed or within 30 days of becoming eligible for plan participation. If the award is performance-based (i.e., an incentive bonus), the election must be made no later than six months before the end of the performance period.

Other key changes include: new rules regarding the delay of distributions or changes to form of distribution, the prohibition of offshore funding and the disallowance of a "trigger" upon a deterioration of financial health of the employer.

Before you take any action with respect to your plan, contact your local WS+B advisor.

State Sales & Use Tax

NJ Urban Enterprise Zone Program

By Harry K. Tuul, CPA, Tax Manager

The New Jersey Urban Enterprise Zone program provides an exemption from sales tax for sales of certain personal property and services that are made to a qualified business for the exclusive use or consumption by the business within an enterprise zone. Under the new law effective July 15, 2006, the exemption from sales tax in an enterprise zone remains effective; however, the procedure for claiming the exemption has changed.

The procedures under the new law provide that sales tax must be collected on sales made to a small business, and use tax must be self-assessed on purchases made on and after July 15, 2006, unless the business is a qualified small business. The new law defines a qualified small business as a business that has annual gross receipts of less than $1 million in the prior annual tax period from all locations, whether or not located in the urban enterprise zone.

Beginning on July 15, 2006, a seller must obtain Form UZ-5-SB (Temporary) from any business claiming the tax exemption within 60 days after a sale is made. However, this form can only be used until September 30, 2006.

Effective October 1, 2006, a qualified small business must use Form UZ-5-SB in order to claim an exemption from sales tax. In order to obtain Form UZ-5-SB, the small business must apply to the New Jersey Division of Taxation and provide all required information that proves the business had total gross receipts of less that $1 million in the prior annual tax period. The Division of Taxation will then certify a business as a qualified small business and will issue a personalized Form UZ-5-SB, Exempt Purchase Certificate. The qualified small business must then provide this form to all vendors in order to make tax-exempt purchases of goods and services.

Any business whose gross receipts for the prior annual tax period is greater than $1 million cannot qualify as a small business. These businesses must pay the 7 percent sales tax at the point-of-sale, but may apply for a refund of sales tax paid on the purchases of goods and services that are used in an enterprise zone. The Division of Taxation has created a new tax form known as A-3730-A, which must be used to claim a refund. The refund claim must be filed within one year of the sale.

For more information on state sales and use tax, please contact your local WS+B advisor.

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Pension Act Summary

The Pension Protection Act of 2006

By Michael H. Hoffman, CPA, Senior Tax Manager, and Hal R. Terr, CPA, PFS, CFP®, Senior Tax Manager

This year was another banner year for tax legislation out of Washington, making strategic tax planning even more important today than ever before. Since 2001, cuts in income tax rates, retirement and college savings as well as charitable-giving incentives have been made in almost every category of federal taxation. By enacting the Pension Protection Act of 2006 (PPA), Congress took action on many issues involving pension plans, IRAs and retirement plans.

The new legislation makes permanent a number of retirement plan and IRA liberalizations that were added to the tax laws in 2001 but were set to sunset after 2010. By making the 2001 changes permanent, the new law preserves the advantages of higher employee-contribution limits for employer plans, higher IRA-contribution limits, more flexible plan rules, portability, a catch-up for those over 50 and an increase in employer-contribution limits. The new law also makes permanent the saver's credit, which would not have been available after 2006 absent the extension.

Prior to the changes made by the PPA, certain employers' retirement plans required that the plan benefit be paid out in a lump sum to the beneficiaries upon the death of the employee participant. If the beneficiary was the employee's spouse, instead of receiving the lump-sum payment, the spouse could roll over the distribution to an IRA. If the beneficiaries were the children of the employee, or other non-spouse beneficiary, the ability to roll over the distribution was not available. Beginning in 2007, non-spouse beneficiaries are eligible to roll over the lump-sum payment to an inherited IRA but will still be subject to the required minimum distribution rules that apply to inherited IRAs of non-spouse beneficiaries.

In addition, the PPA contains provisions to prevent abuse in the charitable sector and provides additional tax incentives for Americans who donate to charities. For 2006 and 2007, the PPA allows owners of traditional and Roth IRAs who are 70 or older to make direct distributions to a qualified charity for up to $100,000 per year. Although the account owner would not receive a charitable deduction, the distribution is excluded from the individual's taxable income. This provision is of particular benefit to those individuals who do not itemize their deductions, and the charitable distribution may be applied to the IRA owner's required minimum distribution.

The establishment of tax-advantaged 529 plans provided efficient ways for parents to save for a child's college education. These accounts allow for tax-deferred growth, and distributions from those plans are tax-free to the extent that the amounts are used for college costs. The PPA made permanent the tax-advantaged treatment for distributions from 529 plans, providing certainty for future education savings planning.

To learn how you can take advantage of this important tax legislation, contact your local WS+B advisor.

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WithumSmith+Brown is the only firm in New Jersey to be named to the "Best of the Best" list of accounting firms in the U.S. compiled by *INSIDE Public Accounting (IPA)*, a national monthly accounting publication. This marks the ninth consecutive year that WS+B has been included in the list of top 25 accounting firms, a distinction earned by a small percentage of the several hundred firms reviewed.

"*INSIDE Public Accounting's* Best of the Best designation is an elite honor because it's based entirely on fiscal and operational performance," *IPA* publisher, Michael Platt, explained. "These 25 firms are at the top of their game and are operating in 'the zone' of exceptional performance."

IPA's Annual Analysis of Firms is compiled from an independent report provided by the publication and evaluates the management strategies and financial success of accounting firms in the U.S. According to *IPA*, WS+B earned this designation because of its excellence in overall performance within these areas.

34th Largest CPA Firm in U.S.

WithumSmith+Brown has been ranked the 34th largest CPA firm in the United States by *Public Accounting Report (PAR)* Top 100 Accounting Firms in America survey. With 30% growth in 2005, the firm moved up its ranking from last year's 38th position.

PAR, published by CCH, has conducted the *PAR* Top 100 annual survey since 1992. The survey analyzes data from firms' most recently completed fiscal year and ranks them by U.S. net revenue.