tax IMPACT

July/August 2008

Economic Stimulus Act of 2008

Take advantage of business incentives before it's too late

Watch your step

3 life insurance slip-ups to avoid

Deferring capital gains taxes with a like-kind exchange

Tax Tips

Medical expense deduction, annual gift tax exclusion and estimated tax payments

Economic Stimulus Act of 2008

Take advantage of business incentives before it's too late

The $152 billion Economic Stimulus Act of 2008 has received a lot of attention for its "recovery rebates" and other personal tax incentives. But as part of its effort to jump-start the economy, the act also provides valuable incentives for businesses to boost their capital spending. Among other things, the act nearly doubles the limit on Internal Revenue Code Section 179 expensing and offers a 50% first-year depreciation bonus for certain business property and qualified leasehold improvements. These incentives are temporary, however, so eligible companies need to act quickly.

An "expense-ive" gift from Uncle Sam

Under pre-act law, Sec. 179 permitted businesses to "expense" — that is, deduct immediately — up to $128,000 in equipment, furniture and other depreciable business assets placed in service in 2008. (Ordinarily, the cost of these assets would be recovered through depreciation deductions over several years.) And the benefits were phased out on a dollar-for-dollar basis when the total cost of qualifying property placed in service during the year exceeded $510,000.

The enhanced expensing election applies only to property purchased and placed in service in tax years that begin in 2008.

The Stimulus act increases these limits to $250,000 and $800,000, respectively, effective for tax years that begin in 2008. This is a great opportunity for small companies, and even some larger ones, to enhance their tax deductions for capital expenditures and boost their cash flow. If able, you'll want to act quickly because the limits decrease to $125,000 and $500,000 (subject to an inflation adjustment) for tax years that start in 2009.

Keep in mind that the enhanced expensing election applies only to property purchased and placed in service in tax years that begin in 2008. So if your business is

on a Sept. 1 to Aug. 31 fiscal year, assets you acquire before Sept. 1, 2008, won't qualify. Also, as before, a Sec. 179 deduction is limited to your taxable income — in other words, you can't use the election to generate a loss. Disallowed deductions can be carried forward to future tax years, though.

The election is generally available for tangible personal property that's newly purchased and is actively used more than 50% for business purposes. If you sell an expensed asset or its business use drops to 50% or less, you may have to recapture a portion of the tax benefit.

A bonus you can depreciate

The Stimulus act also gives companies a first-year depreciation bonus equal to 50% of the adjusted basis of qualifying property that's acquired and placed in service during the 2008 calendar year. And the bonus depreciation is extended through 2009 for property with a recovery period of 10 years or more, such as transportation property and certain aircraft. Property is ineligible if it's acquired pursuant to a binding written contract entered into before 2008.

A powerful combination

Higher limits on Internal Revenue Code Section 179 expensing, combined with the 50% first-year depreciation bonus, can enable a business to write off most of the costs of qualifying property in the first year.

Let's look at an example. During 2008, a calendar-year business acquires and places in service property under the modified accelerated cost recovery system (MACRS). Here are the business's tax deductions for the year:

Assets	Cost	Tax benefit	Deduction
7-year property	$250,000	Sec. 179 (maximum)	$250,000
5-year property	$500,000	Bonus depreciation	250,000
		1st-year MACRS depreciation on remainder*	50,000
		Total 2008 deductions	**$550,000 (73% of asset costs)**

*Bonus depreciation is in addition to normal MACRS depreciation on an asset's remaining cost. In this case, normal depreciation is $500,000 – $250,000 (bonus depreciation) = $250,000 x 20% (first-year depreciation on a 5-year asset) = $50,000.

To qualify for bonus depreciation, which is available for both regular and alternative minimum tax purposes, property must be:

- Eligible for accelerated depreciation under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less,
- Water utility property,
- Off-the-shelf computer software, or
- Qualified leasehold improvement property.

A qualified leasehold improvement is an improvement to a nonresidential building's interior made by a lessee or lessor pursuant to a lease, provided the improved area is occupied exclusively by the lessee and is placed in service more than three years after the building was first placed in service.

In addition, bonus depreciation is available only if the property's "original use" begins with the taxpayer. Generally, that means the property must be new, though in some cases a taxpayer's cost of rebuilding or reconditioning used property may qualify for bonus depreciation. Taxpayers who buy rebuilt or reconditioned property aren't eligible.

The new law also increases the "luxury auto" depreciation cap to $8,000, so that the maximum first-year writeoff for a qualifying vehicle, including bonus depreciation, is now $11,060.

A generous benefits package

The enhanced expensing election and bonus depreciation may be an opportunity for your business to save. And using them together could accelerate the tax benefits of capital investments, thereby reducing the cost of those investments. (For more on this, see "A powerful combination" above.) Be sure to speak with your accountant on how these and other strategies can reduce your company's tax bill.

Watch your step

3 life insurance slip-ups to avoid

Life insurance is a versatile financial planning tool. It provides a source of wealth to fund a variety of estate and business succession-planning strategies. And policies with an investment component offer tax-deferred growth, which you can use to supplement your other retirement savings. What's more, under the right circumstances, a policy's death benefits will be exempt from income and estate taxes.

Careful planning is required to ensure that life insurance proceeds remain tax free. One misstep can trigger estate taxes, income taxes or both, drastically reducing the amount available for your loved ones. Let's examine three life insurance slip-ups to avoid.

1. You own the policy

If you own an insurance policy on your life, the proceeds will be included in your estate and possibly subject to estate taxes, even if you designate someone else as the beneficiary. One way to avoid this result is to use an irrevocable life insurance trust (ILIT) to own the policy. For this strategy to work, you can't retain any incidents of ownership in the policy, such as the right to change beneficiaries or borrow against the policy's cash value. Your cash contributions to the trust to cover premium payments are considered taxable gifts, and a gift tax return may be required. But with proper planning you can minimize or even eliminate gift taxes.

If you transfer a policy or an interest in a policy for valuable consideration, the proceeds may become taxable to the extent they exceed any consideration or premiums paid by the transferee.

When creating an ILIT, watch out for the three-year rule, which draws the proceeds back into your estate if you transfer an existing policy to an ILIT less than three years before you die. You may be able to sidestep the rule, however, by having the trust buy a new policy on your life.

2. A corporation owns the policy

If you're a shareholder in a closely held C corporation with a buy-sell agreement funded by life insurance, the way the agreement is structured has significant tax implications. If it's a redemption agreement, in which the corporation owns policies on the shareholders' lives and uses the death benefits to buy back their shares, the insurance proceeds may trigger the corporate alternative minimum tax (AMT).

A cross-purchase agreement, in which each shareholder buys policies on the other shareholders' lives, avoids this AMT risk. It also gives the remaining shareholders the advantage of a stepped-up basis in the acquired shares, reducing their income taxes on the sale of those shares. The number of policies involved in a cross-purchase agreement makes them somewhat unwieldy, but the potential tax advantages often outweigh the administrative burden.

3. You transfer the policy "for value"

The transfer-for-value rule creates an exception to the general rule that life insurance proceeds are tax free to the beneficiary. Under the rule, if you transfer a policy or an interest in a policy for valuable consideration, the proceeds may become taxable to the extent they exceed any consideration or premiums paid by the transferee. And transfers aren't limited to sales: In certain circumstances, a simple change in beneficiary designations can trigger the rule.

The purpose of the rule is to deter speculation in insurance policies, but its language is broad enough to encompass seemingly legitimate transactions. For instance, if you transfer a policy to your child in exchange for his or her agreement to pay the premiums, you'll trigger the transfer-for-value rule.

There are several exceptions to the rule, including a transfer to a grantor trust, a partnership or corporation in which you're a partner or shareholder, or one of your partners. But there's no exception for transfers to a co-shareholder. So if you and another shareholder exchange policies on each other's lives, the proceeds from each policy will be taxable.

Take care

Life insurance is one tool you can use to meet any number of individual or business financial needs. But it's also a tool that you should handle with care. Otherwise, you may be a victim of one of the life insurance slip-ups outlined here.

Deferring capital gains taxes with a like-kind exchange

Taxes can be an obstacle even in a sluggish real estate market. If you've held property for a long time, it may be worth substantially more than you paid for it, even if its value has declined in recent years. Also, years of depreciation deductions may have reduced or eliminated your tax basis in the property.

So if you're planning to sell property and capital gains will be triggered, find out if a like-kind exchange is an option for you. Also known as a Section 1031 exchange after the relevant section of the Internal Revenue Code, a like-kind exchange may be able to help you defer — or even permanently avoid — capital gains taxes.

How does it work?

Sec. 1031 allows you to defer the gain on real or personal property used in a business or held for investment if, instead of selling it, you exchange it solely for property of a "like kind." For personal property, that means property of the same asset or product class. But virtually any type of real estate will qualify as long as it's business or investment property. You can exchange an office building for a rental apartment complex, for example, but you can't exchange your personal residence unless you first convert it into an investment property.

Despite the term "exchange," it's unusual to find someone with whom you can simply swap properties. Most Sec. 1031 transactions are deferred exchanges, in which you engage a qualified intermediary (QI) who helps you. When you sell your property (the relinquished property), the proceeds go directly to the QI, who then uses the net proceeds to buy replacement property. To qualify for tax-deferred exchange treatment, you must identify replacement property within 45 days after you sell the relinquished property and complete the purchase within 180 days after the initial sale.

What if time is a concern?

Say you come across an ideal investment property that you'd like to trade into, but there's no time to sell an existing property. In that case, a reverse exchange may be the answer.

In a reverse exchange, a special type of QI, called an exchange accommodation titleholder (EAT), acquires title to the replacement property before you sell the property you'd like to relinquish. You can defer capital gains by identifying one or more properties to exchange within 45 days after the EAT receives the replacement property and, in the typical scenario, completing the transaction within 180 days.

A reverse exchange can be useful if you wish to exchange several existing properties for a single replacement property.

There is a narrow exception to the 180-day rule, but it's a more complex transaction that requires additional planning and has more traps then the "standard" reverse exchange. If you're interested in a reverse exchange and have concerns about meeting the 180-day requirement, check with your tax advisor. Otherwise, you may inadvertently create an unexpected tax liability.

A reverse exchange can be useful if you wish to exchange several existing properties for a single replacement property. During the exchange process, you can lease the replacement property from the EAT, which allows you to receive any rental income the property generates and even build on or renovate the property. You'll be obligated to pay any taxes, mortgage interest or maintenance expenses during that period, but you won't be entitled to claim depreciation deductions until you acquire legal title to the property.

Whether you do a reverse exchange or a traditional deferred exchange, using a QI or EAT is critical. If you receive or obtain control of the sale proceeds, or acquire title to replacement property before you sell the property you're exchanging, the transaction won't qualify for Sec. 1031 treatment and your gain will be taxable immediately.

What are the risks?

A like-kind exchange offers many benefits, but there are potential traps that you should be aware of, including:

Getting the boot. Generally, it's best to exchange real estate for property of equal or greater value. Any cash or other non-like-kind property — known as "boot" — that you receive is immediately taxable. Boot isn't always obvious: In addition to cash, it may include debt relief (for example, if a purchaser assumes your mortgage) and certain expenses or fees allocated to you at closing. One way to avoid negative tax consequences is to have your intermediary use boot to make improvements to the replacement property or invest it in other like-kind properties.

Being classified as a dealer. Real estate dealers — those in the business of buying and selling real estate — can't use a Sec. 1031 exchange to defer taxes on property held primarily for sale. Unfortunately, the line between a dealer and an investor isn't always clear. It depends on several factors, including the number of properties you own, frequency of sales, and extent to which you rely on subdividing, developing and advertising to increase sales.

Exchanging the wrong kind of property. Investors often make the mistake of exchanging real estate for an interest in a partnership that owns real estate or a real estate investment trust (REIT). But partnership interests and REITs, as well as stocks and other securities, don't qualify as like-kind property.

Inconsistent ownership. It's vital that the exchanged property and the replacement property be similarly titled or you'll lose the benefit of the deferral. For example, if you and your brother jointly own a piece of land and you wish to exchange it for a parcel that you're going to buy with your sister, you won't be able to defer the gain on the land you're exchanging.

Plan carefully

Like-kind exchanges offer attractive opportunities for real estate investors, but they require careful planning. One wrong move can erase the tax benefits of an exchange, so be sure to do your homework and get professional advice. ◎

tax TIPS

Give your medical expenses a checkup

As you likely know, you can deduct qualified medical expenses — for yourself, your spouse and your dependents — to the extent that they exceed 7.5% of your adjusted gross income (AGI). But what you may not realize is the variety of types of expenses allowed. Some eligible expenses that may surprise you are:

- Acupuncture and chiropractic treatment,
- Noncosmetic dental treatment,
- Cosmetic surgery to correct the effects of an accident or disease,
- Vision correction surgery,
- Psychotherapy,
- Transportation to and from medical facilities,
- Meals for inpatient care and lodging essential to medical care (subject to limitations), and
- Special education needed to overcome a physician-diagnosed learning disability.

Are you making tax-free gifts?

If your wealth is substantial enough so that gift and estate taxes are a concern, don't overlook the tax-saving power of an annual gifting program. The annual gift tax exclusion allows you to give any number of recipients up to $12,000 tax free ($24,000 for gifts you make with your spouse) in 2008. These gifts can be made without using any of your $1 million lifetime gift tax exclusion. Note that the gifts must be of a present interest. (This usually means the recipient must have complete access to the funds, but there are exceptions.)

This amount may not sound like a lot, but it can add up quickly. Suppose you and your spouse have three children and five grandchildren. If you gift $24,000 to each of them every year for 10 years, you'll transfer more than $1.9 million tax free. If this amount would otherwise be taxed in your estate at the current top rate of 45%, the gifting program translates to a tax savings of more than $850,000, plus any applicable state tax.

Boosting cash flow

Estimated tax payments can have a big impact on a company's cash flow. Small taxable corporations (those with less than $1 million of taxable income in each of the preceding three tax years) can base their estimated tax payments on either the preceding year's tax or their expected tax liability in the current year. Large corporations can rely on the preceding year's taxes for only their first installment of estimated taxes.

Some corporations can minimize estimated tax payments by using the preceding year's figures, unless they expect their income to decline in the current year. It may also be possible to lower estimated taxes based on current year taxes by using the annualized income method or, if your business income is highly seasonal, the adjusted seasonal installment method.

Keep in mind that you can't base estimated tax payments on the preceding year's tax unless you have a tax liability for that year. If you anticipate zero tax liability in 2008 but expect to have taxable income in 2009, talk to your tax advisor about how generating a small tax liability this year may minimize next year's estimated tax payments.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2008 TXIja08