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Dear Friends:

In a troubled economy, you may want to hunker down and hold tight, but that could be the wrong strategy. With recent market changes, now is a good time to review your tax situation.

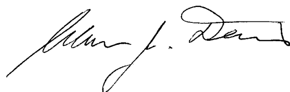
Morison Cogen LLP is pleased to present the March/April 2010 issue of *Tax Impact* as a way to help you improve your financial situation and reduce taxes. The articles cover several topics we think you'll want to know about.

Specifically, we describe how to avoid losing out on rental real estate losses. We show how joint home purchases can reduce estate taxes and look at when it's possible to write off bad business debts. Also, we briefly discuss the net operating loss carryback period, an essentially 100% tax-free IRA, and the status of possible estate tax legislation.

Our firm excels at providing tax and other financial services. We would welcome your questions or comments about the topics discussed or others related to improving your financial situation and reducing your tax bite. Please call us at **267.440.3000** and let us know how we can be of assistance. Also, please tell us of anyone else who might like to receive this newsletter.

We look forward to hearing from you and helping you meet your financial objectives.

Sincerely,



Alan J. Denis, CPA
Chairman

Enclosure

tax IMPACT

March/April 2010

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Don't lose out on rental real estate losses

If you own rental properties, there's a good chance at least one of them is generating a loss. But the passive activity loss (PAL) rules can make it difficult to deduct those losses.

In such a situation, it pays to determine whether you meet the IRS's definition of a "real estate professional." If you qualify, you may be able to convert passive losses into nonpassive losses, creating substantial tax benefits.

A passive activity primer

The PAL rules prohibit taxpayers from deducting losses generated by "passive" business activities — such as certain limited partnerships (for example, one that holds real estate) — from wages, interest, dividends or other "nonpassive" income. Disallowed losses may be carried forward and deducted against passive income in later years or recovered when the passive business activity is sold.

IRS regulations establish several objective tests you can apply to determine whether a passive activity qualifies for a deduction.

A passive activity is a trade or business in which you don't "materially participate." "Participation" is generally any work done by an individual with respect to the activity that the individual owns an interest in. "Participation" doesn't include work that isn't customarily done by an owner if one of the principal purposes for performing the work is to avoid the passive loss rules.

"Material" means "regular, continuous and substantial," but that definition doesn't provide much guidance. Fortunately, IRS regulations establish several objective tests you can apply to determine whether an activity qualifies. Your participation in an activity is material if any *one* of the following is true during a tax year:

- You participate in the activity for at least 500 hours.
- Your participation constitutes substantially all of the participation in the activity by all persons (including nonowners) — in other words, it's a one-person operation.
- You participate in the activity for at least 100 hours and no other person (including nonowners) participates more than you.
- You participate in the activity for at least 100 hours and your total participation in "100 hour" activities totals more than 500 hours.
- You materially participated in the activity for any five of the preceding 10 tax years (or any three previous tax years for a personal service activity).

Even if you don't satisfy one of these tests, you can meet the material participation requirement if, based on all the facts and circumstances, you participate in an activity on a regular, continuous and substantial basis. And married couples can combine their hours. But relying on this subjective test can be risky.

The catch for real estate

There's an added catch when it comes to real estate: The PAL rules treat income from rental

real estate as passive, no matter how many hours you devote to it, unless you qualify as a "real estate professional." (See "Going pro" below.)

There's a limited exception that allows you to deduct up to $25,000 in losses from rental real estate in which you "actively" participate, but the deduction is phased out beginning when adjusted gross income (AGI), with certain adjustments, reaches $100,000 and eliminated when it tops $150,000 for most taxpayers.

Going pro

As mentioned above, you may be able to avoid the PAL limitations and deduct rental real estate losses from *non*passive income if you're a real estate professional. To qualify, you must spend more than half of your working hours and more than 750 hours during the year on real estate businesses in which you materially participate.

Activities you perform as an employee don't count toward these participation requirements unless you own at least 5% of the business. Eligible businesses include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage. Unlike the material participation requirements, you and your spouse can't combine your hours; one of you must individually qualify as a real estate professional.

Even if you're a real estate professional, you must still materially participate in a rental activity before you can deduct losses against nonpassive income. This can be a problem if you're involved with several properties.

Suppose, for example, that you own 10 rental buildings and devote 80 hours per year per building to managing them, for a total of 800 hours per year. You also have two full-time employees who help manage the buildings. Assuming the 800 hours you spent in the last year constitutes more than half of your working time, you would qualify as a real estate professional. But because you spent less than 100 hours on each building, you don't meet the material participation requirements.

You can get around this restriction — and convert your rental losses from passive to nonpassive — by electing on your tax return to treat all of your rental properties as a single activity. But once you make this election, you must stick with it. So, for instance, if your rental activities become profitable in the future, you won't be able to offset your net rental income with passive losses from other activities.

Make the most of your losses

If you have rental real estate losses, find out from your tax advisor whether you can treat them as nonpassive losses. If you can, the ability to deduct rental losses from your wages or other nonpassive income can translate into significant tax savings. ◎

When can you write off bad business debts?

The tax deduction for business bad debts is among the most widely misunderstood provisions in the tax code. Many business owners mistakenly believe they can take a bad debt deduction any time an account receivable or other obligation becomes uncollectible. In practice, the circumstances under which you can write off bad debts are limited.

Know what qualifies

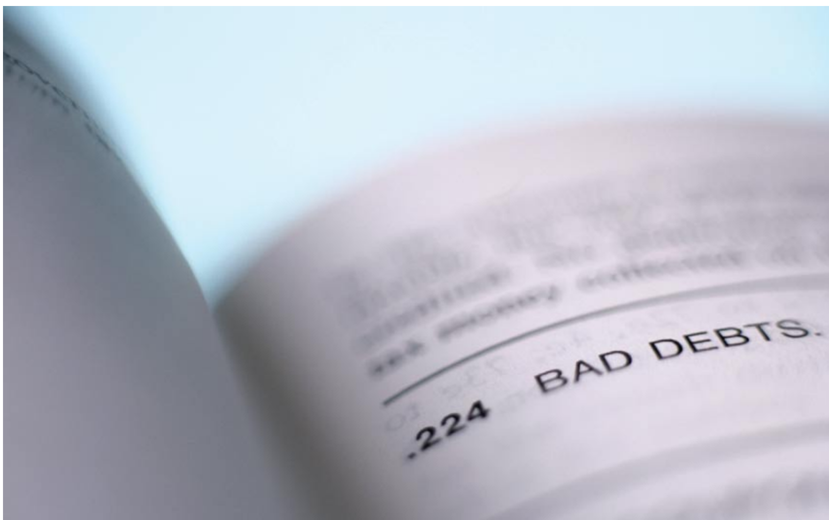
A business bad debt is a loss from the worthlessness of a debt that was created or acquired in your trade or business, or was closely related to your trade or business when it became partly or totally worthless. The most common bad debts involve credit sales to customers for goods or services. Other examples include:

- Loans to customers or suppliers that are made for business reasons and have become uncollectible,
- Business-related guarantees of debts that have become worthless, and
- Debts attributable to an insolvent partner.

The IRS will scrutinize loans to be sure they're legitimate. For example, it might deny a bad debt deduction if it determines that a loan to a corporation was actually a contribution to capital.

A cash-basis business may be able to claim a bad debt deduction if it makes a business-related loan that becomes uncollectible.

There's no standard test or formula for determining whether a debt is worthless; it depends on the facts and circumstances of each case. To qualify for the deduction, you must show that you've taken reasonable steps to collect the debt and there's little likelihood it will be paid. You don't have to wait until the debt is due if the debtor's bankruptcy or other circumstances have rendered it worthless.



Check your accounting method

For a debt to qualify for a bad debt deduction, you must have previously included the amount in your gross income. If your business uses the *cash* method of accounting for tax purposes, you don't report income until you receive payment. So you can't claim a bad debt deduction simply because someone failed to pay a bill. But you may be able to claim a bad debt deduction

if you've made a business-related loan that has become uncollectible.

If your business uses the *accrual* method, you report income as you earn it. So you can take a bad debt deduction if you previously included the entire uncollectible amount in your gross income.

Document your efforts

When you prepare to file your next tax return, work with your tax advisor to determine whether any business debts became totally or partially worthless during the year. If a bad debt deduction is warranted, be prepared to document your efforts to collect the debt and the reasons you believe it's uncollectible.

Home is where the tax savings are

How joint home purchases can reduce estate taxes

When buying a home, the first tax benefits many people think of are the income tax deductions. But there are other important tax-saving opportunities to consider. One strategy — buying a home jointly with a family member — can remove the home's value from your taxable estate.

Joint purchase vs. joint tenancy

Don't confuse a joint *purchase* with joint *tenancy*. Although owning property with a child (or other family member) as joint *tenants* offers simplicity (when you die, the property's title automatically passes to the joint owner), this strategy has serious drawbacks: Adding your child's name to your home's title generally is considered a taxable gift of half the property's value, and some or all of the home's value may be subject to estate taxes. You also expose the home to the claims of your child's creditors and can lose a great deal of control over the property.

In a joint *purchase*, you (or you and your spouse) buy a life interest in the home (giving you the right to live there for your lifetime) and your child purchases the remainder interest. You retain control over the property, including the right to mortgage or sell it (subject to the remainder interest). After your death (or the deaths of you and your spouse), the home — including any appreciation — passes to your child estate-tax free. (See the Tax Tip on page 7 for information on the status of the estate tax for 2010 and 2011.)

In a joint purchase, after your death (or the deaths of you and your spouse), the home — including any appreciation — passes to your child estate-tax free.

Gift and estate taxes

Ordinarily, a joint purchase with a family member results in gift tax on the property's full purchase price. But there's an exception for a home, provided it's your principal residence or a second home, such as a vacation home.

To escape gift taxes, you and your child must pay adequate consideration for your respective

interests in the home. The relative prices of the two interests are set by IRS tables based on your life expectancy (or the joint life expectancies of you and your spouse) and the applicable federal interest rate at the time of the transaction.

Let's look at an example. Alison bought a home for $500,000. When she dies 20 years later, the home, which has increased in value to $1.5 million, is passed to her son, Jason. If Alison has exhausted her estate tax exemption and her marginal estate tax rate is 45%, her estate is liable for $675,000 in federal taxes on the home.

Suppose, instead, that Alison and Jason buy the home jointly, and Alison's life interest and Jason's remainder interest are valued at $375,000 and $125,000, respectively. Provided Alison's life interest is zero at her death and Jason can afford to purchase his interest with his own funds, a joint purchase generates $675,000 in estate tax savings.

Income taxes

When property is transferred at death, the recipient's tax basis is generally "stepped up" to the property's value on the date of death. The recipient can turn around and sell the property without triggering any capital gains tax. In a joint purchase, however, the remainder interest holder's tax basis is the amount he or she paid for the interest, potentially creating income tax liability when the property is sold.

In the previous example, Jason's tax basis is $125,000. If he sells the home immediately after his mother's death, he'll have a capital gain of $1,375,000. If the federal capital gains tax rate is 15%, he'll owe $206,250 in federal taxes. But when that capital gains tax is netted against the federal estate tax savings, the family comes out ahead.

The result could be quite different if estate or capital gains tax rates change. And, if Alison dies without a taxable estate, the benefit of this strategy will be lost.

Don't rush

Buying a home jointly with a loved one can yield significant tax advantages. But don't rush into a decision to make a joint home purchase; consider all the emotional and financial implications first. ◎

Home sweet homebuyer credit

The Worker, Homeownership and Business Assistance Act of 2009 (WHBAA) extended the first-time homebuyer credit to April 30, 2010 — June 30 for homes purchased pursuant to a contract signed by April 30. The credit is $8,000 ($4,000 for married filing separately) or 10% of the purchase price, whichever is less. The act also offers a modified credit up to $6,500 ($3,250 for married filing separately) for many current homeowners.

The WHBAA also increased the income limitations: Now, the credit is phased out beginning at modified adjusted gross income of $125,000 ($225,000 for joint filers).

If you're considering a home purchase and would qualify for the credit, you may want to make every effort to find a home and have a contract in place by April 30 so you can take advantage of this valuable tax savings. Additional rules and limits apply, however, so consult your tax advisor first.

tax TIPS

Much ado about NOLs

The Worker, Homeownership and Business Assistance Act of 2009 (WHBAA) extended the net operating loss (NOL) carryback period to five years (up from two or, in some cases, three) for most businesses. Previously, the extension was available only to certain small businesses.

If your business is experiencing NOLs, you have some choices to make. Here are critical questions to ask:

Which NOL should you carry back? You can use the extended carryback period for one tax year beginning or ending in 2008 or 2009. If you're on the calendar year, you can carry back an NOL from 2008 or 2009. If you're on a fiscal year, you can choose one of three loss years: 1) your year ending in 2008, 2) your year beginning in 2008 (and ending in 2009), or 3) your year beginning in 2009. If you qualify as an eligible small business, you may be able to use the extended carryback for a second taxable year.

How far back should you carry the NOL — three, four or five years? Or should you elect to forgo the NOL carryback and carry the loss forward to future years? Note that there are strict rules related to this election. For example, once the carryback year is selected, this choice is irrevocable.

Your tax advisor can analyze your situation and help you determine which strategy would produce the greatest tax savings. ◎

A 100% tax-free IRA?

Traditional IRAs offer deductible contributions, but withdrawals are taxable. Roth IRA contributions aren't deductible, but qualified withdrawals are tax free. And if you have children who work at after-school or summer jobs, they may be able to enjoy the best of both types of IRAs: They can earn up to the standard deduction amount ($5,700 in 2010) tax free, and they may contribute up to 100% of their earned income or $5,000, whichever is less, to a Roth IRA. (You may even make the contribution for them.) The result is essentially a 100% tax-free IRA. ◎

Keep a close eye on the estate tax

As of this writing, the estate tax (but *not* the gift tax) has been repealed for 2010 only, and in 2011 estate (*and* gift) tax rates and exemptions are scheduled to return to levels dictated by pre-2001 law. It's expected Congress will repeal the repeal, perhaps retroactively to Jan. 1, and take action to prevent the return of the pre-2001 law. In fact, legislation may have been signed into law by the time you're reading this. Check with your tax advisor for the latest information. ◎

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