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tax IMPACT

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Give your company — and yourself — the gift of tax savings

3 tips to implement before year end

The holiday season is a great time to be thinking of others in your family and community. It's also important to take time to address your business's tax situation. You can minimize the amount you give to the IRS, leaving you with more to invest in your business or save. Don't delay, because many tax-saving techniques have to be implemented before year end.

1. Time income and deductions

The accounting method you use for tax reporting purposes can greatly affect year end planning. Cash-basis taxpayers recognize income when it's actually or constructively received and deduct expenses when they're paid. Accrual-basis taxpayers report income when it's earned and expenses when they're owed, regardless of when the cash actually changes hands.

A fundamental objective of year end tax planning generally is to defer income to next year and accelerate expenses and other deductions into this year. But a different approach may be called for if you expect your business's marginal tax rate to increase next year. In that case, you could be better off accelerating income into 2008 and deferring deductions to 2009.

Whichever approach is appropriate for your company, your strategy will depend on your ability to control the timing of income and deductions, which in turn depends on your accounting method. A cash-basis business may be able to defer income to next year by delaying mailing invoices until late in the year or accelerate deductions by prepaying certain expenses this year.

An accrual-basis business has less flexibility to shift income and deductions between tax years. Delaying invoices, for instance, isn't enough. The company would have to postpone shipping products or performing services until early next year, which may not be advisable.

2. Defer tax on advance payments

Even if your company uses the accrual method of accounting, you might be able to defer the tax on certain advance payments. This option may be available if you receive payments in advance of performing services or delivering goods. It also may apply to advance payments for:

- The use of intellectual property and software,
- Certain guaranty and warranty contracts,
- Certain subscriptions,
- Certain memberships in organizations, and
- The use of property, such as hotel facilities or trade show booths, provided such use is ancillary to the provision of services.

You can defer advance payment income for one year to the extent it's not recognized in revenue on an applicable financial statement, such as an audited financial statement or one filed with the SEC or another government agency (other than the IRS). Also, certain advance payments are eligible for a two-year deferral. Even if

you don't have an applicable financial statement, you may still be able to defer advance payment income if you have a reasonable method for demonstrating that it's earned in a later year.

3. Increase your basis

If you're a shareholder in an S corporation, be sure you have sufficient basis in your stock to deduct any losses. Owners of S corporations often assume they can deduct their share of business losses, but that deduction is limited to their tax basis. Disallowed deductions may be carried forward to future years.

Although this rule also applies to other "pass-through" entities, including partnerships and limited liability companies (LLCs), it's generally a bigger obstacle for S corporations because a shareholder's basis isn't increased by corporate debt. If you anticipate a business loss this year and your basis is insufficient, you can boost your basis before Dec. 31 by increasing your capital contributions or making a loan to the corporation.

A fundamental objective of year end tax planning generally is to defer income to next year and accelerate expenses and other deductions into this year.

Another possibility is for the corporation to make a deemed dividend election on its 2008 federal income tax return. This technique is available if a business previously operated as a C corporation and has accumulated earnings and profits (AE&P) from its C corporation years.

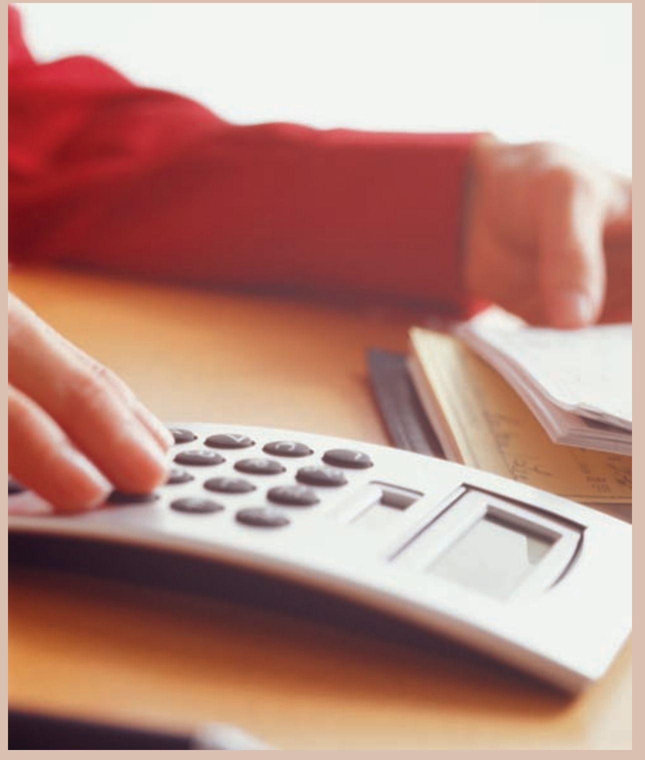
When an S corporation makes a deemed dividend election, the corporation is treated as if it had distributed AE&P to its shareholders on the last day of the tax year and the shareholders immediately transferred those sums back to the corporation as capital contributions. Each shareholder's basis is increased by the amount of his or her capital contribution.

Deemed dividends are taxable, but with current tax rates on qualified dividends at only 15%, in many cases this tax liability will be outweighed by increased loss deductions.

Deduct now, pay later

An IRS ruling earlier this year confirmed that accrual-basis employers can deduct their share of payroll taxes this year for deferred compensation — such as bonuses and vacation pay — paid next year. The requirements:

- The deferred compensation must be vested by year end.
- The amount of the employer's liability must be determined with reasonable accuracy.
- The deferred compensation must be paid within 8½ months after the close of the employer's tax year.



Keep in mind that the rules regarding deduction of losses are complex and there are other areas to consider, including passive activity and at-risk rules.

Act before year end

The tips discussed here are just a few of the many strategies available for businesses to cut their tax bills. In addition, implementing these or other strategies may have implications in other areas of your business. So you'll want to consult your tax advisor before acting. Don't delay, because some strategies need to be applied by Dec. 31 or you may be making an unnecessary gift to the IRS this holiday season. ◎

The IDGT: A useful tool for transferring your business to your heirs

It's a common dilemma for many business owners: The bulk of your wealth is tied up in your company and you'd like to begin transferring it to your children. But you have several concerns, including reducing the tax bite, retaining a degree of control and ensuring you have enough for a comfortable retirement.

One solution that can resolve all of these issues is to sell your business interests to an intentionally defective grantor trust (IDGT). An IDGT allows you to minimize or even eliminate gift and estate taxes while retaining control of your company and providing yourself with an income stream.

Creating the defect

An IDGT is designed so that you, the grantor, are treated as the owner for income tax purposes — as you would be under a traditional grantor trust — but not for estate tax purposes. This trust type intentionally violates one or more of the grantor trust rules without violating any of the estate tax inclusion rules.

A properly structured IDGT allows you to remove substantial assets from your estate — including all future appreciation in value.

One way to create an intentional defect is to draft a trust that provides a nonadverse party (other than the grantor) with the power to add beneficiaries. This will allow the trust to be treated as a grantor trust without triggering the estate tax inclusion. "Nonadverse party" generally refers to a person, including a trustee, who lacks a substantial beneficial interest in the trust. Another option would be to include a provision allowing the grantor to reacquire trust assets by substituting assets of equal value.

Reducing your taxable estate

A properly structured IDGT allows you to remove substantial assets from your estate — including all future appreciation in value. At the same time, you're treated as the owner of the trust for income tax purposes, so taxes on the trust's income are passed through to you. Why is that a good thing? Paying the trust's income taxes is the equivalent of making additional tax-free gifts to your children or other beneficiaries.

Let's say, for example, you fund an IDGT with $1 million in assets that earn income of $100,000 per year and your effective tax rate, including state taxes, is 40%. By paying the $40,000 income tax, which isn't considered a taxable gift, you reduce your estate by that amount, saving $18,000 in estate taxes at current rates ($40,000 x 45%). At the same time, the trust avoids tax on that income, increasing its value and preserving more for your family.

One word of caution: To ensure that you aren't deemed to be making an additional gift, the trust must be properly structured. Working with an estate planning attorney who has expertise in these trusts is advisable.

Avoiding gift taxes, creating an income stream

If you transfer business interests to an IDGT, you may generate a substantial gift tax bill. To the extent those interests are worth more than the lifetime gift tax exemption (currently $1 million) and, if it applies, the annual gift tax exclusion (currently $12,000 per person), the gifts will be taxed at 45% (the current rate) — more, if they're also subject to the generation-skipping transfer tax.

That's where the sale comes in. By selling assets to an IDGT rather than giving them to the trust, you can minimize or even eliminate gift taxes on the transfer. Plus, because you're the owner of the trust for income tax purposes, selling assets to an IDGT is like selling them to yourself. This means you won't recognize any capital gains on the sale or be taxed on the note payments.

For this strategy to work, several things must happen:

- The trust must have economic substance apart from the sale. Typically, this is done by funding the trust with "seed money" equal to 10% or more of the purchase price. This initial contribution is a taxable gift but, in most cases, you can use your $1 million lifetime exemption to shelter the initial gift from gift taxes.
- To avoid having the sale treated as a partial gift, you must sell the assets to the trust at fair market value in exchange for a promissory note that bears interest at or above the applicable federal rate. Generally, this rate is well below commercial rates.
- The business must generate sufficient income and cash flow to cover all required payments of interest and principal.

One advantage of a sale to an IDGT over other estate planning techniques is that it gives you the flexibility to adapt the payment terms to your income needs and your business's cash flow situation. For example, the note might call for interest only with a balloon payment at the end of the term. A potential disadvantage is that your heirs won't receive a stepped-up basis in the business, which may lead to a capital gains hit down the road.

Staying in control

One of the biggest estate planning challenges is that techniques for reducing gift and estate taxes on assets typically require you to relinquish ownership of those assets. An IDGT is one tool you can use to reduce taxes while still retaining some control over assets.

You might transfer business assets to a family limited partnership (FLP), for instance, and then sell limited partnership interests to the IDGT while retaining a small general partnership interest. Not only do you retain management control, but you can usually sell the limited partnership interests for less than their underlying value, as limited partnership interests generally are entitled to valuation discounts for lack of marketability and control.

A versatile tool

"Defective" is a bit of a misnomer. An IDGT can be effective in meeting a variety of estate planning objectives. With proper planning, a sale to an IDGT allows you to transfer substantial business interests to your children or other family members at low or no gift-tax cost, while shielding those interests and all future growth from estate taxes. At the same time, you retain management control over the business and continue to enjoy the fruits of your labor. ◎

Selling your home at a loss can mean higher taxes

When you sell your home at a profit, the tax code is quite generous. You can exclude up to $250,000 ($500,000 for married couples) in capital gain on the sale of a principal residence. If you sell your home at a loss, however, the code is downright stingy: The loss isn't deductible and, in a harsh twist of irony, you may end up owing taxes.

Debt and taxes

The problem is cancellation of debt (COD) income. If you sell your home for less than the total mortgage principal and unpaid interest and penalties on the property, and the lender forgives the excess debt, you may have COD income taxable at ordinary income tax rates. Typically, this happens when you sell your home at a loss, but you can have COD income even if you sell it at a gain.

Suppose, for example, Mary bought her home in 2000 for $300,000 with a $60,000 down payment and a $240,000 mortgage. In 2005, the home's value had increased to $500,000 and Mary took out a $200,000 home equity loan, which she used to buy a rental property. In 2008, she sold the home for $380,000, which the bank accepted in full satisfaction of her debt. Mary's $80,000 gain is tax free, but she has $60,000 in COD income from the debt proceeds used to buy the rental property. Assuming she's in the 28% tax bracket, she'll end up with a $16,800 tax bill.

Like most tax rules, there are a few exceptions. COD income isn't taxable if the debt is discharged in bankruptcy or if you're insolvent when the debt is canceled. Determining whether you're insolvent is complicated, but generally it means that your total debts exceed the fair market value of your assets.

Keep in mind that cancellation of a nonrecourse loan in connection with a foreclosure doesn't result in COD income. (In this situation, you're not personally liable for the debt, so the lender's only remedy is to take possession of the home.) This exception is limited to foreclosures and doesn't apply to a "short sale," in which the lender allows you to sell the property for less than the amount you owe and accepts the sale proceeds in satisfaction of your mortgage.

Relief from Congress

The Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA) provides some temporary relief. For 2007, 2008 and 2009, the act allows homeowners to exclude up to $2 million of COD income in connection with qualified principal residence indebtedness. This relief is available not only for foreclosures, but also for short sales and mortgage workouts in which the lender agrees to new terms that lower your monthly payments.

To qualify, the debt must be used to acquire, construct or substantially improve your home. In other words, COD relief isn't available for a home equity loan that's not used for home improvement.

Avoid surprises

Of course, selling property at a loss is never an ideal situation. In the event that it's necessary to do so, understanding the tax implications of a home sale is essential so that there are no surprises come tax time.

A strategy that pays dividends

If you invest in mutual funds, you may have arranged for dividends to be automatically reinvested rather than paid out to you. If that's the case, remember to calculate the gain or loss on these dividends when you sell your shares. The dividends increase your basis, which reduces your taxable gain or increases your capital loss.

Suppose you invested $50,000 in Fund A several years ago and you've had a total of $8,000 in dividends reinvested in the fund. You sell your shares for $70,000 and reinvest the proceeds in Fund B. Your capital gain on the sale of Fund A is $12,000 ($50,000 + $8,000 = $58,000; $70,000 - $58,000 = $12,000). At today's 15% long-term capital gains tax rate, the tax would be $1,800. If you forget to add the reinvested dividends to your basis, however, you'll end up paying $3,000 in taxes on a $20,000 gain.

An extra $1,200 in taxes may not seem like a lot, but you'll lose the compounded growth those dollars would have earned in Fund B. Over the years, neglecting reinvested dividends can have a significant impact on your portfolio. If your mutual funds are invested through a broker that provides you with basis information on your sales, confirm that the reinvested dividends are included. ◎

tax TIPS

Handle charitable gifts with care

The holiday season is a time of giving to your loved ones as well as the charities and causes you care about. Although there may be no limits to your generosity, there are limits to the amounts you can deduct on your tax return. Here are some points to keep in mind:

The deduction limits. Charitable deductions for cash gifts are limited to 50% of your adjusted gross income (AGI), and 30% for gifts to private foundations. The fair market value of long-term capital gains property is deductible up to 30% of your AGI, and 20% for gifts of publicly traded securities to private foundations. There are differing rules for other noncash deductions. Except for donations of publicly traded stock, donations of noncash items exceeding $5,000 must have a qualified written appraisal.

Not all donations are deductible. You can only deduct contributions to *qualified* charities and, contrary to popular belief, political contributions are never deductible. If there's any doubt, check IRS Publication 78, which lists the organizations eligible to receive deductible contributions.

Keep in mind that in recent years the IRS has begun requiring more substantiation of donations from donors. For instance, taxpayers making cash donations of any amount must have a bank record or written communication from the charity. Canceled checks and credit card statements should be adequate for your records. ◎

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