LOUIS TOMMASINO
Certified Public Accountants, A Professional Corporation
6265 Greenwich Drive, Suite #210, San Diego, CA 92122
Phone: (858) 623-0336
www.tommasino-cpa.com

CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor℠

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What's Inside

New IRS Rules May Offer Tax Breaks for Property Owners

The IRS has published temporary regulations on the tax treatment of tangible property. These regulations are effective now, and they may create valuable tax saving opportunities for property owners.

What they cover

The new rules provide guidance on amounts paid to acquire, produce, or improve tangible property. The IRS states that they cover the accounting for, and dispositions of, property subject to depreciation. The published regulations are 68 pages long, covering many topics.

Among those topics, the regulations illustrate when taxpayers can immediately deduct outlays for property repairs. Such costs usually are considered deductible repair expenses if they do not materially add to the value or useful life of property. Conversely, activities that increase or restore a property's value, substantially add to its useful life, or adapt it to a different use are considered improvements. The money spent on improvements must be capitalized and depreciated over a period of years.

Under the new regulations, repairs made during a time when a property is being renovated or rehabilitated may be deducted if they were not incurred because of the improvement. The costs of routine maintenance on property that is not a building or structural component are generally deductible.

The regulations define routine maintenance as a recurring activity that a taxpayer expects to perform to keep property in its ordinarily efficient operating condition. Examples include inspection, cleaning and testing of an item of equipment, and replacement of parts of the equipment with comparable replacement parts.

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Determining deductions

The regulations also may provide tax relief to property owners who remove a component of a building and replace it. An owner in this situation is not required to capitalize and depreciate the amount paid for the old part while also capitalizing and depreciating the amount paid for the new one. The retirement of a structural component of a building can be considered a separate disposition; the new regulations allow the property owner to recognize a loss on the disposition of a structural building component before the disposition of the entire building. Therefore, the owner will not have to keep depreciating building components that are no longer in service.

Under these new rules, property owners may want to commission certain studies to see if any substantial tax savings can be realized under the new rules. For instance, a property owner might benefit from a building component study that documents the original cost of building components or systems that the owner has replaced.

Example 1: Mary Palmer owns an apartment building. She spends $225,000 to replace the entire roof of the building. Under the new regulations, Mary must capitalize the cost of the new roof and recover her expense via depreciation.

Mary hires a qualified party to perform a building component study that concludes the old roof had a cost of $150,000. The new regulations permit Mary to deduct the adjusted depreciable basis of the old roof. If that adjusted depreciable basis is $112,500, Mary is entitled to a $112,500 tax deduction in the year the new roof is installed. Mary won't have to keep depreciating the old roof and deducting a few thousand dollars each year.

Looking at leases

A lease abandonment study also might be worthwhile. Such a study could document the costs necessary to prepare a property for a new tenant.

Example 2: Nick Raymond purchased a fully occupied building a few years ago. In 2012, one tenant vacates a leased space. Nick decides he needs to remove and replace some of the components put in place for the former tenant in order to attract a new tenant. The replacement items include walls, electrical wiring, plumbing lines, and ceiling tiles.

Nick commissions a lease abandonment study and determines the replaced items cost $60,000. Under the new regulations, Nick can deduct the adjusted basis of the replaced items, which might come out to be about $51,000, in 2012. Again, this upfront deduction is more valuable than extended depreciation.

If you are a property owner and plan on replacing a structural component or renovating a tenant's space, contact our office to see if the temporary regulations can help deliver sizable tax savings. ■

Did You Know?

From 1926 to 2011, large company U.S. stocks have returned 9.6% per year. Although stocks have disappointed in the past 10 years (returning 2.9% per year), they have done better in the last 20 years (7.8% per year), 30 years (11.0% per year), and 40 years (9.8% per year).

Source: Morningstar

The Gift Tax Still Matters

The Internal Revenue Code includes a gift tax. One of the reasons for having a gift tax is to prevent people from avoiding the estate tax by making gifts during their lifetime to reduce the size of their taxable estate. There is a unified lifetime exclusion amount for the gift and estate taxes ($5.12 million in 2012). Because the exclusion is unified, the amount of the exclusion used to prevent taxation on lifetime gifts reduces the amount of the exclusion that can be used to reduce the estate tax.

Additionally, there is an annual gift tax exclusion, which is currently $13,000 per recipient. If an individual makes gifts equal to or less than the annual exclusion amount to a recipient, the individual's lifetime exclusion is not reduced.

Example: Bonnie Dawson, an elderly widow with a net worth over $8 million, gives $4 million to Richard Dawson, her only child, in 2012. Say that Bonnie dies in 2016 with a $4 million estate. If the federal estate tax exclusion in 2016 is $5.12 million, as it is in 2012, Bonnie's estate will be under the threshold and, thus, owe no federal estate tax.

That is, Bonnie's estate would owe no estate tax if not for the federal gift tax. After the annual $13,000 exclusion, Bonnie's $4 million gift to Richard results in a taxable gift of $3,987,000. In 2012, the lifetime gift tax exclusion is also $5.12 million. Assuming Bonnie had not made any taxable gifts in the past, she will not have to pay gift tax, but her $3,987,000 taxable gift in 2012 will reduce her gift and federal estate tax exclusion by that amount. Consequently, Bonnie has only a $1,133,000 estate tax exclusion remaining. If Bonnie dies with a $4 million estate when she has a $1,133,000 exclusion remaining (this assumes no increase in the exclusion amount before her death), her estate will be nearly $3 million over the limit. The federal estate tax bill could top $1 million.

Uncertain future

As mentioned, the federal estate tax exclusion is now $5.12 million. Under current law, married couples effectively have a $10.24 million estate tax exclusion, no matter which spouse dies first. Therefore, many people believe they will not owe any estate tax. If estate tax isn't a threat, why pay attention to the gift tax?

There may still be reasons to plan around the gift tax. For one, there is no guarantee that the current federal estate tax exclusion amount will remain in place. If no legislation is passed between now and year-end 2012, the gift and estate tax exclusion will drop from $5.12 million in 2012 to $1 million in 2013. Even if that drop is averted by legislation this year, the exclusion amount could be reset below $5.12 million, perhaps to $3 million or $3.5 million. (President Obama has proposed setting the estate tax exclusion amount at $3.5 million in 2013.) The lower the estate tax exclusion, the more estates will be subject to estate tax, and the more families that could benefit from gift tax planning.

Another reason to plan for the gift tax is that the numbers mentioned previously relate to federal estate tax. Many states have their own estate tax, with exclusions much lower than $5.12 million. If you leave an estate worth, say, $2 million or $3 million, your heirs might owe hundreds of thousands of dollars in state estate tax. Depending on where you live, knowing how the gift tax works can lead to strategies that will reduce state estate tax.

Yet one more reason to keep the gift tax in mind is the requirement to file a gift tax return. In general, an individual must file a gift tax return if he or she gives gifts in excess of the exclusion amount to a donee. Although the lifetime gift tax exemption is ample at $5.12 million, the 2012 annual gift tax exclusion is modest at $13,000. If you make a gift contribution of $15,000 to your child's 529 college savings plan in 2012, you'll be over the filing threshold. In that case, you'll have to file a gift tax return.

To avoid adding hassle and paperwork to your life, try to stay within the $13,000 limit this year. That amount will rise in the future to track inflation. ■

Trusted Advice

Deducting Investment Interest

- Margin interest is investment interest if the money you borrow from your broker is used to purchase assets held for investment, rather than for other purposes.
- Investment interest expense may be deducted. Typically, the amount you can deduct is no more than the amount of your net investment income, which includes interest income from investments.
- You cannot deduct investment interest incurred to buy tax-exempt bonds.
- You can include qualified dividends and net capital gains as net investment income, but doing so will disqualify those dividends and gains from using the special 0% and 15% tax rates.
- Our office can help you make tax-efficient decisions on how much net investment income to report.

Investing on Margin Increases Risk and Potential Rewards

Although stocks have been volatile lately, they have been attractive long-term investments. The broad U.S. stock market has returned approximately 10% per year for the past 25, 30, 35, and 50 years—and that's still true after the bear markets of 2000–02 and 2008–09. If you have a long time horizon and can tolerate periodic slides, you probably should hold some of your portfolio in stocks or stock funds.

Investors who can tolerate stock market risks may be able to enhance returns by investing on margin or borrowing from their broker to buy securities using their own holdings to secure the loan. Assuming that

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stocks continue to rise, long term, margin investing can increase your exposure and overall gains. You shouldn't overlook the risks of margin investing, but you also should realize that tax advantages may push your investment results toward the plus side.

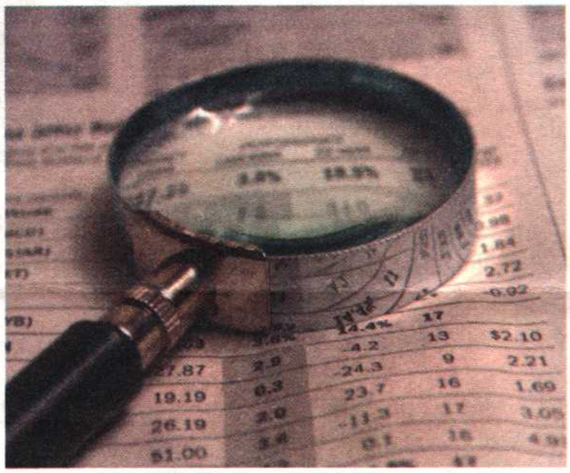
Double play

When you invest on margin, you borrow money to buy securities. Once you set up a margin account with your brokerage firm, the firm will lend you money, secured by your holdings there. Base interest rates on margin loans might be in the 6%–7% range now, but you can pay more or less if you have a small or large account with the firm.

Typically, the maximum margin allowed on stocks is 50%. By borrowing, say, $50,000 on margin, you can buy as much as $100,000 worth of stocks. Then, you'll stand to gain or lose twice as much as you would if you had not invested on margin.

Where do the tax benefits come in? The interest you pay on a margin loan may be tax deductible (see the Trusted Advice column "Deducting Investment Interest" for more information).

Example: Say you get a margin loan at a 6.5% interest rate, and your



effective tax rate (federal, state, local) is 35%. With a 35% tax deduction, your net borrowing cost is 4.225%: 65% of 6.5%. If your after-tax investment returns from the assets bought on margin top 4.225%, you'll benefit from using the margin loan. Based on long-term stock market results, investing on margin can be a reasonable strategy for those who can tolerate the risk.

Moreover, the tax savings from deducting margin interest come right away. For many stock market investors, substantial taxes are deferred for many years until they sell the shares, and favorable long-term capital gains rates may apply.

Although the numbers may seem favorable, don't downplay the risks involved with investing on margin. If your investments lose value, you may get a margin call—a demand for more cash or securities in your brokerage account. If you don't provide the cash or securities that your broker requires, the firm can sell securities from your account and use the proceeds for loan repayment. One way to reduce this risk is to use less margin—20% or 30%, perhaps, instead of 50%. You'll own less stock, but you'll also have less chance of receiving a margin call. ■

Business Owners May Defer Tax on an Employee Stock Ownership Plan Sale

Many owners of small companies plan to sell at some point, perhaps to finance their retirement. If you are in that situation, you may have a very low cost basis in the company's shares. On a sale, you could owe a substantial amount of income tax, especially if tax rates on long-term capital gains have increased by the time you sell.

You can prepare now for a huge future tax break. To do so, plan on selling your shares to an employee stock ownership plan (ESOP). An ESOP is a qualified retirement plan with the tax advantages you'd expect, such as tax deductions for contributions. ESOPs also provide employee motivation and a market for the shares you own.

Happy ending

Yet another ESOP advantage can be found in Section 1042 of the tax code. Under this section, you may defer the tax on the capital gain you report from selling your company's stock to an ESOP. To qualify, you must meet several criteria, such as the following:

- The ESOP must own at least 30% of the total value of your company's outstanding stock (other than certain preferred stock) or at least 30% of each class of your company's outstanding stock (other than certain preferred stock). This must be true immediately after you sell your shares.

- You must have owned your company shares for at least three years before the sale.
- Your company must be a C corporation.
- If the company's stock is not readily tradable on an established securities market, you must have a qualified appraisal that supports the selling price.
- You must reinvest the sales price in qualified replacement property (QRP) during a replacement period that begins three months before the sale of company stocks and ends 12 months after the sale.

Generally, QRP includes securities issued by domestic corporations. Such corporations must be active businesses, which, for these purposes, means that no more than 25% of the corporations' gross receipts were passive investment income for the year preceding the year the securities were purchased.

Example 1: Bart Rogers, age 65, is the sole owner of his small business, which he started 30 years ago. Bart sells his company to an ESOP and nets a $2 million long-term capital gain. Assuming a 15% tax rate, Bart would owe $300,000 to the IRS.

However, Bart reinvests all of the sales proceeds in a portfolio of domestic stocks and bonds that are QRP. He owes no immediate income tax from the sale, thanks to the Section 1042 tax deferral. Bart receives the income from, and participates in any appreciation of, the $2 million worth of securities.

Noteworthy

In the previous scenario, the tax deferral will go on as long as Bart holds onto his QRP. But what happens if Bart invests in a bank stock for its high dividend and then decides to sell after the bank reports a loss? What happens if Bart invests in a corporate bond that's redeemed in a few years?

In such cases, Bart no longer owns the QRP. Under Section 1042, if Bart relinquishes the QRP, in whole or in part, he'll recognize the gain that he deferred due to his purchase of the QRP and owe tax on it. Suppose Bart invests 25% of the sales proceeds in Big Bank Co. stock. He'll owe tax on 25% of the deferred gain if he sells his Big Bank Co. shares.

If you want to extend the tax deferral as long as possible, you can put the sales proceeds into so-called "ESOP notes." These are floating-rate notes issued by highly-rated corporations. The terms on these notes vary, but for example, they might have a 40-year maturity, with 30 years until first call. (A call gives the issuer the right to redeem the note prematurely.)

ESOP notes usually pay interest equivalent to the yields on short-term securities. Thus, yields are scant now. However, the banks and brokerage firms selling these notes may offer to let you borrow 80% or 90% of the face value of your ESOP notes, so you can reinvest elsewhere.

Example 2: Bart Rogers clears $2 million from the sale of his company and defers the tax on the gain by investing $2 million in an ESOP note. He then borrows $1.8 million, using the ESOP note to secure the loan. Bart invests that $1.8 million in a diversified portfolio of stocks and bonds.

In this example, Bart still owns the ESOP note, which is the QRP. Consequently, he maintains his tax deferral. Meanwhile, Bart can trade or redeem the stocks and bonds he has purchased with the borrowed funds without triggering the deferred income tax. If Bart wishes, he can use some of the borrowed money for personal expenses. The net cost of the ESOP note may be modest, compared with the value of the tax deferral.

If Bart dies while still holding the long-term ESOP note, his heirs will inherit it. Assuming that current tax law still applies at that time, the heirs will get a basis step-up; therefore, no one will ever owe capital gains tax on the sale of Bart's company. Our office can help you decide if an ESOP can fit into your succession plan for your business. ■

Trusted Advice

Transferring Qualified Replacement Property

- Under the tax code, the death of a person holding qualified replacement property (QRP) from an ESOP sale will not trigger the deferred tax.
- Another exception applies when QRP is given away. The recipient assumes the deferred tax liability upon disposition of the QRP.
- In at least one private letter ruling, the IRS stated that transferring QRP as part of a divorce settlement will be treated as a gift. The deferred gain won't be taxed immediately.
- Although private letter rulings apply only to the taxpayer making the request, this decision may indicate how the IRS will treat similar situations.

Keep Track of Noncash Contributions

Throughout the year, you probably make multiple donations of items other than cash. You might give used furniture to Goodwill, for example, or donate a pre-flat screen TV to a homeless shelter. Such contributions may cut your tax bill if you itemize deductions on your tax return, but you need to proceed carefully.

Most important, you should get a receipt for all noncash contributions. The receipt will show that you actually gave books, clothing, furniture, or whatever to a specific charity on a given date.

Valuing your deduction can be tricky. The tax law says that you are entitled to a deduction for the fair market value of each item. But what is the fair market value of a used computer or an old lamp?

Setting the price

In some cases, the fair market value is simple to determine.

Example 1: Jill Warner buys flowers every week and has them delivered to her church for display. Jill receives no reimbursement and does not take the flowers home after the services. Jill can deduct the amounts she spends on the flowers, which is the fair market value.

At Christmas, Jill spends $200 on toys and donates them, still in their boxes, to a charity that distributes the toys to needy children. Again, the price Jill paid for the toys is the fair market value because they were unused and donated immediately. She can deduct the $200 she spent.

Donations of used goods, though, generally are more difficult to value. One approach is to check websites, such as the Salvation Army's, which provides a valuation guide at www.satruck.org/donation-value-guide.

For example, a working color TV might be valued anywhere from $75 to $225, according to the Salvation Army's guide. The value of a man's raincoat on this list might be between $5 and $20. (A Salvation Army receipt will have a more extensive valuation guide on the back, listing items ranging from adding machines to wigs.)

You also might value used items by going to online sites such as eBay and Craigslist to see what used items sell for. Alternatively, you can price goods at a thrift shop. In any case, you should record your efforts to find the fair market value of the items you donate, in case your deductions are questioned.

Under the tax code, you generally can't deduct donations of used household goods or clothing unless the items are in "good used condition or better." The IRS doesn't define that term precisely, but it probably means that an item can be used as-is by a recipient; junk or trash won't qualify. You might want to take photos of items you donate to show their condition.

Going private

In recent years, many charities have solicited auto donations. Often, they implied that any car would be accepted and that donors would enjoy better financial results, after tax, than they'd realize from a sale or trade-in.

The IRS responded to such practices by issuing reminders and warnings about vehicle donations. IRS Publication 561, "Determining the Value of Donated Property," includes a section specifically devoted to donations of cars, boats, and aircraft. It says that the fair market value of a donated vehicle is the price listed in a used vehicle pricing guide for a private party sale, not the dealer's retail price. What's more, that price is valid only if the guide lists a private sales price for a vehicle that is the same make, model, and year and sold in the same area; in the same condition; and with similar options, accessories, and warranties as the donated vehicle.

Example 2: Luke Barnes donates a car in poor condition to charity. A used car guide lists the dealer retail value for a similar car in poor condition at $1,500. However, the guide also shows the price for a private party sale of the car at $700. Luke can take a $700 tax deduction for donating the car. ■

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Sidney Kess, CPA, JD, Editor. For AICPA customer service call (888) 777-7077 or visit *www.cpa2biz.com*.