

TAX & BUSINESS STRATEGIES

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2008 Offers Many Tax Benefits

Several new laws were enacted in December of 2007 that will affect taxpayers in 2008. The following is an abbreviated summary of each of these new tax provisions. Please give us a call for additional details if you believe any of these may impact you.

Home Mortgage Debt Forgiveness – Generally, any forgiven debt becomes taxable income to a taxpayer unless they qualify for exclusion of the debt income under an insolvency exception. Addressing the subprime lending crisis, Congress passed a law providing tax relief to homeowners for up to \$2 million (\$1 million for married taxpayers filing separately) of forgiven debt on a primary residence. The basis of the taxpayer's home is reduced by the excluded amount, which will result in a potentially larger gain for properties foreclosed upon and for homes that are sold in the future. If a taxpayer qualifies, the home sale exclusion can be used to offset up to \$250,000 of gain for each owner. The provision is retroactively effective for 2007 through 2009.

Caution! The exclusion applies only to the discharge of debt incurred to buy or substantially improve the taxpayer's primary home (acquisition debt) and does not cover debts incurred to pull equity out of the home for other purposes. Acquisition debt includes refinanced debt to the extent the amount of the refinancing doesn't exceed the amount of the acquisition debt at the time of the refinance.

Mortgage Insurance Premium Deduction Extended – The mortgage insurance premium deduction, which was originally available only in 2007, was extended for three years and will be deductible through 2010. This provision permits taxpayers to treat certain amounts paid for qualified mortgage insurance as home mortgage interest, but is phased out at higher levels of adjusted gross income (AGI). To be deductible, the insurance must be in connection with home acquisition debt, the insurance contract must have been issued after 2006, and the taxpayer must pay the premiums for coverage in effect during the year. There are special rules for allocating prepaid premiums.

Home Sale Exclusion Liberalized for Surviving Spouse – Prior to the passage of this new legislation, a surviving spouse could use the up-to-\$500,000 home sale gain exclusion

Dear Client:

The new laws enacted in December of 2007 bring many changes and will impact taxpayers this year. This newsletter edition gives you a brief summary of those provisions to help you prepare for the 2008 tax season. To discuss the full benefits of these changes, please give our office a call.

Due to the subprime lending crisis, Congress passed a law that provides home mortgage debt forgiveness. In addition, the mortgage insurance premium deduction was extended, the home sale exclusion was liberalized for the surviving spouse, and tax relief was given to volunteer responders. If some of these provisions may apply to you, we can provide you with more information and discuss them in detail.

Another opportunity that may interest you is the special tax rates that currently apply to gain recognized from the sale of capital assets held for more than a year. Beginning this year, these special rates, which apply to net long-term capital gains and qualified dividends, drop to zero percent to the extent that your regular tax rate is less than 25% and 15% for all other capital gains.

Finally, we have an article that discusses the tax ramifications that may result with the disposal of personal property business assets. The tax consequences will depend on several factors and can be complicated, so let us help you avoid unpleasant surprises at tax time.

Keep in mind that there are many other areas that could help minimize your tax liability, so please call our office for an appointment to discuss your specific needs.

Watch out for changes as Congress works to deal with the economic crisis.

...Continued Inside

The tax consequences of disposing of business assets depends upon how the property was used, how long it was owned, and the method of disposition. There are numerous ways of disposing of an asset, so we can give only an overview.

The key to knowing the tax ramifications of dispositions is to understand the tax term “adjusted basis.” Any gain or loss from the disposition of a business asset is measured from adjusted basis. Adjusted basis is generally the cost of the item reduced by any business deductions taken for the item. Let’s say you purchase computer equipment for \$1,000 and it is in a class of business property that must be depreciated over five years. You can elect to write off any portion of the item the first year (within the Sec. 179 expense limitations) and depreciate the balance over five years. If you elected to depreciate the item instead of taking the Sec. 179 expense election, your depreciation deduction would be \$200, and your adjusted basis after the first year would be \$800 (\$1,000 – \$200). If you then sold the equipment for \$900, you would have a \$100 (\$900 – \$800) taxable gain. Why? Because \$100 of your cost was recovered as the depreciation you had previously taken as a deduction. On the other hand, if it was sold for \$500, you would have a \$300 deductible loss. So, as you can see, you must take into account how much of the cost of the asset has already been written off to determine any subsequent gain or loss.

Favorite and frequently-encountered deductions for taxpayers are non-cash contributions to charity. Although there are some special rules, taxpayers can generally deduct the lesser of cost or fair market value (FMV) of personal items contributed to a charitable organization. For business assets, adjusted basis is substituted for cost. For example, if a taxpayer contributes to charity a desk that was used only for personal purposes and never for business, that had cost \$150 and has a FMV of \$50, the taxpayer can take a \$50 charitable deduction. However, if the desk had been a business asset and its cost had been fully deducted (depreciated), the taxpayer’s charitable deduction would be zero, since the adjusted basis would have been zero and was less than the FMV.

When a business asset is exchanged (traded-in) for a like-kind item, generally any gain or loss that would have resulted from the sale of the

asset increases or decreases the adjusted basis of the replacement property. Thus, where a sale would result in a gain, the gain can be avoided by exchanging the item, such as trading in one business vehicle for another. On the other hand, if a sale would result in a loss, it is probably to the taxpayer’s advantage to actually sell the business asset so a loss can be taken.

Gains and losses from the sale of business assets are not included on the business schedule in the tax return where net profit or loss from operating the business is figured, and generally do not affect the taxpayer’s self-employment tax. Generally, losses from selling business assets are

fully deductible in the year of sale. Gains, to the extent they are attributable to depreciation, are generally treated as ordinary income (but still not taxable for self-employment tax purposes), and any additional gain is treated as capital gain. If the asset was held for more than a year, the long-term capital gains rates will apply.

At times, you may simply scrap an item because it has no further use in your business and has no resale value. When this happens, treat the disposition as a sale for no money, which will produce a loss equal to the balance of the adjusted basis at that time. If an item ceases to be used for business purposes and is converted to personal use, your personal basis becomes the

adjusted basis at the time of conversion, with no additional deduction for the business. If the item is subsequently disposed of, any amount received in excess of the adjusted basis would be taxable, but any loss would not be deductible.

If you simply give the item away to an individual, neither the business nor you, as an individual taxpayer, is allowed a deduction. The general rule is that the recipient’s basis will be the asset’s adjusted basis at the time of the gift. However, where a sale in the hands of the recipient would result in a loss, the loss would be based on the lower of the item’s adjusted basis or FMV at the time of the gift. If the value of the asset, plus other gifts given to the same individual during the year, exceeds \$12,000 (2008), a Gift Tax return generally will be required.

Disposing of personal property business assets can be complicated, so please call us for additional information.

Disposing of Business Assets Without the Tax Bite

Many taxpayers fail to understand the tax ramifications of disposing of personal property such as equipment, furniture and autos used in business and end up with unpleasant surprises at tax time...

Zero Capital Gains Rate in 2008 Requires Careful Planning

One of the greatest benefits of the tax code is the special tax rates that currently apply to gain recognized from the sale of capital assets held for more than a year (long-term). The special tax rates apply to virtually all capital assets including land, improved real estate, your home, and business assets in excess of the accumulated depreciation previously deducted.

Beginning in 2008, these special rates, which apply to net long-term capital gains (LTCG)⁽¹⁾ and qualified dividends, drop to zero percent to the extent that your regular tax rate is less than 25% and 15% for all other capital gains. These rates, which apply only to non-corporate taxpayers, also apply for the alternative minimum tax and are available through 2010 barring any future tax law change.

This zero tax rate provides an extraordinary opportunity for a taxpayer to cash in on certain gains and pay no tax. This could be tax paradise for those who carefully plan their transactions this year through 2010.

The conventional strategy in the past was to offset as much of your gains as possible with losses from selling other assets in your portfolio. If you have an overall loss, then it is limited to \$3,000 (\$1,500 for married taxpayers filing separately), and any excess carries over to the next year. Keep in mind that losses from the sale of business assets are generally separately allowed in full in the year of sale, and not mixed with the losses from the sale of other capital assets. So with this change in the law, a new strategy emerges: it may be more appropriate to take gains to the extent they would be taxed at zero percent.

What this zero tax means to you is that there is no tax on your long-term capital gains to the extent that your regular tax rate is less than 25%. Before you make plans to sell everything in 2008 through 2010, remember that the gain itself adds to your income, impacts income-based limitations, and may possibly push you into a higher regular tax bracket, so it is a balancing act to take advantage of this zero rate. Of course, you can also use losses to offset the gains but contrary to past conventional strategy, you should have enough losses only to keep the gain within the zero tax rate. If your income is too high to take advantage of the zero tax rate, then continue to employ the conventional strategies discussed above for 2008 through 2010.

The zero tax rate applies to the amount of your taxable income below the 25% tax bracket. For 2008, this "breakpoint" is the "top" of the 15% bracket and is:

- \$32,550 for single taxpayers and married taxpayers filing separate returns;
- \$65,100 for married taxpayers filing joint returns and surviving spouses; and
- \$43,650 for heads of households.

Thus, the amount of your adjusted net capital gain taxed at 0% is:

- (1) The breakpoint amount for your filing status, **minus**
- (2) Your "other" taxable income (taxable income reduced by adjusted net capital gain).

The following issues may also come into play when planning your capital gains and losses strategies: (1) Gains from the sale of inherited capital assets are

(2008 Offers Many Tax Benefits Continued...)

only if he or she had filed a joint return with the deceased spouse for the year of sale. That meant the higher joint exclusion was allowed only if the home had been sold in the year of the deceased spouse's death. Thus, if the home were sold in a year after the year of a spouse's death – when a joint return would no longer be allowed to be filed – the surviving spouse could get a maximum home sale gain exclusion of only \$250,000.

For sales and exchanges after Dec. 31, 2007, a new law allows a surviving single spouse to qualify for the \$500,000 exclusion if the sale occurs no later than 2 years after the deceased spouse's death, and the couple otherwise meets the qualifications for the \$500,000 exclusion immediately before the spouse's death.

This may or may not be beneficial, since a surviving spouse, depending upon the state of residence and the manner in which the title is held, will have a 50% or 100% step up (or step down) in basis of the home as a result of the spouse's death. So, a sale within the two-year period after the spouse's death may not result in a gain in excess of \$250,000 anyway – at least in the current real estate market in most locations. But for those surviving spouses who do have a home sale gain greater than \$250,000, this new law will be a significant benefit.

Tax Relief for Volunteer Responders – Another provision included in the December tax law changes, effective in 2008 through 2010, was a provision that creates an exclusion from income for certain state or local tax benefits (a rebate or reduction of state or local income or property tax) and qualified payments (up to \$360 a year) granted to members of qualified volunteer emergency response organizations. This would include state or local organizations whose members provide volunteer firefighting or emergency medical services.

These are not the only tax changes you can expect in 2008. Congress is worried about a recession and is currently considering economic stimulus provisions. When we will see the new legislation is anyone's guess. Hopefully, it will be a lot quicker than last year and instead of the usual patches we've had in prior years, there will be a meaningful solution to the alternative minimum tax (AMT).

automatically long-term; (2) By election, long-term capital gains can be used to increase the amount of investment income when figuring the investment interest deduction, but then aren't eligible for the lower capital gain tax rates; (3) Losses from selling personal-use capital assets, such as your home or auto, are not deductible, and (4) You may have short and/or long-term capital losses from a prior year to account for. Also take into consideration how your state taxes capital gains; most do not have a 0% LTCG rate, and many do not have any special rates for capital gains.

Please give our office a call so that we can help you develop a strategy that will suit your unique situation.

⁽¹⁾ Net capital gain is generally the excess of net long-term capital gains over net short-term capital losses, subject to certain netting rules. However, the zero tax rate doesn't apply to collectibles gain or gain taxed on sales of certain small business stock, both taxed at a maximum rate of 28%, or to unrecaptured Sec. 1250 (depreciation) gain, which is taxed at a maximum rate of 25%.

TAX CALENDAR MARCH - JULY 2008

March 17, 2008:

- 2007 calendar year Corporation and S Corporation returns are due, including any taxes owed. This is also the due date for providing Schedule K-1 to the S Corporation shareholders. If you cannot complete and file the Corporation return by the March due date, file for the automatic six-month extension to give yourself until September 15 to file the return.

March 31, 2008:

- This is the due date for electronically filing (not by magnetic media) 1099 forms, W-2 forms, W-2G forms and tip reporting. File these forms electronically if you did not previously file by other means on February 28.
- This is the last day to withdraw funds from your Traditional IRA if you turned age 70½ in 2007 and haven't taken your 2007 distribution yet. In addition, this is the last day to withdraw funds from your SEP or Keogh plan if you are retired and turned age 70½ in 2007. Failure to take the required distributions could result in substantial penalties.

April 15, 2008:

- First quarter estimated tax installment payment for the 2008 tax year is due.
- Filing due date for your 2007 income tax return and to pay any taxes that are due. If you expect to owe, estimate how much and include your payment with the extension. If you owe

taxes when you do file your extended tax return, you will be liable for both the late payment penalty and interest from the due date.

- Filing due date for the 2007 calendar year Partnership return(s) and to provide Partnership Distribution Forms (Form K-1) to the partners. If you cannot file a Partnership return by the April due date, file for the automatic six-month extension to give yourself until October 15.

June 16, 2008⁽¹⁾:

- The second installment of your 2008 individual estimated taxes is due. If your income or deductions have changed significantly, you should call this office to determine if any adjustment in estimates is appropriate.
- U.S. citizens living abroad on April 15, 2008 must file a 2007 income tax return (if not already filed) or file for an extension.

June – July 2008:

- Time to review your 2008 year-to-date income and expenses to ensure your estimated tax payments and withholding are adequate to avoid underpayment penalties.

⁽¹⁾ Normally this date falls on the 15th of the month. However, when falling on a Saturday, Sunday or holiday, it becomes the next business day.

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

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TAX & BUSINESS STRATEGIES

SINCE YOU ASKED...

YOU ASKED: My daughter, who is my dependent, attends college full-time. My ex-husband pays all of her tuition. Since I claim her as a dependent, my ex-husband is unable to claim the tuition credit. Is that correct?

ANSWER: Yes, your ex-husband cannot claim the tuition credit, since it is claimed by the individual who takes the personal exemption for the student. Thus, if your daughter was emancipated, not your dependent, and claimed herself on her own tax return, she would be the one who claims the credit. Good news for you, however. Since you claim her as a dependent, you are the one that claims the credit even though you did not pay the tuition.

YOU ASKED: I purchased a maintenance plan for my office photocopy machines. The contract is for three years, and I was given a discount for prepaying the entire cost of the contract up front. After doing this, I was later told that I might not be able to deduct the entire cost of the contract this year. Is that true?

ANSWER: Unfortunately, that is true. Generally, where an expense relates to a period covering more than 12 months, IRS and most courts agree that the deduction must be spread over the period to which the expense applies. In your case, you'll need to spread the deduction over the three-year period of the maintenance contract.