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INDIVIDUALS

Understanding Those Economic Stimulus Rebates

In the weeks ahead, the U.S. Treasury begins sending those well-publicized Economic Stimulus payments to qualifying individuals. Here's a quick summary on who will be receiving those payments and a few tips to assure that opportunities are not overlooked.

The maximum rebate

For most individuals who file a return and pay tax, the rebate will be \$600 for single filers and \$1,200 in the case of a joint return. The rebate amount is limited to the tax liability, as reported on the 2007 Form 1040. And for those with a dependent child under age 17, there will be an additional \$300 per child.

But upper income filers are subject to a phase-out. This phase-out is based on the taxpayer's Adjusted Gross Income shown on the 2007 tax return. As this income exceeds \$75,000 for a single filer or \$150,000 in the case of a joint return, the rebate begins to diminish at the rate of 5% of income. If a single filer's total income exceeds \$87,000 or a joint filer's income exceeds \$174,000, the rebate is zero. For each qualifying dependent child of the taxpayer, it takes another \$6,000 of income before the rebates are totally phased out.

The minimum rebate

For lower income filers, there is a minimum rebate of \$300 per taxpayer or \$600 in the case of a joint return. Unlike the general rebate discussed above, this amount is not limited by the amount of income tax paid for the year. Rather, it will be sent to filers who have little or no tax.

In general, this minimum rebate can be claimed by those who report at least \$3,000 of wages and self-employment income, or at least \$3,000 of Social Security benefits, or those who report at least \$1 of tax liability, because gross income exceeds the minimum filing threshold (\$8,950 for single taxpayer income or \$17,900 for joint filer income).

The opportunities

The minimum rebate is available to a large number of lower income individuals who normally are not required to file a tax return. But the IRS has announced that a 2007 Form 1040 must be submitted in order to allow the U.S. Treasury to identify the individual as eligible for a rebate. The IRS website has a simplified approach for these individuals, allowing them to submit a Form 1040A that only shows either a wage amount or gross Social Security benefits in order to trigger the rebate. The Form 1040A can be submitted anytime before October 15, 2008.

Those with elderly parents who are normally non-filers or perhaps that non-dependent 24-year-old grad student are encouraged to submit a 2007 Form 1040A. Rebates also will be issued to the estates of those who died during 2007 and similarly may not have been required to file a Form 1040. Again, the executor should submit a 1040A to document that at least \$3,000 of Social Security benefits were received by that person while alive during 2007.

Annuities: Divide and Conquer

For many individual investors, annuities have a feature that is very attractive: tax deferral with the investor deciding when to access that deferred income. The tax deferral arises because the growth in the cash value of the underlying investments is not taxable until either a cash withdrawal is taken by the owner or a series of lifetime annuity payments are established. Most investors tend to hold their annuities and occasionally take distributions in retirement as their needs dictate.

But withdrawals from annuities face a harsh tax reality: any distributions are considered to first come from the deferred income. Only after all of the deferred income has been withdrawn is the investor considered to receive a tax-free withdrawal of the original investment.

Example

Edna, age 80, owns an annuity acquired about 25 years ago that has a current market value of \$200,000. Edna originally invested \$50,000 in this annuity contract. To the extent that Edna takes any withdrawal amount up to \$150,000, it will be considered to come from the deferred income portion of the annuity, and Edna will be required to report ordinary income in her Form 1040.

The partial exchange strategy

The IRS has recently issued a Revenue Procedure that provides a strategy that may allow those holding highly appreciated annuities to arrange a partial withdrawal that is not entirely ordinary income (Rev. Proc. 2008-24). This strategy relates to the ability to do a partial exchange of one annuity into another, followed by a surrender of one of the annuity contracts 12 months later.

In general, it is permissible to accomplish a tax-deferred exchange of one annuity for another. Thus, an individual holding an annuity with a large deferred gain could split that annuity, having the insurance company roll some portion of the cash value of the old annuity into a new annuity contract. This is known as a Section 1035 exchange, and the result is simply to defer a proportionate amount of the gain into the new annuity contract. Using the facts from the previous example, here's how that strategy can be utilized:

Example

Edna, in the preceding example, surrenders half of the value of her large annuity and has the insurance company issue a second annuity worth \$100,000 (Edna's old annuity is now also worth \$100,000, as half of its cash value was rolled into the new annuity contract). As one would expect, the tax cost in the annuity is also split proportionally, so that Edna has a \$25,000 tax cost in each \$100,000 annuity. But now, if Edna surrenders one of the annuities in full, she receives a \$100,000 distribution that is considered to be \$25,000 of the return of her cost and \$75,000 of ordinary income. Previously, if Edna withdrew \$100,000 from the single large annuity, it was considered entirely ordinary income.

New IRS safe harbor

The new IRS Revenue Procedure allows a taxpayer to exchange an annuity into other annuity contracts and subsequently accomplish a surrender, provided that the two transactions are separated by at least 12 months. As a result, if Edna's split of the large annuity into two equal annuities occurred on June 15, 2008, Edna would need to wait until after June 15, 2009, before she could surrender one of the annuities and apply its separate cost recovery. This IRS

safe harbor provides an important opportunity for those with large deferred annuities who might benefit from restructuring that annuity into several smaller contracts.

BUSINESSES

Beat the Clock on the Depreciation Deadline

We previously sent communication about the 2008 Economic Stimulus Act and the depreciation incentives. Congress has greatly improved first-year depreciation deductions for one year only, hoping that businesses will accelerate their capital expenditures and help the economy to improve. The added deductions are significant, but the clock is ticking, and in most cases businesses have only until December 31, 2008, to acquire assets that qualify.

Increase in Section 179 deduction

For tax years beginning in 2008, the first-year Section 179 deduction has been expanded to \$250,000 (it was \$125,000 in 2007). The Section 179 deduction is generally labeled a small business provision, as it only applies to businesses whose current year asset additions are beneath a specific dollar threshold. But that threshold has been expanded for tax years beginning in 2008 also. It now has a starting point of \$800,000 of current asset additions (formerly about \$500,000). Above that amount, the Section 179 deduction phases down dollar-for-dollar so that a business is totally ineligible for any Section 179 above \$1,050,000 of asset purchases.

Caution: Fiscal year businesses only have the enhanced Section 179 deduction available for their tax year beginning in 2008 and ending in 2009.

50% bonus depreciation

50% bonus depreciation is also available as a first-year deduction, but in this case eligibility hinges on acquiring “original use” property during the 2008 calendar year. In terms of ordering, any Section 179 deduction is claimed first, followed by the 50% bonus depreciation.

Example

Smallco purchases new equipment during 2008 costing \$700,000. After claiming the maximum Section 179 deduction of \$250,000, Smallco then claims 50% bonus depreciation of \$225,000 (50% of the remaining cost of \$450,000). The remaining cost after the 50% bonus deduction is then recovered under the normal rules, such as five-year or seven-year cost recovery, as the case may be. Assuming Smallco was in a five-year depreciable category with respect to its equipment, its total deductions in 2008

for depreciation from the \$700,000 equipment purchase would be approximately \$520,000 (\$250,000 Section 179 deduction plus \$225,000 50% bonus plus \$45,000 of regular depreciation).

There are a number of qualification rules with respect to the 50% bonus that distinguish it from the Section 179 deduction. For example, the bonus depreciation applies to new property only and not used assets. Also, if a new asset is acquired by trade, both the boot and any remaining depreciable basis of the relinquished asset qualify for the 50% bonus (but it's boot only for the Section 179 deduction). A broader array of assets qualifies for the 50% bonus. In general, all assets except buildings will satisfy the criteria, and even then leasehold improvements to an older structure can qualify for the 50% bonus.

Please let us know if we can assist in projecting how these added depreciation incentives can fit your capital expenditure plans.

Fiscal Year Business Trap

As noted in the previous article, the Section 179 first-year depreciation deduction for small businesses has been increased to \$250,000 for tax years beginning in 2008. However, for partnership and S corporation small businesses that operate on a fiscal year, there is a trap in the way these rules were drafted by Congress. Because of the fiscal year status, such a partnership or S corporation would pass the Section 179 deduction into the 2009 Form 1040 of the business owner. But by 2009 the tax law reverts back to the regular Section 179 limit of \$125,000 (probably \$130,000 by 2009 with inflation indexing). Here's an illustration of the flaw in the law:

Example

Lea is the 100% shareholder of an S corporation using a November 30 fiscal year. For its tax year beginning December 1, 2008, and ending November 30, 2009, the corporation acquires a significant amount of equipment to take advantage of the new depreciation provisions. However, if a \$250,000 Section 179 deduction is passed through to Lea's 2009 Form 1040, she will only be allowed to claim the normal Section 179 amount (approximately \$130,000) for 2009. The expanded \$250,000 Section 179 limit could not be claimed in her 2009 Form 1040.

As a result, fiscal year partnerships or S corporations with a majority individual owner effectively do not have the benefits of the expanded \$250,000 Section 179 deduction. This looks like a technical oversight in the drafting of the law, but because it affects only a small number of businesses, it is doubtful if Congress will make a legislative correction. As a result, small business owners with fiscal year partnerships or S corporations need to recognize this limitation when budgeting their equipment additions under the one-year Economic Stimulus depreciation incentives.

Business Auto Tax Break

Most business owners are well aware that automobiles and other passenger vehicles produce only modest tax benefit when purchased by a business. For many years, Congress has restricted the depreciation deductions associated with passenger autos. For example, for 2008, an auto purchased and used 100% for business purposes is limited to a first-year depreciation deduction of \$2,960. In the second year of use, the depreciation cap is \$4,800, \$2,850 for the third year, and finally only \$1,775 for each succeeding year. For light trucks, minivans and SUVs, these deduction limits are a few hundred dollars greater. But the bottom line is that there is little tax incentive to purchase a vehicle for business use.

But the Economic Stimulus Act has opened a window, providing a greater first-year depreciation deduction for new business vehicles acquired and placed in service by December 31, 2008. Under this one-year rule, the normal first-year vehicle depreciation cap is increased by \$8,000. Accordingly, a passenger auto, light truck or van will produce a first-year depreciation expense of approximately \$11,000 rather than the usual lower \$3,000 limit.

Caution: As many business owners are aware, a truck or larger SUV with a gross vehicle weight rating of over 6,000 lbs. has not been subject to these low depreciation limits. Rather, those vehicles are allowed up to a \$25,000 Section 179 first-year deduction, followed by full depreciation over a five-year statutory recovery period. And, under current law, new vehicles over 6,000 lbs. also qualify for the 50% first-year bonus write-off.

But the pending Energy Conservation Tax Act would curtail these special rules and treat these heavier SUVs as any other passenger auto. They would be subject to the first-year limits discussed above (\$3,000 in general, but approximately \$11,000 if acquired by December 31, 2008).

ESTATE PLANNING

Using Today's Low Interest Rates

Estate planning is all about transferring assets to your heirs, whether accomplished during your lifetime or through your estate. If selling assets or making transfers by gift makes sense in your situation, now might be the time to give those lifetime transfers special attention. It's no secret that real estate values have slumped. Assets such as rental properties or vacation homes with a current appraisal reflecting today's lower values might be efficiently transferred out of your ownership at a bargain compared to values a year or two earlier. A current appraisal is generally necessary, and that should reflect the latest market values.

Often, an even more significant discounting can be accomplished with low interest rates. Each month, the IRS publishes a minimum set of interest rates that can be used in family sale transactions. A key point is that today's current low rates can be used to lock a long-term note on a sale to a family member.

Example

Bob, age 65, has a rental property that he would like to sell to his son, who assists in the management of this property. Assuming that the market value of this property is \$1 million, Bob sells it on a 30-year note, locking in the May 2008 long-term IRS minimum interest rate for annual payments at a rate of 4.21%. Had Bob sold this property one year earlier, the IRS minimum interest rate would have required a payment of \$5,000 per month greater than is required today. Over the 30-year term of the note, his son will pay about \$150,000 less interest. Even if interest rates rise in the future, this installment contract would be protected from any IRS adjustment.

Other techniques

The current low interest rates also favor more sophisticated asset transfer techniques, such as the use of a Grantor Retained Annuity Trust (GRAT). A GRAT is another technique for moving assets to the next generation, but without creating a locked-in gain or a long-term installment sale. Rather, an asset expected to appreciate, such as S corporation stock in a family business, is "sold" to a GRAT in exchange for a fixed-term annuity of equal value. At the end of the trust term, the trust assets are distributed to the beneficiaries and at that point are totally out of the grantor's estate. The current (May 2007) IRS interest rate for structuring this annuity is only 3.2%. It was 5.6% as recently as one year ago. Again, the current low interest rates have the effect of allowing a greater asset value to pass to your heirs.

Please let us know if we can assist in designing a sale or annuity transaction that helps you meet your objectives of asset transfers to children or other heirs.