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**FINANCIAL PLANNING**

**Annuities: Surrender Strategies**

A recent Wall Street Journal article commented on the mistakes that investors often make in disposing of an unwanted annuity (*Maxey*, July 9, 2007). A key point was that those looking to cash in an annuity often do so in haste, ignoring the potential tax cost and surrender charges.

In general, annuities come in two flavors. Traditional annuities grow based on the general interest crediting rate of the issuing insurance company, while variable annuities hold underlying stock and bond mutual funds. In this second case, the cash value may increase or decrease depending upon the performance of the underlying investments. A common feature of both forms is the internal insurance charge which tends to be a drag on performance compared to a similar investment in non-annuity form.

But annuities have a significant tax deferral advantage. The growth in the cash surrender value of the underlying investments is not taxable until annuity payments are received or a cash-out is taken by the owner.

The Wall Street article commented on how some investors who surrender an unwanted annuity are surprised by the large tax cost. That is certainly a valid observation. An annuity that has been untouched for 30 years, for example, typically has appreciated significantly, and can bring a substantial tax bill. The amount received is considered ordinary income, even though the underlying investments may represent capital appreciation in stocks and funds that otherwise would be capital gain.

For those contemplating the cash-in of an unneeded annuity, the article commented on the importance of shopping around, both with the issuing insurer and also with the secondary market. Some annuities are capable of a sale to a third party, giving the investor another option.

But what about taking advantage of a key annuity attribute: A lifetime payout that you cannot outlive? An annuity can generally be “annuitized,” with the issuing insurance company committing to a lifetime monthly payout. This shifts the risk of extended longevity to the insurance company. Using an annuity as a core monthly retirement income source is probably an underutilized feature.

And there are other choices as well. Perhaps the annuity should simply be left to your heirs. Or how about leaving it to charity where all of that accrued income might avoid taxes?

Unfortunately, designating your heirs as beneficiaries does nothing to cleanse the significant deferred income tax cost. Unlike many other investments, annuities do not receive a fresh tax cost when they pass through an estate. Accordingly, all of that income will still be taxable to your children or other heirs when they cash in the annuity after you are gone.

Charitable transfers, of course, fare better. If an annuity is transferred to a charity during lifetime, the owner must recognize the deferred income at the point of transfer. But an offsetting charitable deduction is allowed for the full proceeds of the annuity that move to the charity. Generally, this should produce a charitable deduction that is larger than the income by the sum of the owner’s investment in the annuity contract.

Another option is to pass the annuity to charity after death by naming a charity as the beneficiary. For those who desire to leave some amount to charity as a bequest, using an annuity is a tax-efficient choice. The charity is not subject to any income taxes when it receives the proceeds. Other assets with no deferred tax liabilities can then be left to your heirs.

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## **BUSINESS TAX DEVELOPMENTS**

In late May of 2007, Congress passed the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28, enacted 5/25/2007). This legislation contained several changes that will be welcome news for businesses, in the form of better depreciation, an improved tax credit for hiring certain workers, and a new structure for a husband-wife owned business. In addition, there is a major adverse change regarding the infamous kiddie tax (see Individual Tax Developments below).

## Section 179 Expanded Depreciation

One of the more important tax provisions for small businesses has been the ability to claim a first year Section 179 depreciation deduction of up to \$100,000 of equipment additions per year. This provision has been inflation indexed annually, and recently had reached \$108,000.

The new legislation increases the Section 179 annual dollar limit to \$125,000, effective for tax years beginning in 2007. And, in an important corollary adjustment, the asset addition phase-out threshold has been increased to \$500,000. For the small business owner, understanding this phase-out threshold may be the more important development. As eligible equipment additions within any year exceed this phase-out threshold, there is a dollar-for-dollar reduction in the eligible Section 179 amount.

For those businesses reporting on fiscal years, the old limits apply for tax years beginning in 2006 and ending in 2007. Here is a chart summarizing these amounts:

<u>Tax Year</u>	<u>Sec. 179</u>	<u>Asset Addition</u>
<u>Beginning In</u>	<u>Annual Limit</u>	<u>Phase-out Range</u>
2006	\$108,000	\$430,000- \$538,000
2007	\$125,000	\$500,000- \$625,000

*Example.* Ajax Construction, a calendar year S corporation, is enjoying a profitable year and acquires a number of items of equipment in 2007 to improve its depreciation deductions. The sum of those asset additions is \$600,000. Ajax must reduce its \$125,000 Section 179 limit for 2007 by \$100,000, the amount by which its qualifying property acquisitions exceed \$500,000. Accordingly, Ajax may only claim \$25,000 of Section 179 deductions for 2007. Had Ajax limited its current year equipment additions to \$500,000, it would have qualified for a full \$125,000 first year Section 179 deduction.

Small business owners who are able to budget their annual equipment additions to stay beneath the asset addition phase-out threshold may actually have greater first year depreciation deductions than those who exceed that threshold!

## Liberalized Jobs Tax Credit

For years, the tax law has incited employers to hire disadvantaged workers by providing tax credits. An employer who hires an individual from one of nine various targeted groups qualifies for a tax credit. At a minimum, the credit is \$2,400 for each

eligible hire (40% of the first \$6,000 of wages). Individuals from some groups qualify for greater credits, and those credits extend into the second year of employment of that individual. The targeted groups included individuals employed from families receiving welfare benefits, disabled veterans, rehabilitation referrals, food stamp recipients, and the like.

The recent Small Business Act has expanded one of these targeted categories in a very significant manner, in a change that has not been well-publicized to the business community.

The new category of eligible workers is labeled “designated community residents.” It must be an individual who has attained age 18 but not age 40 on the hiring date, and has his or her principal residence within a rural renewal county. A rural renewal county is defined as any county outside of a metropolitan statistical area that has had a population loss from 1990 through 1994, and again from 1995 through 1999. Page 4 of the IRS instructions for Form 8850 identifies the counties within each state that qualify as rural renewal counties (Form 8850 instructions are available at the IRS website: [www.irs.gov](http://www.irs.gov), under Forms and Instructions). Assuming that an individual meeting these criteria is employed and earns at least \$6,000, the employer will qualify for a potential \$2,400 Work Opportunity Tax Credit.

The individual must have been engaged to begin work after May 25, 2007, and must be certified at the time of hire by the state workforce agency for the applicable location. Employers have only 28 days after the job applicant begins work to submit a certification request to their state workforce agency. IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, is used for this purpose.

Any business that may have hired a “rural renewal county” resident within the last 28 days should submit this paperwork to the state employment agency, so that they may investigate and complete the certification that will allow this tax credit. A key aspect is that the worker does not need to be a low-income individual or in any other disadvantaged category. This could, in fact, be a highly paid professional worker who happens to reside in a county that has experienced population losses during the prior decade. Please let us know if we can assist in establishing procedures that assure that this and other jobs credit opportunities are not overlooked.

As a further benefit, any Work Opportunity Tax Credit now has a greater likelihood of producing immediate tax savings. In the past, this and other business credits have only been allowed to reduce regular tax and not alternative minimum tax (AMT). This meant that many business owners could only utilize small amounts of these credits annually, even though their business may have qualified for large tax credits.

But for tax years beginning after 2006, the Work Opportunity Tax Credit will offset any tax, whether it is regular tax or AMT. This will make these jobs credits even more lucrative than in the past.

## **Spousal Joint Ventures**

In general, if an entity has two or more owners, it must either report as a partnership or a corporation. In theory, it has not been possible for two individuals to simply split a business, and each report their respective share of the income and deductions as a proprietorship within their respective Form 1040s.

Beginning in 2007, the new legislation provides a special election for a husband and wife, allowing them to treat a “qualified joint venture” as two proprietorships rather than a more formal partnership. A qualified joint venture is available if the only members are a husband and wife who file a joint Form 1040. Further, both spouses must materially participate in the business activity, to the extent of at least 500 hours per year. Finally, this is an elective provision to which both spouses must consent.

When this election is made, the spouses can avoid the formality of filing an actual partnership return. Rather, each spouse simply reports the respective share of the joint venture as a sole proprietorship. Each proprietorship share is subject to the self-employment social security tax.

**Observation:** While this new rule provides welcome simplicity, it does not produce any direct tax savings. Further, until the IRS provides guidance on making the election and operating guidelines for these spousal joint ventures, it would be premature to take action.

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## **INDIVIDUAL TAX DEVELOPMENTS**

### **New Complex Kiddie Tax Rules**

For many years, Congress has imposed the infamous “kiddie tax” on the unearned income of a younger child. The motivation has been to prevent parents from shifting investment income, such as interest, dividends and capital gains, to the lower bracket tax returns of their children. From its inception, the kiddie tax applied the parents’ tax rate to the unearned income of a child under age 14. But beginning in 2006, Congress extended the kiddie tax to reach those under age 18.

The kiddie tax allows the child to have only \$1,700 of investment income and gains at the child’s low rate. Any excess is taxed at mom and dad’s top tax rate.

Now, in the recent tax legislation, effective beginning with the 2008 tax year, the kiddie tax has been expanded in a very complicated manner to potentially reach children through age 23! This expanded kiddie tax actually aims at two groups who have attained age 18: (1) those who have their 18<sup>th</sup> birthday during the year, and (2) those who are in full-time student status for at least five months of the year and attain their 19<sup>th</sup> through 23<sup>rd</sup> birthday during the particular tax year.

But there is a further test for those in this age 18-23 upper tier group. For the kiddie tax to apply, the individual must have earned income, such as from wages and self-employment income, that does not exceed one-half of the amount of the individual's support for the tax year. In measuring support, amounts received as a scholarship are not taken into account.

Support, of course, is a figure that is difficult to quantify. Support takes into account the various expenditures for that child during the year, such as food, shelter, clothing, medical care, education, recreation and the like. Often, support is provided in kind, such as lodging provided by parents. In that case, the item is measured in terms of its fair market value. In determining support, only amounts actually expended or provided during the particular year are considered. If the child has low personal earnings (wages and self-employment income) compared to the support amount, he or she will be subject to the kiddie tax during the years 18-23, assuming he or she is also in student status. But if the child has a larger wage amount compared to his or her support, the child will be exempt.

*Example.* Ben is a college student, age 20, with several scholarships. During 2008, items expended for Ben's support include room, board, tuition and other items that total \$26,000. However, Ben has received several scholarships in the total amount of \$6,000 that reduce the outlay for his tuition. Accordingly, his total support for 2008 is \$20,000. Ben has a W-2 from employment at his school during 2008 for \$7,000. Ben is subject to the kiddie tax, because his earned income of \$7,000 does not exceed \$10,000 (half of his support for the year excluding the amount covered by scholarships).

If Ben had greater wages for 2008, such as \$11,000 in total employment, he would not be subject to kiddie tax. In that case, Ben could recognize interest and dividend income or sell securities with significant capital gain recognition without imposition of his parents' tax rate on his unearned income.

**Observation:** A surprising aspect of this kiddie tax expansion is that its application has no bearing on the child's dependency deduction. The dependency exemption for a student or young adult generally goes to the party (parent or child) that provided over half of that child's support for the year. The kiddie tax, instead, simply looks to

the W-2 and self-employment income of the student, and does not consider who provided the sources of support for the child for the year.

In many cases, particularly among upper income families, a student may not be a dependent of the parents because the student's assets (received through earlier gifts from parents or grandparents) have provided over half of the student's support for the year. And yet that student could be subject to kiddie tax at the parents' tax rate, simply because the student had low W-2 income for the year. It is even possible under this set of rules to have the kiddie tax apply to an estranged child who no longer is in communication with the parents!

**Strategies.** Here are some thoughts about how to react to this new kiddie tax. First, because the age 18-23 rule does not take hold until 2008, those who have children presently in that age group should consider recognizing gains and investment income in their tax returns during 2007. A 19 year old's mutual funds and stocks can be sold in this year without any kiddie tax, but it may be a different story next year.

Secondly, is it possible the child's W-2 and self-employment earnings could approach over half of their support amount, so that the 2008 kiddie tax did not apply? If so, adding to that W-2 income by employing the child in a family business could be of benefit.

Investment strategies for saving for college for a child will need rethinking. Rather than build up funds that will now be cashed in kiddie tax years when needed for college, consider the efficiency of state-sponsored 529 plans. These investments are never taxed if withdrawn and expended for higher education.

Finally, for many, the kiddie tax may not be that costly, at least with respect to capital gains. For example, if a child is holding unsold stocks that have been received as a gift from parents, the sale will produce a capital gain. At the child's rate, it would be taxed at 0% in 2008, but with kiddie tax it is a 15% capital gain rate. While no tax is the perfect answer, the full capital gain rate of 15% is hardly a confiscatory tax.

If any of these strategies merit discussion with respect to your personal situation, let us know.