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CPA CLIENT TAXLETTER

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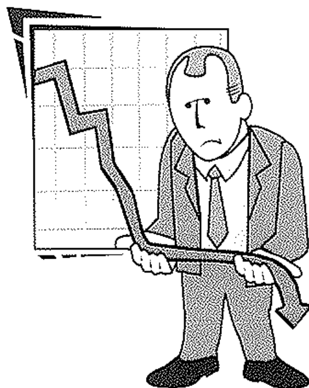
New Law Eases *Some* Mortgage Woes

After years of soaring home prices, housing values are falling in many areas of the U.S. In some cases, homeowners are selling for less than their mortgage balance or even walking away from highly leveraged houses. Such actions can have serious and unexpected tax consequences. However, temporary relief is available, thanks to the Mortgage Forgiveness Debt Relief Act of 2007, which President Bush signed into law at year's end.



Can't win for losing

The tax code generally requires a taxpayer to pick up taxable income when debt is discharged. That is, if a lender forgives debt you owe, you will have income equal to the amount of the cancelled debt.

Example #1: Suppose Jim Smith bought a house for $450,000 at the peak of the real estate boom. He made a $50,000 down payment and obtained a $400,000 mortgage. Jim, who used the house as his primary residence, was personally liable for the mortgage. In 2007, when the loan balance was $390,000, Jim got a job in a different city and sold the house. He received only $350,000 because the house had lost value.

As you can see, Jim lost his $50,000 down payment. What's more, the $350,000 he received was not sufficient to cover the $390,000 mortgage value. Nevertheless, the lender agreed to accept his $350,000 and canceled the loan, effectively forgiving $40,000. Normally, the lender would report that $40,000 cancellation of debt to the IRS. Likewise, the lender would report to the IRS when a mortgaged property was abandoned, foreclosed, repossessed, or reacquired by the lender.

In all such cases, the resulting income would be taxed at ordinary income rates. With $40,000 in taxable income from cancellation of debt, Jim might owe $10,000–$15,000 in tax.

Tax relief for debt relief

The new law relieves Jim from having to pay this tax. This provision is retroactive, so it applies to discharges of home mortgage debt that occurred in 2007. A similar tax shelter applies to debt cancelled in 2008 and 2009. Up to $2 million of cancelled debt qualifies for the tax relief.

As you might expect, there are limits to the tax break. For one, it applies only to debt relief from "qualified principal residence indebtedness." That is, the exception to prevailing law applies only to debt that was used to acquire, construct, or improve your principal residence, and the debt must be secured by that residence. Thus, there is no tax break for discharge of a home equity loan if the loan proceeds were used for purposes

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other than home improvements. Debt relief for vacation homes and investment property also will trigger taxable income.

What's more, if you do use this provision to avoid cancellation-of-debt income on your principal residence, the basis of your home (its cost for tax purposes) will be reduced by the amount of canceled debt. This might cost you tax on a sale if your long-term gain is over $250,000 ($500,000 for couples filing joint returns).

At a loss for tax savings

In the preceding example, this new law will save Jim some tax, but he still faces a difficult situation. On a personal residence sale, you can't deduct the loss and you can't use the loss to offset the tax you owe on a capital gain from another asset sale.

Example #2: What if Jim decides to rent the home to a tenant instead of selling it at a steep loss? He might plan to use the home as rental property until the housing market recovers. In the meantime, he'll live elsewhere and collect rental income. Here Jim faces another unpleasant surprise. According to the tax code, when a tenant moves in and a former residence is converted to rental property, the home gets a new basis. That basis will be whichever is *lower*, the owner's current basis or the fair market value of the house.

Here, Jim's basis in the converted property would be its depressed value of $350,000. If he sells a year later for $375,000, he'd have a $25,000 taxable gain on a property he bought for $450,000 and sold for $375,000.

In fact, the IRS might say that Jim's basis (the value of the house at the time of its conversion to rental property) was lower than $350,000. Then he'd owe even more tax on the sale. To avoid this problem, Jim should obtain a timely appraisal when the conversion takes place. He could ask a local real estate agent for a dated statement, assigning a likely selling price for the house at that time.

Example #3: What if Jim had bought a house as investment property in 2004 or 2005? Suppose he wants to sell because the house is losing money—even if that means taking a loss on the deal. In this scenario, Jim's loss would be a capital loss, for tax purposes. He could use that capital loss to offset capital gains, perhaps from stocks he sold. If Jim has no capital gains, though, he can deduct only $3,000 per year against his ordinary income. He can carry forward unused losses to later years, but they will continue to be of limited value (a $3,000 deduction each year) until and unless he has capital gains to offset.

The bottom line is that there are many pitfalls that you must avoid if you own real estate that has lost value. Our office can help you by examining your options and explaining their outcomes so you can make a fully informed decision.

Enjoy Real Tax Savings From Investment Property

Falling prices have created a buyer's market in housing. The same trends might encourage you to shop for a home that you can rent to tenants. Rents may firm as more would-be home buyers are denied mortgages and rent homes instead. What's more, tax breaks for real estate investors can make such ventures attractive.

Sheltered cash flow

Owners of investment property are entitled to some non-cash deductions, such as depreciation. These deductions may help you avoid tax on any net rental income you receive.

Example: Suppose that you buy a house that you rent for $2,000 per month. That's $24,000 per year. Also suppose that all of your expenses add up to $19,000 per year. You would put $5,000 into your pocket. However, you might have a $9,000 depreciation deduction in this hypothetical example. Now you'd have a $4,000 loss, for tax purposes. With a taxable loss, you'd owe no tax. Thus, your $5,000 in cash flow will be tax free, sort of.

Paying the price

Is this tax-free cash flow really tax free? Not exactly. Depreciation deductions lower your basis in the property. A lower basis, in turn, will increase your tax on an eventual sale. Fortunately, the tax on prior depreciation deductions is capped at 25%. Thus, you may defer tax normally owed at rates up to 35% and pay it years later at a 25% rate.

There is actually a way to avoid paying tax on the depreciation deductions you've taken. Under current law, assets such as real estate get a basis

step-up to market value when they're left to heirs. Therefore, if you hold on to investment property until death, your heirs can sell the property for its current value and owe no capital gains tax. All the tax-free cash flow you received during your lifetime will never be taxed.

Gain from losing

In the example above, you wound up with a $4,000 loss, for tax purposes. Such a loss might be deductible, depending on your adjusted gross income (AGI). Losses from rental properties are known as passive losses. If your AGI is no more than $100,000, passive losses are deductible, up to $25,000 per year.

Over $100,000, this deduction is phased out. Say you own a rental property with a tax loss and your AGI is $120,000. You are 40% of the way through the $100,000–$150,000 phase-out range, so your maximum passive loss deduction is 60% of $25,000: $15,000. If your AGI is $150,000 or more, you generally cannot deduct passive losses.

Loss carryovers

If you have passive losses that you can't deduct right away, they may be carried forward to future years indefinitely. Those losses can be used to offset any taxable income you might have from rental properties. If you haven't used your passive losses by the time you sell the property, they will be deductible against your ordinary income in the year of sale. If you have a gain on the sale, favorable capital gains rates will apply.

An active approach

The tax laws described above relate to passive losses. Your losses won't be passive if you are a real estate professional. To be treated as a real estate professional, you must spend more than half your working time on real estate—at least 750 hours a year. Then you can deduct any losses from rental property right away, regardless of your AGI.

Limits on Passive Activity Loss Deductions

Adjusted Gross Income	Maximum Annual Deductions
Up to $100,000	$25,000
$110,000	$20,000
$120,000	$15,000
$130,000	$10,000
$140,000	$ 5,000
$150,000 or More	0

Source: www.webtax.com

How to Handle Company-Owned Real Estate

Business owners often have to make decisions about the offices, warehouses, and other real estate they use. At some point, you may decide that your company should be a property owner. Whether you buy existing real estate or develop a new property, some strategies can make the venture less costly.

Careful cost allocation

With any real estate investment, raw land is not eligible for depreciation deductions. Thus, it's in your interest to have less of your cost allocated to land and more allocated to building and improvements.

What's more, commercial real estate generally has a 39-year depreciation schedule. However, machinery and equipment and other items not part of the base building can be written off more quickly, perhaps over five or seven years. The costs of carpets, linoleum, and window treatments, for example, often can be depreciated rapidly. The same might be true for appliances and communications systems.

Our office can help you work with a consulting firm that has engineering expertise, which will be especially helpful in the case of new construction. If tax reduction is a goal, from the beginning of a project more costs can be allocated to shorter-lived items, resulting in accelerated tax deductions. And even if you already are depreciating your building on a 39-year schedule, it may be possible to file amended returns to claim deductions you could have taken in prior years.

Savvy sale-leaseback

What if your company owns a building that is fully depreciated and therefore not providing much in the way of tax deductions? One strategy would be to buy the building yourself, as the company owner, or have a group of owners form a limited liability company (LLC) to buy the building. Most of the purchase price could be borrowed. Then you could lease the building back to the company.

What does this accomplish?

- The company will have continued use of the building.
- The company's gain on the sale of the building will be taxable. However, any tax might be reduced by corporate deductions or operating losses, including a net operating loss carryforward.
- The net proceeds, after tax, will be available to the company.
- Going forward, the company will have deductible lease payments, to replace the depreciation deductions that no longer will be available.
- You (as well as any other members in an LLC) will have income from the lease payments to pay down the debt incurred to buy the property.
- You will be able to start a new depreciation schedule determined by your cost basis in the building. Those deductions can offset the income you receive from the lease payments.

Retirement revenues

A sale-leaseback may be especially attractive if you're about to retire. Lease payments from the company can pro-

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vide supplemental retirement income. Ultimately, you might sell the building to provide even more spending money in retirement. Alternatively, you can hold on to the building and pass it to your heirs, who may get a basis step-up to market value when they inherit. To qualify for all the benefits listed above, the sale-leaseback must be valid.

Among the requirements:

- The property's useful life must exceed the lease term.
- All the terms of the deal—selling price, lease rate, renewal rates, and any repurchase option—must be at fair market value.
- By the terms of the deal, the property buyers must bear some risk of losing money and must have reasonable expectations to profit from the sale-leaseback.

TIPS For Keeping Up With Inflation

As oil prices climb and the value of the U.S. dollar sinks, inflation might pick up. Higher inflation, in turn, can damage your portfolio. One way to protect yourself is to put some money into investments that will act as inflation hedges. For example, you can buy Treasury Inflation-Protected Securities (TIPS).

Safe and sheltered

TIPS are Treasury bonds, so they are protected against default by the federal government. As is the case with all Treasury issues, the interest income from TIPS is exempt from state and local income tax. You can buy new issues of TIPS with 5-, 10-, or 20-year maturities. They can be ordered, generally without a fee, at *www.treasurydirect.gov*. If you don't want to buy and hold TIPS on your own, there are several TIPS funds in which you can invest. They're available from fund families such as Fidelity and Vanguard.

Up with inflation

Despite the similarities noted above, TIPS are different from other types of Treasuries. If you invest $10,000 in a standard Treasury paying 4.5%, for example, you'll collect $450 in interest each year. At maturity, you'll get your $10,000 back. With TIPS, the interest rate might be only 2%. Why settle for a 2% yield when you could get 4.5%? Because TIPS increase in value, to keep pace with inflation.

A matter of principal

Say you invest $10,000 in TIPS paying 2%. Suppose that inflation is running at a 4% rate. TIPS pay interest every six months, and their principal is reset then. If inflation is 4%, the six-month reset would be half that amount: 2%.

Now the TIPS you bought for $10,000 would have a face value of $10,200, including the $200 (2%) inflation adjustment. And so on, every six months. Over the years, your principal might grow to $10,500, $11,000, $12,000, or more, depending on the inflation rate.

Moreover, TIPS investors enjoy compound growth of principal. In our example, TIPS bought at $10,000 were worth $10,200 after six months. If the inflation rate remains at 4%, another 2% increase would result 6 months later. This 2% increase would be based on the reset value of $10,200, so the inflation adjustment would be $204, and the TIPS would be worth $10,404 after one year.

Increasing interest

In the example above, the fixed interest rate was set at 2%. Although the rate is fixed, the interest payments aren't. As TIPS principal increases, that 2% would be paid on the inflation-adjusted principal. Suppose the TIPS you bought for $10,000 reach $12,000 in inflation-adjusted principal. The 2% interest rate would amount to $240 (2% of $12,000) and the semi-annual interest payment would be $120.

Bottom line

Suppose that you bought 10-year TIPS with a 2% interest rate. Further suppose that inflation averages 4% per year for those 10 years. Your ultimate return would be 6% per year: 4% in principal adjustments and 2% in interest payments. You would be better off with TIPS than with a standard Treasury issue yielding 4.5%. In fact, if TIPS pay 2% when Treasuries of the same maturity pay 4.5%, TIPS would be a better choice as long as the inflation rate exceeds the 2.5% difference.

The TIPS tax trap

When you invest in TIPS, you will owe tax each year on both parts of your return—the increase in principal value as well as the interest. Thus, you'll owe tax on money you might not receive for years. Suppose you receive $200 in interest payments from TIPS this year, while the principal grows by $400. You'll owe tax on $600 of income but have only $200 in hand. One solution is to hold TIPS in a tax-deferred retirement account such as an IRA. You won't owe tax until the money comes out of the IRA, so you'll avoid paying tax on "phantom income."

The situation is trickier if you expect to live in a high-tax state when taking money from your IRA.

Withdrawals will be subject to state and local income tax, so you'll be losing the benefit of the tax exemption offered by Treasury bonds. Our office can help you determine whether it makes sense to hold TIPS in a tax-deferred retirement account.

Annualized Inflation Rates	
1997 through 2006	2.4%
1992 through 2001	2.5%
1987 through 1996	3.7%
1982 through 1991	3.9%
1977 through 1986	6.6%
1972 through 1981	8.6%
1967 through 1976	5.9%
1962 through 1971	3.2%
1957 through 1966	1.8%
1952 through 1961	1.3%

Source: Morningstar

Make the Most of Low-Interest Loans From Your Company

If you're a business owner, your company may be a valuable source of cash. Borrowing from your firm may be more appealing than applying for a bank loan or using credit cards for money you need personally. There's a catch, though. If you borrow from your company at a below-market rate, you might have to pick up taxable income equal to an imputed interest rate.

In a truly worst case scenario, the IRS might call the transaction a dividend rather than a loan. You'd have taxable income equal to the amount received, and your company would not get a deduction. Fortunately, there are some exceptions for loans between employees and employers that you might be able to use when borrowing from your company.

Modest amounts

Loans that total no more than $10,000 won't trigger imputed interest. Be sure to make the loan formal, with repayment terms, in order to avoid its recharacterization as a dividend. (In fact, you should make any loan between you and your company formal.)

Relocation

A loan made in connection with a business-related relocation also may avoid such adverse tax consequences.

Example: Your company moves from one area of the U.S. to another. You move to be near the company. In this scenario, your company could loan money to you, interest free. No interest will be imputed if certain conditions are met. Such a loan must be secured by your new residence, which must be at least 50 miles from the old one. The loan must not be transferable. You, the borrower, not only must promise to perform future services, you also must pledge to itemize deductions each year the loan is outstanding.

Bridge loans

In today's housing market, you may find it difficult to sell your home quickly. At the same time, you may want to buy a house right away if your company moves to a new location. The tax code allows you to take a low-interest bridge loan from your company. In order to avoid tax problems, you must meet all of the above conditions for relocation loans.

Other conditions also apply:

- Under the terms of the loan, the debt must be repaid in full within 15 days after the sale of the old home.
- The amount of the loan can't exceed your equity in your old home. (You're allowed to make a reasonable estimate.)
- The old home must be sold rather than converted to business or rental property.

Separate checks

If you hope to qualify for a relocation or bridge loan, a savvy strategy is to open a separate bank account in which the borrowed funds may be deposited. That will make it obvious the loan proceeds have been used to purchase a new residence, helping you to justify your reliance on one of those exceptions.

When it Pays for Married Couples to Split Gifts

Amid political uncertainty, you can't know whether the federal estate tax will be eased or even repealed altogether. In this situation, it makes sense to reduce your taxable estate. You can do so by giving away assets. A gift tax applies, but you can find shelter by using the annual gift tax exclusion and the lifetime gift tax exemption. These tax breaks enable you to shed assets from your estate without paying tax.

Split decision

Married couples have double exclusions and exemptions. If the assets given away come from only one spouse, the couple can elect to "split" gifts. Despite the term, splitting gifts doubles the giver's tax shelter, rather than halving the tax benefits. The annual gift tax exclusion, now set at $12,000 per year per recipient, effectively increases to $24,000 with gift splitting.

Example #1: Jane Smith has three children. She can give them a total of $36,000 worth of assets in 2008 ($12,000 to each) in addition to any payments she makes for medical bills or school tuition. Jane can make that $36,000 worth of gifts without owing gift tax. She won't even have to file a gift tax return. Jane's husband Bob also can give a total of $36,000 to their three children this year. With such gifts, twice as many assets can be removed from their estates in 2008, tax free. This is true even if Bob has minimal assets in his own name and scant concerns about estate tax. By gift splitting, this couple can make the most of their combined gift tax exclusions.

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Doubling up

To split their gifts, Jane could give each child up to $24,000 this year, not $12,000. Then Bob would elect to join in the gift. This election is made on a gift tax return. The split must be 50-50 and both spouses must consent to this election. By consenting, Bob effectively gives $12,000 to each child this year. He uses up his exclusion and cannot make any other tax-free gifts to the children in 2008.

To qualify for gift splitting, spouses must meet certain conditions:

- Both spouses must be U.S. citizens.
- Neither spouse can remarry during the year.
- All gifts made by either spouse to any recipients during the year must be reported as being split 50-50.

Exceeding the exclusion

Suppose you'd like to give more than $24,000 per recipient this year. Gift splitting can still be used as you eat into your lifetime $1 million gift tax exemption.

Example #2: Jane and Bob's oldest child, Lynn, wants to buy a house. Jane decides to help by giving Lynn $300,000. One approach is for Jane to use her $12,000 exclusion and go over the 2008 limit by $288,000. If Jane has made no other taxable gifts, she will owe no gift tax.

That doesn't mean this large gift will be tax free, however. Jane's $1 million lifetime gift tax exemption will be reduced by $288,000, diminishing her remaining gift tax exemption from $1 million to $712,000. What's more, that $288,000 taxable gift will shrink Jane's estate tax shelter. Suppose Jane dies next year, when the federal estate tax exemption is $3.5 million. Assuming Jane has made no other taxable gifts, her estate tax exemption would be reduced by $288,000, from $3,500,000 to $3,212,000.

Instead, Jane and Bob could choose to split the $300,000 gift. Then $24,000 will be covered by the annual exclusion. The excess $276,000 will reduce their lifetime gift tax exemptions and their estate tax exemptions by $138,000 apiece.

Powerful payoff

Gift splitting enables a married couple to give away up to $2 million worth of assets, over and above the amounts sheltered by the annual exclusion, free of the gift tax. Subsequent to the gifts, that $2 million worth of assets might grow to $4 million, $8 million, or more. All of that potential appreciation will escape estate tax.

Of course, you shouldn't give away assets that you or your spouse might need for your own well-being.

Wasted efforts

Gift splitting also may be used for gifts to trusts. Even if the annual $12,000 exclusion can't be used, in some cases the $1 million lifetime exemption may be employed. However, you should not split gifts to certain types of trusts, including qualified personal residence trusts (QPRTs), grantor retained annuity trusts (GRATs), and grantor retained unitrusts (GRUTs). If you split gifts and the grantor dies during the trust term, the other spouse will lose valuable tax benefits.

Example #3: Paul Jones creates a GRAT and transfers assets into it. Based on current interest rates and the duration of the term, the value of the transfer is placed at $400,000. Paul and his wife Ann split the gift, effectively using up $200,000 apiece of their gift tax exemptions. If Paul dies before the trust term, the trust assets would go back into his estate and the $200,000 worth of gift tax exemption that he used would be restored. However, Ann would not get any refund or tax relief. Thus, she would have used up $200,000 worth of gift and estate tax exemption and received no benefit. For these types of trusts, one donor should bear all the gift tax consequences.

Gift and Estate Taxes

Exemption Amounts		
Year	For Gift Tax Purposes	For Estate Tax Purposes
2008	$1 million	$2 million
2009	$1 million	$3.5 million
2010	$1 million	Unlimited

Sources: IRS, American Bar Association

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