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TAX AND BUSINESS *Alert*™

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Some taxpayers have seen the value of their investment real estate decline precipitously during the recent economic downturn. In response, they may have abandoned the idea of making money on their investment and are looking for a way out. Making a charitable gift of the investment real estate to save on taxes may seem like the way to go. However, individuals thinking of donating their devalued property to charity and taking a charitable gift tax deduction should perform a careful analysis to ensure the most favorable result.

Taxpayers considering a donation of property that has decreased in value should note a charitable deduction is limited to the property's fair market value (FMV) at the time of contribution and not necessarily the original purchase price. And, the loss sustained from the decline in value is not deductible for federal income tax purposes. Thus, it is generally better from a tax standpoint to sell the real estate, recognize the loss (if allowable), and donate the proceeds to charity. See the following example.

Example: Contribution of property that has decreased in value.

Fred and Cathy have a large net worth, substantial income, and are charitably

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inclined. They own a parcel of real estate (raw land) held for investment they would like to gift to their church. They purchased the property six years ago for \$180,000.

Unfortunately, the property has declined in value, and a recent appraisal indicates a current value of only \$40,000.

If Fred and Cathy donate the property to their church, their charitable contribution deduction is limited to the *lower* of the property's cost (\$180,000) or FMV (\$40,000), and no deduction for the \$140,000 loss will be allowed. Alternatively, a sale of the property would result in the recognition of a \$140,000 long-term capital loss. A gift of the sale proceeds to the church would then result in a \$40,000 charitable contribution deduction, the same deduction amount as donating the property. But, by selling



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Golf Carts and the Plug-in Electric Drive Motor Vehicle Credit

There has been great deal of confusion lately concerning which vehicles actually qualify for the Plug-in Electric Drive Motor



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Vehicle Credit. The confusion seems to center mainly around whether golf carts qualify. As background, taxpayers can take a tax credit related to

the purchase of a new qualified plug-in electric drive motor vehicle. Among other requirements, the vehicle must be manufactured primarily

for use on public streets and able to reach a speed of 20 miles per hour on level payment. The maximum credit available in 2010 is \$7,500, and it must be claimed in the year the vehicle is placed in service.

In response to media reports describing a tax credit for the purchase of golf carts, the IRS clarified that electric golf carts do not qualify for the credit because they are not manufactured primarily for use on public streets. In addition, most golf carts cannot attain the required 20 mph. So, media reports describing a tax credit for golf carts are generally erroneous.

The IRS has also clarified that there is no limit on either the number of vehicles a taxpayer may purchase or the amount of credit a taxpayer may report as a result of purchasing these vehicles.

Increased Producer Deduction for 2010

The Domestic Production Activities Deduction, also known as the Section 199 deduction or "Producer Deduction," was initially 3% of *qualified production activities income*, jumped to 6% in 2007, but has increased again. The Producer Deduction was established by the American Jobs Creation Act of 2004.

The definition of *qualified production activities*, or QPAI, is very broad. These activities include, but are not limited to, traditional manufacturing of tangible personal property; domestic construction; civil engineering and architectural services for U.S. projects; production of electricity, gas, and potable water; software production; film and videotape production and licensing; growing of agricultural products and food (farming);

and processing agricultural products for food.

The deduction has increased once again in 2010 and is now set at 9% of QPAI. (The deduction remains at 6% for certain oil-related qualified production.) So, if you qualified for this deduction in prior years, your federal tax bill may decrease a bit in 2010 if you continue to qualify. If you did not qualify in prior years, or you did qualify but the benefit was minimal, you might want to take another look at your financials in light of the increased deduction available.

The Producer Deduction is available to individual business owners as well as C corporations, S corporations, partnerships, and other entities. Please call us to discuss this opportunity to reduce your federal income taxes or if you have questions about any individual or business tax compliance or planning issue.

Filing Status and the Final 1040

Although we can't escape death or taxes, we may be able to minimize the federal income taxes due on our final Form 1040. Filing a tax return after we die (we are then known as the "decedent") is probably not something most of us think much about. But, a final Form 1040 generally must be filed for the year of our death, and, just as in life, is typically due by April 15th of the following year. Normal tax accounting rules regarding the recognition of income and deductions generally apply for this final return. And, as is the case during life, tax planning opportunities are available both when death is imminent and after death. For instance, several decisions can affect the income or deductions reported on that final return. However, as we will discuss below, a major decision for married individuals concerns whether to file a joint return for the year of death.

When a married taxpayer dies, and the surviving spouse does not remarry during the year, the spouse may file a joint return with the decedent for the year of death, but is not required to do so. The joint return will include income and deductions for the decedent prior to the date of death and the surviving spouse's income and deductions for the entire year. If the surviving spouse remarries before the close of the tax year that includes the date of death, a separate return must be prepared for the decedent. Listed below are some of the advantages and disadvantages for joint filers to consider when filing that final return.

Advantages of Filing a Joint Return

Since the surviving spouse's tax year does not end upon the death of the decedent, it may be possible to reduce their combined income tax liability. They can accomplish this by accelerating or postponing income or deductions to maximize use of the joint tax rates. Some other benefits include, but are not limited to: (a) use of one spouse's excess deductions against the income of the other spouse (e.g., excess charitable contributions); (b) an increase in the IRA contribution limit (because of the spousal IRA rules); and (c) the

ability of the decedent's net operating loss (NOL), capital loss, and passive activity loss (subject to the limitation) carryovers to offset income of the surviving spouse. Note that any NOL or capital loss carryover of the decedent that is not used on the final return (whether separate or joint) will expire unused.

Disadvantages of Filing a Joint Return

Filing a joint return with the surviving spouse is not always the best option. One disadvantage of filing a joint return for the decedent's final tax year is that the decedent's estate and the surviving spouse are jointly and severally liable for any tax, interest, and penalties due on the joint return. In addition, when the surviving spouse is not the sole beneficiary of the estate, the decedent's personal representative may not be willing to expose the estate to potential unknown liabilities (e.g., tax on the surviving spouse's unreported income). Potentially, this exposure may be avoided because of the innocent spouse rules. Also, filing a joint return can negatively impact the amount of the decedent's deductions that are subject to adjusted gross income (AGI) limitations (e.g., medical, casualty, miscellaneous itemized) since AGI is based on joint income rather than separate income. Finally, the surviving spouse must cooperate with the decedent's personal representative by sharing the information necessary to prepare the return and by signing the return once it is prepared.

Planning for that final 1040 is something we may not think much about, but it is a good idea all the same. Please contact us to discuss this or any other tax-related issue you might have. 📞



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Using Employee Stock Ownership Plans (ESOPs)

The owner of a closely held corporation, including an S corporation, who wants to sell an interest in the business but does not have a buyer, can often use an Employee Stock Ownership Plan (ESOP) to create a market for the company's stock. An ESOP is a special type of qualified retirement plan established for the benefit of the corporation's employees. Unlike the typical qualified plan, an ESOP invests primarily in the employer's



stock. An ESOP may be a stock bonus plan or a combination of a stock bonus plan and a money purchase plan, which has been designed to include the various tax and regulatory requirements of an ESOP.


To create a market for the business, the owner arranges to sell his or her shares in the corporation to the ESOP. The corporation establishes the ESOP for the benefit of its employees and funds it with tax-deductible cash contributions. The ESOP uses the contributed cash to purchase qualifying employer securities from shareholders, who may either remain with the company or retire. ESOPs may also borrow money from the employer, its shareholders, or third parties to purchase stock, and these loans

are exempt from the prohibited transaction rules. An ESOP holding S corporation stock is counted as a single shareholder for the 100-shareholder limit, regardless of the number of ESOP participants.

The stock acquired by the ESOP is allocated to employees' accounts, typically on the basis of compensation. As a qualified plan, amounts allocated to employees' accounts are not taxable to the employees when contributed. Instead, they accumulate on a tax-deferred basis until the employee retires, becomes disabled, dies, or otherwise terminates employment. The employee or beneficiary recognizes income when the stock is distributed or when the stock is sold and the proceeds are distributed to the employee.

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the property, they would have a \$140,000 investment loss that could be used to offset a like amount of investment gains. The loss could also be used to offset ordinary income, but is generally limited to the amount of investment gains (if any) plus \$3,000 of ordinary income per year (filing jointly).

This example demonstrates a facet of the tax code some taxpayers might find surprising. But, as you probably know, that is not unusual. Please contact us if you have any tax compliance or planning questions or if you just want to discuss some tax-saving ideas. 

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