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TAX MATTERS

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It’s time for mid-year tax planning

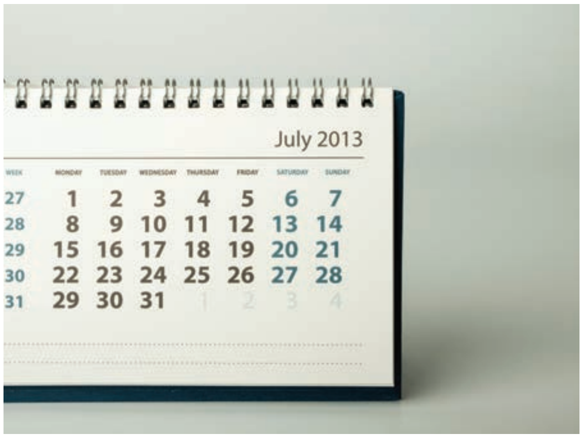
ATRA offers businesses many opportunities

Early this year, the American Taxpayer Relief Act (ATRA) triggered a flurry of activity as taxpayers scrambled to assess the new law’s impact on their 2012 tax bills. Now that the dust has settled, it’s a good time to embark on some mid-year tax planning. Businesses, in particular, have many tax-saving opportunities, some of which might not be available next year. ATRA provides other opportunities, as well.

Invest in equipment and other depreciable assets

If your business needs new equipment or other depreciable property, consider acquiring it this year to take advantage of enhanced deductions before they expire.

Internal Revenue Code Section 179 allows a business to immediately “expense” the full cost of equipment, machinery, furniture, vehicles and other qualifying assets. Before ATRA, the limit on Sec. 179 deductions had been scheduled to drop to $25,000 for 2013. And the investment phaseout threshold (above which the Sec. 179 deduction is reduced dollar-for-dollar) was to



fall to $200,000. But ATRA extended previous limits of $500,000 and $2 million, respectively, through Dec. 31, 2013.

Be aware that Sec. 179 expensing can’t reduce taxable income below zero to create a net operating loss. And, because of the phaseout, businesses that invest $2.5 million or more won’t benefit, because their deduction will be completely phased out.

Fortunately, this doesn’t mean that businesses making larger investments can’t enjoy enhanced depreciation-related breaks under ATRA. The act also extended 50% bonus depreciation through the end of 2013 (2014 for certain transportation and longer-period production property). This provision allows you to immediately write off 50% of the cost of certain capital expenditures, including tangible property with a recovery period of 20 years or less, purchased computer software, water utility property and qualified leasehold improvement property.

Unlike Sec. 179 expensing, which is available for new or used property, bonus depreciation is available only for “original use” property. Generally, this means new property, but in some cases bonus depreciation is available for property a taxpayer converts from personal to business use.

The new law also extends 15-year accelerated depreciation for qualified leasehold and retail improvements and qualified restaurant property placed in service by the end of 2013. And it allows up to $250,000 of the Sec. 179 deduction to be applied to such property. Finally, it allows 50% bonus depreciation to be applied to qualified leasehold improvement property.

Claim research credits

The tax credit for increased research expenditures expired at the end of 2011, but ATRA revived it through Dec. 31, 2013. This valuable credit is complex and widely misunderstood and, as a result, is often overlooked.

If your business conducts research in connection with developing new or improved products, technologies or processes, consult your tax advisor to determine whether you qualify for the credit. It's available to businesses in a wide range of industries, including manufacturing, technology, health care, construction, agriculture, and even retail and finance.

Set up a deferred compensation plan

If you haven't done so already, consider setting up a nonqualified deferred compensation plan for your highly compensated employees. Significant tax increases this year for high earners make these plans an attractive employee recruitment and retention tool.

Deferred comp: Timing is everything

A nonqualified deferred compensation plan offers valuable benefits for highly compensated employees. To avoid losing these benefits, it's critical for employers and employees to comply with Internal Revenue Code Section 409A. Among that section's requirements:

- Employees must make deferral elections *before* the beginning of the year in which they earn the compensation being deferred (except for certain performance-based compensation).
- Benefits must be paid on a specified date, according to a fixed payment schedule or on the occurrence of a specified event (such as death, disability or termination of employment).
- Once compensation is deferred, payments can be delayed (by five years or more) but not accelerated. Elections to delay benefits must be made at least 12 months in advance.

What if employees want to defer a portion of *this* year's compensation to soften the blow of higher taxes? Ordinarily, they'd be required to have made the deferral election in 2012, but there's an exception for newly established plans and new participants in existing plans: Employees can defer 2013 compensation, provided they make the election within 30 days after they become eligible.

A nonqualified deferred compensation plan enables highly compensated employees to defer a portion of their salaries on a pretax basis, reducing the impact of higher tax rates or even moving employees into a lower bracket. It also allows them to set aside funds for retirement well in excess of contribution limits for 401(k) and other qualified plans. This year, the maximum employee deferral to a 401(k) plan is $17,500 ($23,000 for employees 50 or older by the end of the year).

As you consider the benefits of nonqualified deferred compensation, keep in mind that your contributions won't be deductible until your employees actually receive them. Also, familiarize yourself with Internal Revenue Code Sec. 409A, which imposes strict requirements on the timing of deferred compensation. (See "Deferred comp: Timing is everything" above.)

Be prepared

These are only some of the opportunities to consider in light of ATRA. You may benefit from other extended breaks as well, such as the Work Opportunity credit for hiring veterans and people from certain disadvantaged groups, or a wide variety of energy-related breaks. As you consider your tax-planning options for 2013 and beyond, also keep an eye on Congress. New legislation may require you to alter your tax strategies.

Follow the rules when you refinance a home

Are you pondering the idea of refinancing your home? It may be a great time to do so, because mortgage rates continue, as of this writing, to be quite low but are expected to begin to increase. While it's smart to look for the best deal, it's also wise to understand the tax consequences.

There are many ways to say "home"

The mortgage interest deduction is available for interest on loans secured by your principal home or a second home. What's considered a "home"? You might be surprised at what qualifies. For example, U.S. tax law considers a mobile home, trailer or boat to be a home so long as it has sleeping, cooking and toilet facilities.

The tax treatment of interest on a new loan will depend on whether you do a straight replacement loan or a cash-out refinancing.

The tax code allows you to deduct interest on up to $1 million in "acquisition indebtedness" — which is simply debt that's used to buy, build or substantially renovate a home — plus interest on up to $100,000 in home equity debt that's used for *any* purpose. If you're subject to the alternative minimum tax (AMT), however, the rules are more restrictive. So be sure to consult your tax advisor.

The limits apply to the combined principal of all loans secured by your principal and second homes. If your tax status is married filing separately, the limits are cut in half to $500,000 and $50,000, respectively.

The IRS has clarified that homeowners who have more than $1 million in acquisition indebtedness may deduct interest on the excess as home equity debt (subject to the $100,000 limit).

Straight replacement vs. cash-out refinancing

When you refinance your mortgage, the tax treatment of interest on the new loan will depend on whether you do a straight replacement loan or a cash-out refinancing. With a replacement loan, you borrow an amount equal to the outstanding balance on the old mortgage. Interest on the new mortgage is fully deductible, so long as your total acquisition indebtedness is no more than $1 million.

With a cash-out refinancing arrangement, in which you borrow *more* than you need to cover your outstanding mortgage balance, the tax treatment depends on how you use the excess cash. If you use it for home improvements, for example, it's considered acquisition indebtedness, and the interest is deductible (subject to the $1 million limit). If you use it for another purpose, such as buying a car or paying your child's college tuition, it's considered home equity debt subject to the $100,000 limit.

Why points matter

When you buy a home, prepaid interest is deductible immediately. When you refinance, these "points" are amortized and deducted ratably over the life of the loan. Let's say you refinance a $500,000 mortgage with a new, 30-year loan, paying two points ($10,000). Even though you pay the points up front, you must deduct them over 30 years at a rate of $333 per year. (First- and last-year deductions, however, will be less.)

On the other hand, if you're already amortizing points — from a previous refinancing, for example — and you refinance with a *new* lender, you can deduct the unamortized balance in the year you refinance. But if you refinance with the *same* lender, you must add the unamortized points from the old loan to any points you pay on the new loan and then deduct the total over the life of the new loan.

There's an exception for certain cash-out refinancings. You can immediately deduct points attributable to the portion of the new loan that's used to improve your principal residence. In the previous example, if you use $100,000 of the $500,000 loan for home improvements, you can deduct one-fifth of the points, or $2,000, up front.

Work with a pro

Is your head spinning yet? Don't worry; that can be remedied by working with your tax advisor. He or she can explain the rules and run the numbers, so you know exactly what you're getting into when refinancing your home. ◎

Can you afford long-term care?

Consider trading in a life insurance policy for LTC coverage

One of the greatest threats to the financial security of your retirement as well as to the achievement of your estate planning goals may be a nursing home stay or some other form of long-term care. According to the U.S. Department of Health and Human Services (HHS), approximately 70% of people over age 65 will need some type of long-term care services during their lifetimes. And given the staggering cost of such care — private rooms in nursing homes average around $90,000 per year, says HHS — these expenses can take a big bite out of your nest egg.

Long-term care (LTC) insurance can be a great way to protect your wealth against this risk, but it can be expensive, especially if you're already

over 65. One option for funding an LTC policy is to trade in a life insurance policy or annuity contract that you no longer need.

The tax-free exchange

For some time, taxpayers have been allowed to make total or partial tax-free exchanges of life insurance policies and annuity contracts. Typically, annuity exchanges involve nonqualified annuities (as opposed to qualified annuities, which are associated with an employer's qualified retirement plan).

Under Internal Revenue Code Section 1035, you can exchange one life insurance policy for another, one annuity contract for another, or a life insurance policy for an annuity contract without triggering taxable gains. (You cannot, however, exchange an annuity contract for a life insurance policy.)

In 2006, Congress added LTC policies to that list, effective beginning in 2010. This means you can use an existing life insurance policy or annuity to fund the purchase of a new LTC policy without immediate tax consequences.

As long as you exchange an existing policy or annuity for a stand-alone LTC policy, you'll *permanently* avoid tax on the gain. If, however, you exchange it for a policy that combines LTC benefits with life insurance or annuity benefits, any gains that become part of the new policy's cash value or annuity payouts may eventually be taxed. In addition, special rules apply to *partial* exchanges of *annuities* for LTC policies, including a 180-day waiting period before making any withdrawals from the annuity.

Let's look at an example: Nick has a life insurance policy with a $200,000 cash surrender value and a $100,000 tax basis. He exchanges it for a $200,000 single-premium, stand-alone LTC policy. Before 2010, Nick would have owed tax on the $100,000 gain. But now it's an income-tax-free exchange. If the insurance company didn't offer single-premium policies, Nick could have financed the purchase using a series of partial tax-free exchanges to meet his annual premium obligations.

To execute an exchange, you must arrange a *direct transfer* of funds from one insurance carrier to the other. If you take possession of the funds — no matter how briefly — you'll be treated as if you'd made a taxable surrender of the policy or contract. Unlike an IRA, there's no "rollover" option for tax-free exchanges.

As long as you exchange an existing policy or annuity for a stand-alone LTC policy, you'll permanently *avoid tax on the gain.*

Handle with care

Before you execute a tax-free exchange, discuss the process with your advisors. Compare the benefits of an exchange with other financing options and review your current financial needs to be sure you can do without the life insurance policy or annuity that would be exchanged. ◎

Charitable deductions: Form over substance

To support a charitable deduction, you need to comply with IRS substantiation requirements. This generally includes obtaining a *contemporaneous* written acknowledgment from the charity stating the amount of the donation, whether you received any goods or services in consideration for the donation, and the value of any such goods or services. "Contemporaneous" means the *earlier* of 1) the date you file your tax return, or 2) the extended due date of your return.

A recent U.S. Tax Court case (*Durden*) demonstrates the importance of obtaining proper acknowledgment on a timely basis. In that case, the taxpayers claimed deductions for donations to their church, substantiating them with canceled checks and a written acknowledgment from the church.

The IRS denied the deduction, however, because the acknowledgment failed to state whether the taxpayers received goods or services in consideration of their donations. The taxpayers obtained a second acknowledgment from the church that contained the required statement, but the IRS — and the Tax Court — refused to accept it because it wasn't "contemporaneous." ◎

Home office deduction simplified

Earlier this year, the IRS announced an optional "safe harbor" method for claiming the home office deduction. Beginning with their 2013 tax returns, taxpayers can use this method in lieu of calculating, allocating and substantiating their actual expenses. Other rules — such as the requirement that the office

be used regularly and exclusively for business — still apply.

The safe harbor deduction is capped at $1,500 per year, based on $5 per square foot up to a maximum of 300 square feet. Homeowners who take advantage of the safe harbor can't depreciate the business portion of their homes, but they can claim allowable mortgage interest, property taxes and casualty losses on the home as itemized deductions — without allocating between personal and business use. The safe harbor doesn't limit deductions for business expenses unrelated to the home. ◎

Now may be the time to buy QSBS

The American Taxpayer Relief Act extended the 100% exclusion for gain on sales of qualified small business stock (QSBS) to QSBS acquired through 2013. If you invest in QSBS by the end of this year and hold the stock for more than five years, you'll be able to sell it *tax-free*. The requirements for a stock to qualify as QSBS are complicated, but your tax advisor can help determine whether a particular stock is eligible for this tax break. ◎

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