Client Bulletin

CPA Client Bulletin
Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

New IRS Rules May Offer Tax Breaks for Property Owners

May 2012

What's Inside

The IRS has published temporary regulations on the tax treatment of tangible property. These regulations are effective now, and they may create valuable tax saving opportunities for property owners.

What they cover

The new rules provide guidance on amounts paid to acquire, produce, or improve tangible property. The IRS states that they cover the accounting for, and dispositions of, property subject to depreciation. The published regulations are 68 pages long, covering many topics.

Among those topics, the regulations illustrate when taxpayers can immediately deduct outlays for property repairs. Such costs usually are considered deductible repair expenses if they do not materially add to the value or to the useful life of property. Conversely, activities that increase or restore a property's value, substantially add to its useful life, or adapt it to a different use are considered improvements. The money spent on improvements must be capitalized and depreciated over a period of years.

Under the new regulations, repairs made during a time when a property is being renovated or rehabilitated may be deducted if they were not incurred because of the improvement. The costs of routine maintenance on property that is not a building or structural component are generally deductible.

The regulations define routine maintenance as a recurring activity that a taxpayer expects to perform to keep property in its ordinarily efficient operating condition. Examples include inspection, cleaning and testing of an item of equipment, and replacement of parts of the equipment with comparable replacement parts.

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Senior Statistic

On average, retired households spend about 80% of what working households spend.

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Determining deductions

The regulations also may provide tax relief to property owners who remove a component of a building and replace it. An owner in this situation is not required to capitalize and depreciate the amount paid for the old part while also capitalizing and depreciating the amount paid for the new one. The retirement of a structural component of a building can be considered a separate disposition; the new regulations allow the property owner to recognize a loss on the disposition of a structural building component before the disposition of the entire building. Therefore, the owner will not have to keep depreciating building components that are no longer in service.

Under these new rules, property owners may want to commission certain studies to see if any substantial tax savings can be realized under the new rules. For instance, a property owner might benefit from a building component study that documents the original cost of building components or systems that the owner has replaced.

Example 1: Mary Palmer owns an apartment building. She spends $225,000 to replace the entire roof of the building. Under the new regulations, Mary must capitalize the cost of the new roof and recover her expense via depreciation.

Mary hires a qualified party to perform a building component study, which concludes that the old roof had a cost of $150,000. The new regulations permit Mary to deduct the adjusted depreciable basis of the old roof. If that adjusted depreciable basis is $112,500, Mary is entitled to a $112,500 tax deduction in the year the new roof is installed. Mary won't have to keep depreciating the old roof and deducting a few thousand dollars each year.

Looking at leases

A lease abandonment study also might be worthwhile. Such a study could document the costs necessary to prepare a property for a new tenant.

Example 2: Nick Raymond purchased a fully occupied building a few years ago. In 2012, one tenant vacates a leased space. Nick decides that he needs to remove and replace some of the components put in place for the former tenant in order to attract a new tenant. The replacement items include walls, electrical wiring, plumbing lines, and ceiling tiles.

Nick commissions a lease abandonment study and determines the replaced items cost $60,000. Under the new regulations, Nick can deduct the adjusted basis of the replaced items, which might come out to be about $51,000, in 2012. Again, this upfront deduction is more valuable than extended depreciation.

If you are a property owner and you plan on replacing a structural component or renovating a tenant's space, contact our office to see if the temporary regulations can help deliver sizable tax savings. ■

Did You Know?

Health care spending is the only budget item that steadily increases with age. Such outlays account for about 10% of expenses for those between ages 50 and 64, but increases to approximately 20% for those age 85 and over.

Source: Employee Benefit Research Institute

The Gift Tax Still Matters

The Internal Revenue Code includes a gift tax. One of the reasons for having a gift tax is to prevent people from avoiding the estate tax by making gifts during their lifetime to reduce the size of their taxable estate. There is a unified lifetime exclusion amount for the gift and estate taxes ($5.12 million in 2012). Because the exclusion is unified, the amount of the exclusion used to prevent taxation on lifetime gifts reduces the amount of the exclusion that can be used to reduce the estate tax.

Additionally, there is an annual gift tax exclusion, which is currently $13,000 per recipient. If an individual makes gifts equal to or less than the annual exclusion amount to a recipient, the individual's lifetime exclusion is not reduced.

Example: Bonnie Dawson, an elderly widow with a net worth over $8 million, gives $4 million to Richard Dawson, her only child, in 2012. Say that Bonnie dies in 2016 with a $4 million estate. If the federal estate tax exclusion in 2016 is $5.12 million, as it is in 2012, Bonnie's estate will be under the threshold and, thus, owe no federal estate tax.

That is, Bonnie's estate would owe no estate tax if not for the federal gift tax. After the annual $13,000 exclusion, Bonnie's $4 million gift to Richard results in a taxable gift of $3,987,000. In 2012, the lifetime gift tax exclusion is also $5.12 million. Assuming Bonnie had not made any taxable gifts in the past, she will not have to pay gift tax, but her $3,987,000 taxable gift in 2012 will reduce her gift and federal estate tax exclusion by that amount. Consequently, Bonnie has only a $1,133,000 estate tax exclusion remaining. If Bonnie dies with a $4 million estate when she has a $1,133,000 exclusion remaining (this assumes no increase in the exclusion amount before her death), her estate will be nearly $3 million over the limit. The federal estate tax bill could top $1 million.

Uncertain future

As mentioned, the federal estate tax exclusion is now $5.12 million. Under current law, married couples effectively have a $10.24 million estate tax exclusion, no matter which spouse dies first. Therefore, many people believe they will not owe any estate tax. If estate tax isn't a threat, why pay attention to the gift tax?

There may still be reasons to plan around the gift tax. For one, there is no guarantee that the current federal estate tax exclusion amount will remain in place. If no legislation is passed between now and year-end 2012, the gift and estate tax exclusion will drop from $5.12 million in 2012 to $1 million in 2013. Even if that drop is averted by legislation this year, the exclusion amount could be reset below $5.12 million, perhaps to $3 million or $3.5 million. (President Obama has proposed setting the estate tax exclusion amount at $3.5 million in 2013.) The lower the estate tax exclusion, the more estates will be subject to estate tax, and the more families that could benefit from gift tax planning.

Another reason to plan for the gift tax is that the numbers mentioned previously relate to federal estate tax. Many states have their own estate tax, with exclusions much lower than $5.12 million. If you leave an estate worth, say, $2 million or $3 million, your heirs might owe hundreds of thousands of dollars in state estate tax. Depending on where you live, knowing how the gift tax works can lead to strategies that will reduce state estate tax.

Yet, one more reason to keep the gift tax in mind is the requirement to file a gift tax return. In general, an individual must file a gift tax return if he or she gives gifts in excess of the exclusion amount to a donee. Although the lifetime gift tax exemption is ample, at $5.12 million, the 2012 annual gift tax exclusion is modest, at $13,000. If you make a gift contribution of $15,000 to your child's 529 college savings plan in 2012, you'll be over the filing threshold. In that case, you'll have to file a gift tax return.

To avoid adding hassle and paperwork to your life, try to stay within the $13,000 limit this year. That amount will rise in the future, to track inflation. ■

Investing on Margin Increases Risk and Potential Rewards

Although stocks have been volatile lately, they have been attractive long-term investments. The broad U.S. stock market has returned approximately 10% a year for the past 25, 30, 35, and 50 years—and that's still true after the bear markets of 2000–2002 and 2008–2009. If you have a long time horizon and can tolerate periodic slides, you probably should hold some of your portfolio in stocks or stock funds.

Investors who can tolerate stock market risks may be able to enhance returns by investing on margin, or borrowing from their broker to buy securities using their own holdings to secure the loan. Assuming that stocks continue to rise, long term, margin investing can increase your exposure

and your overall gains. You shouldn't overlook the risks of margin investing, but you also should realize that tax advantages may push your investment results toward the plus side.

Double play

When you invest on margin, you borrow money to buy securities. Once you set up a margin account with your brokerage firm, the firm will lend you money, secured by your holdings there. Base interest rates on margin loans might be in the 6%–7% range now, but you can pay more or less if you have a small or large account with the firm.

Typically, the maximum margin allowed on stocks is 50%. By borrowing, say, $50,000 on margin, you

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can buy as much as $100,000 worth of stocks. Then you'll stand to gain or lose twice as much as you would if you had not invested on margin.

Where do the tax benefits come in? The interest you pay on a margin loan may be tax deductible (see the Trusted Advice column "Deducting investment interest" for more information).

Example: Say you get a margin loan at a 6.5% interest rate, and your effective tax rate (federal, state, local) is 35%. With a 35% tax deduction, your net borrowing cost is 4.225%: 65% of 6.5%. If your after-tax investment returns from the assets bought on margin top 4.225%, you'll benefit from using the margin loan. Based on long-term stock market results, investing on margin can be a reasonable strategy for those who can tolerate the risk.

Moreover, the tax savings from deducting margin interest come right away. For many stock market investors, substantial taxes are deferred for many years, until they sell the shares, and favorable long-term capital gains rates may apply.

Although the numbers may seem favorable, don't downplay the risks involved with investing on margin. If your investments lose value, you may get a margin call—a demand for more cash or securities in your brokerage account. If you don't provide the cash or securities that your broker requires, the firm can sell securities from your account and use the proceeds for loan repayment. One way to reduce this risk is to use less margin—20% or 30%, perhaps, instead of 50%. You'll own less stock, but you'll also have less chance of receiving a margin call. ■

Trusted Advice

Deducting investment interest

- Margin interest is investment interest if the money you borrow from your broker is used to purchase assets held for investment, rather than for other purposes.
- Investment interest expense may be deducted. Typically, the amount you can deduct is no more than the amount of your net investment income, which includes interest income from investments.
- You cannot deduct investment interest incurred to buy tax-exempt bonds.
- You can include qualified dividends and net capital gains as net investment income, but doing so will disqualify those dividends and gains from using the special 0% and 15% tax rates.
- Our office can help you make tax-efficient decisions on how much net investment income to report.

TAX CALENDAR

MAY 2012

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2012

June 15

Individuals. If you are not paying your 2012 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2012 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2011. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2012.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

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