KOS
KESSLER ORLEAN SILVER
CERTIFIED PUBLIC ACCOUNTANTS
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UPDATE
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What's to Like About Like-Kind Exchanges?

The real estate market is in the midst of an extended slump throughout most of the country. That makes it more difficult for investors to buy or sell buildings and other property. To compound matters, a sale could result in significant tax consequences for real estate property that has appreciated in value since it was acquired.

Fortunately, there is a way you may be able to avoid any dire tax problems. Assuming a suitable replacement property can be identified, you can arrange an exchange of properties. As long as the properties are "like-kind," you generally do not have to pay any current tax on the exchange.

HOW IT WORKS

The rules for like-kind exchanges apply to investment or commercial property. (They cannot be used for personal residences.) This refers to the nature, character or class of the property—not its grade or quality. For example, a swap of an office building for an apartment building of the same value can qualify as a like-kind exchange. As a result, neither party has to report taxable income.

Other types of property may qualify under the rules, but the majority of these transactions involve real estate. However, in the real world, trading real estate properties is usually not so simple.

FORTUNATELY, THERE IS A WAY YOU MAY BE ABLE TO AVOID ANY DIRE TAX PROBLEMS.

CASE IN POINT

Suppose you want to acquire real estate, but the owner is not interested in any of the properties that you own. The tax law allows you to take the "like-kind exchange" concept one step further. The exchange can involve multiple parties if the two owners cannot agree on the properties to be swapped.

The IRS has approved the use of a qualified intermediary to facilitate the deal, as long as the intermediary is not connected to one of the other parties. Be aware that time restrictions are involved in a multiple-party swap. In general, (1) the property you are receiving must be identified within 45 days of the original transfer and (2) you must take title within 180 days (or your tax return due date plus any extensions, if that is sooner).

EXAMPLE

Say that Mr. Able wants to acquire property owned by Ms. Baker. However, Able does not own any property that Baker desires in return. After discussing a number of locations, the two of them strike a deal with Mr. Clay. Baker agrees to take Clay's property, Clay acquires title to a property owned by Able and Able obtains the property he wanted all along.

Assuming like-kind properties are involved, the entire transaction may be tax-free if the deal is completed within the necessary deadlines.

There is, however, one catch: if you receive any money or property as part of the deal, the additional amount—called "boot" in tax lingo—is subject to income tax. On the other hand, no loss is recognized by the taxpayer who provides the boot. The assumption of a greater mortgage is also treated as taxable boot for this purpose.

Finally, be aware that the IRS recently announced that it is on its guard for like-kind exchanges it considers to be abusive in nature. This is a complex area of the tax law, so be sure to consult with us before you strike a deal.

New Joint Crackdown on Employment Taxes

The IRS figures the more, the merrier. That is why it has announced it is teaming up with more than half of the individual states to resolve employment tax issues and corral offenders. This collaborative effort is intended to provide a centralized and uniform methodology for improving employer compliance in this area.

DETAILS

The new initiative is the by-product of the teamwork between various state agencies, the U.S. Department of Labor, the National Association of State Workforce Agencies, the Federation of Tax Administrators and the IRS.

As of this writing, 29 states are represented in information-sharing agreements. They are, in alphabetical order: Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington and Wisconsin. More are expected to follow.

The IRS and the states are hoping that their joint efforts will reduce fraudulent filings, uncover tax avoidance schemes and ensure proper worker classifications. In particular, it will try to clarify the features distinguishing independent contractors from employees. This classification of workers is often contested by both sides.

QUESTIONS

What can employers expect to occur? The IRS and the participating states hope to accomplish the following:

- An exchange of employment tax information for civil cases involving attempts to evade or inappropriately reduce employment tax liabilities;
- An exchange of information using either actual employment tax reports or a template compatible with federal and state information that the oversight team has developed;
- Participation in coordinated enforcement efforts;
- Sharing of independently conducted examination results or side-by-side cooperation on an examination;

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Build an Estate Plan for the Future

Despite the scheduled repeal of the federal estate tax in 2010, the tax will be revived in 2011—with a vengeance—unless Congress takes action. Thus, estate planning remains a critical concern for well-to-do families. Fortunately, however, there are various estate-planning tools at your disposal that may benefit your heirs. Here are a few prime examples.

WILL

A will is usually the centerpiece of an estate plan. For one thing, your assets are distributed according to its terms. Secondly, it may contain other key provisions (e.g., naming the guardian for minor children). And you can use a will to establish tax-saving trusts (see below).

Naturally, a will does not do much good if your assets cannot be located or the terms are not clear. It is generally recommended that you prepare a letter of instructions to accompany your will.

CREDIT SHELTER TRUST

This type of trust is used by married couples to maximize the tax benefits of the federal estate-tax exemption in conjunction with the unlimited marital deduction. Currently, the credit can be used to shelter up to $2 million from estate tax. (This figure will increase to $3.5 million for 2009 before the estate tax is eliminated in 2010. The tax is scheduled to be revived in 2011 with a less-favorable estate-tax exemption.)

LIVING TRUST

A living trust allows you to pass assets to beneficiaries without going through probate. In some cases, this can save both time and money for your family. However, a living trust is generally used as a complement to a will—not as an outright replacement. Note: Living trusts may cause other complications, depending upon the applicable state laws.

CHARITABLE REMAINDER TRUST

If you own property that has appreciated in value, you might set up a charitable remainder trust. Typically, the trust provides you with income during your lifetime. After your death, the proceeds go to a designated charity. As an added incentive, you are entitled to a current tax deduction based on the value of the property transferred to the trust.

GRATS AND GRUTS

Grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs) are devices that allow you to receive payments for a term of years or your lifetime. The remainder then goes to the named beneficiaries. In brief, a GRAT pays out a fixed amount while a GRUT is based on a fixed percentage of assets. In either case, the trust is irrevocable.

Use these tools in tandem as part of a comprehensive estate plan. We can provide guidance in this area.

Putting a Mortgage Into Reverse

For some homeowners in a tough spot, it may make sense to "back into" a reverse mortgage. In brief, this financial-planning technique allows you to tap the equity that has been building up in your principal residence over the years. It may be used to help pay expenses of elderly people during retirement or to free up cash for medical procedures or other unexpected emergencies.

Instead of a conventional mortgage where you pay the bank (or another financial institution) each month, the bank pays you. That is why it is called a "reverse" mortgage.

HOW IT WORKS

A reverse mortgage is the direct opposite of a conventional mortgage. With a conventional mortgage, you receive a lump sum that is combined with your down payment. Then you repay the loan principal, plus interest, through installments over a period of time (e.g., 15 or 30 years).

Conversely, with a reverse mortgage, the lender provides you with monthly payments based on the appreciated value of your home. Thus, you can benefit from your build-up in equity on the home while you are still living there.

Note that a homeowner must be at least 62 to qualify for a reverse mortgage. If you are married, both you and your spouse have to meet this age requirement.

The actual amount you are eligible to receive each month depends on a number of factors including:

- **Your age and life expectancy or the ages and life expectancies of a married couple;**
- **The current value of the residence;**
- **The amount of the total equity you are relinquishing;**
- **The length of the loan term; and**
- **The annual interest rate charged by the lender.**

As you might imagine, the older you are and the more your home is worth, the more money you are likely to receive.

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BRIEFS

INVESTMENT ADVISORY FEES

In a significant new case, the U.S. Supreme Court has ruled that the usual 2%-of-AGI (adjusted gross income) deduction floor for miscellaneous expenses applies to most investment advisory fees paid by a trust or estate. The trustee of an affluent family's trust argued that the fees were fully deductible under a tax law exception. But the nation's high court disagreed because the fees are miscellaneous expenses that are commonly incurred by individuals.

DOUBLING UP

Certain workers may be entitled to time off under the Family and Medical Leave Act (FMLA). However, that does not necessarily mean they can "double up" by working another job at the same time. One suggestion for employers: impose a "no moonlighting" policy in your company manual. Be consistent about applying the ban. This may prevent employees from taking unfair advantage of the law. Recent FMLA changes will be reflected in a future issue.

FAST TRACK SETTLEMENTS

The IRS has announced that it is expanding its "fast track settlement plan" for small-business owners and self-employed individuals. This initiative is designed to expedite case resolution. Initially, it was being tried out in Chicago, Houston and St. Paul, MN. Now five more areas have been added: Philadelphia; central New Jersey; San Diego; Laguna Niguel, CA; and Riverside, CA. The IRS says it will evaluate the benefits of the plan later this year.

ACCENTUATING THE POSITIVE

It may seem counter-intuitive, but some business experts advise you to concentrate on the strengths of your employees rather than their weaknesses. This philosophy is based on the principle that you can increase productivity by challenging your best people to do more. Conversely, dwelling on the negative may result in decreased productivity. Since your time is valuable, focus your main efforts on boosting spirits instead of dampening them.

TIPS, TRAPS & TRENDS

HOW TO GIVE STOCK TO CHARITY

Depending on your situation, you may decide to give a gift of stock or some other appreciated property instead of cash to a charity. The rules are slightly more complicated, but the tax benefits for such generosity may be well worth it.

Basic Premise

If you donate stock that would qualify for long-term capital gain if you sell it (i.e., you have held the stock for more than one year), you can deduct an amount equal to its fair-market value. On the other hand, if the stock would not qualify for long-term capital gain treatment if it is sold (i.e., it has been held for one year or less), your deduction is limited to your basis in the stock.

Of course, this could affect the way you give to charity. For instance, let's say John owns Fast Track stock that cost him $5,000 11 months ago. The stock is currently worth $8,000. If John gives the Fast Track stock to charity, his deduction is limited to an amount equal to his $5,000 basis. However, if John waits just one more month and a day to donate the stock, his deduction is increased to its $8,000 fair-market value.

In other words, you get the tax benefit of appreciation in value when you donate property held more than one year. You are never taxed on the $3,000 appreciation in value.

Similarly, you might choose to donate low-basis stock instead of high-basis stock absent any extenuating circumstances.

Suppose the stock you are donating to charity has declined in value. In that case, your deduction is limited to the fair-market value, regardless of how long you have held the property. You cannot deduct the difference in your basis and the stock's fair-market value.

Other Considerations

Other special rules apply to gifts of appreciated property. For instance, if you donate artwork to a museum, your deduction is limited to your basis in the property if it is not used to further the charity's tax-exempt function. Stipulate that the artwork must be displayed where it can be viewed by the public.

Whether property has appreciated or depreciated in value, you should obtain an independent appraisal of the property's current worth. This is the best proof you can have if your deduction is ever challenged by the IRS. Also, you are required to attach an appraisal to your return for property donations exceeding $5,000.

KNOW THE TAX BOUNDARIES FOR INVESTMENT INTEREST

There are times when it may make sense to borrow money to make an investment. Can you deduct the interest paid on the loan for your personal tax return? The short answer is "yes," but there are limits on the deduction.

To further complicate matters, you may have to make a crucial decision at the time you file your tax return. It involves the tax treatment of capital gains and dividends.

Basic Rules

You may only deduct investment interest that is directly attributable to investment purposes. For instance, if you take out a loan for a personal vacation, the interest is nondeductible. It is purely a personal expense.

If a loan is made partially for investment purposes and partially for personal reasons, you must make an allocation based on the appropriate percentage. We can help with the necessary calculations.

Qualified interest may be deducted on your personal tax return only up to the amount of your net investment income. This is the amount of your investment income reduced by investment expenses other than interest.

For purposes of this tax law limit, investment expenses are income-producing that are allowable deductions after applying the 2% limit on aggregate miscellaneous itemized expenses. A few examples of these deductible income-producing expenses are certain fees for investment advisory services, safe deposit box rentals (for investments other than tax-exempt securities), etc.

Investment income includes such items as interest, dividends, royalties, gains from sales of investment property and income from annuities. However, net long-term capital gain and dividends qualifying for the preferential tax status generally do not count as investment income for purposes of the investment interest deduction, unless you make a special election.

Key Point

You can choose to include long-term gain and low-taxed dividends in your net investment income computation, but you must reduce the gain eligible for the maximum tax rate by the same amount. Currently, the maximum tax rate for long-term capital gain and most domestic dividends is 15% for taxpayers with a regular income tax bracket higher than 15%.

For other taxpayers with a regular income tax bracket of 10% or 15%, the preferential tax rate on long-term capital gain and qualified dividends is only 5% for 2007.

Even Better

This 5% tax rate is scheduled to drop to 0% for 2008 through 2010.

Finally, other special tax rules, such as limits on passive activities, may also come into play when the computations are made. This requires a thorough examination of your personal facts and circumstances.

Don't jump to any conclusions. Discuss your personal situation with us.

Putting a Mortgage Into Reverse

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OTHER CONSIDERATIONS

Because reverse mortgage payments are considered payments on a loan, they are not subject to federal income tax. In addition, the payments should not affect eligibility for Medicare or Social Security benefits.

Of course, there are various other considerations for homeowners. For instance, be sure to check out all the costs (e.g., points, appraisal fees, etc.) that are part of the deal. As an alternative, you may also want to consider a reverse mortgage that lets you retain some of the appreciated value in your home.

In addition, you might not be so quick to dip into the home equity you have worked so hard to establish. You might also consult with other family members who could be affected by this technique. Clearly, it could have long-term ramifications. Thus, this technique is not right for everyone.

You are legally required to have financial counseling before you embark on a reverse mortgage. Make sure you understand all of the implications before you commit to this type of arrangement. We can help.

NEWS FROM KOS

Jeff Arnol's daughter, Alyssa, graduated from Deerfield High School and will be attending the University of Wisconsin – Madison in the fall. She will be a third generation Badger.

Scott Brown ran in the One America Half Marathon in Indianapolis in May. The race was to raise funds for the Leukemia and Lymphoma Society.

Barb Vela's grandson, Matthew, graduated Palomba Junior High School in May and will be attending Grayslake North High School in the fall.

Sandy Alper's grandson, Tyler, also graduated Hawthorne Middle School South and will be attending Vernon Hills High School in the fall.

Geoff Harlow's daughter, Kay, graduated from Evanston Township High School and will be attending Indiana University in the fall.

Lynn Steer's granddaughter, Elizabeth, graduated Palatine High School and her grandson, Justin, graduated from DePaul University with a masters in business with a concentration in finance.

Larry Krupp became Vice-President of the University of Illinois Library Friends Foundation. He and Valerie Anderson-Jones attended the Chicago-Kent College of Law Annual Conference on Not-for-Profit Organizations in May.

Geoff Harlow appeared twice on the NBC 5 News prior to April 15, discussing tax-saving ideas. Geoff also received a Distinguished Service Award from the Illinois CPA Society.

KOS UPDATE

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New Joint Crackdown on Employment Taxes

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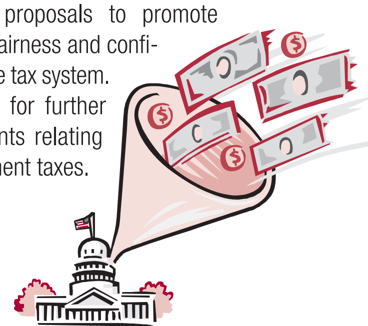
- A concerted attempt to be consistent with their examination results, reducing the chances that states might classify a worker as an employee while the IRS classified the worker as an independent contractor or vice versa.
- Sharing employment tax training opportunities and materials; and
- Sharing outreach opportunities to the business community whenever that is practical.

The new initiative meets the necessary disclosure requirements for ensuring the privacy of taxpayer information. In addition, all participating states must demonstrate that they have systems in place to ensure the safety of any IRS data they will receive as a part of the information-sharing agreements.

The joint crackdown is also expected to result in legislative proposals to promote increased fairness and confidence in the tax system. Stay tuned for further developments relating to employment taxes.



For questions or comments about the **KOS UPDATE** newsletter please contact **Jeffrey Arnol** at **jarnol@koscpa.com** or **Jeffrey Butler** at **jbutler@koscpa.com.**

To add the name of a friend or associate or to update your own address, just send it to **info@koscpa.com.**

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