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TAX IMPACT

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Tick tock

Timing is everything when making philanthropic decisions

If philanthropy is important to you, determining the best time to make charitable gifts can be a complex decision. There are many factors, both practical and financial, to consider.

When today is better

Perhaps the most important decision you must make is whether to make donations during your lifetime or after your death through your will or living trust. One advantage of making lifetime gifts is that you can see how your generosity makes a difference.

Lifetime gifts generally are advantageous from a tax standpoint as well. When you leave property to charity in your will or living trust, your estate can claim a charitable deduction to the extent that the property is included in your gross estate. If you donate property during your lifetime, however, not only is the property's value excluded from your estate — resulting in the same estate tax benefit as a bequest — but you're also entitled to a charitable income tax deduction.

Keep in mind that charitable income tax deductions are limited based on your adjusted gross income (AGI), the type of asset donated and the type of organization receiving the gift. (See "AGI limitations on charitable contribution deductions" on page 3.) Donations in excess of the limit can be carried over in most cases for up to five years and in some cases up to 15 years.

When later is better

Sometimes, charitable bequests are preferable to lifetime gifts. Here are a few such situations:

- If you're uncertain about your future financial needs, large lifetime gifts may be risky. By making gifts in your will or living trust, you retain the ability to use these resources during your life.
- The charitable estate tax deduction generally is unlimited, so a charitable bequest may be preferable if the AGI limits would reduce the benefits of the charitable income tax deduction.
- If you wish to benefit a foreign charitable organization, it's preferable to do so through your will or living trust. You can claim charitable deductions for income tax purposes only for gifts to U.S. charities, while your estate may also deduct donations to foreign charities.

Your gifting strategy and your spouse

If you're married, you can use a charitable bequest strategy to deduct the fair market value of ordinary income property. For example, if you make a lifetime donation of ordinary income property to a public charity, the deduction is limited to the property's cost basis and also is subject to the 30% AGI limitation.

An alternative is to leave the property to your spouse in your will or living trust. The bequest is shielded from estate tax by the unlimited marital deduction,

and your spouse's cost basis in the property is "stepped up" to its fair market value. Your spouse can then donate the property to charity and take an income tax deduction for its full fair market value.

Make smart charitable gifts

These are just a few examples of the factors you should consider when planning for charity. To make the most of your charitable gifts, it's important to understand the differences between charitable income tax and estate tax deductions.

AGI limitations on charitable contribution deductions[1]

		Private foundations[2]	
	Public charities	Operating	Nonoperating
Contribution type			
Cash and unappreciated property	50%	50%	30%
Ordinary income property[3]	50%	50%	30%
Long-term capital gains property[4]	30%	30%	20%

[1] For this purpose, adjusted gross income (AGI) is computed without regard to the deduction for charitable contributions and any deduction for a net operating loss carryback.
[2] An operating foundation spends at least 85% of the lesser of its adjusted net income or its minimum investment return in carrying out its exempt activities and meets certain other tests. Others not meeting this definition are nonoperating foundations.
[3] Deduction is generally limited to the property's adjusted basis.
[4] Generally, the full fair market value of the property is deductible, subject to the percentage limitations.
Source: U.S. Internal Revenue Code

Choosing when to start collecting Social Security

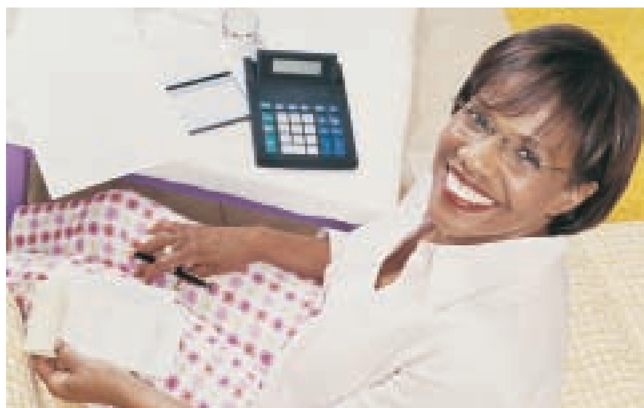
Although Social Security likely won't provide enough income for you to maintain your desired lifestyle during retirement, the benefits can still be significant. For example, someone earning $100,000 per year can expect to receive annual benefits in the neighborhood of $25,000. So, Social Security is an important factor to consider in your retirement planning — especially in deciding when to start collecting benefits.

Calculating your benefits

To qualify for Social Security benefits, you must accumulate at least 40 "work credits" during your working life. You earn one work credit for a specified dollar amount of earnings up to four credits per year. All full-time and many part-time workers can earn the work credits they need in 10 years.

Your benefits are based on the average of your highest 35 years of earnings. Earnings you receive before age 60 are indexed for inflation so that they approximate current dollars. For example, if you earned $60,000 in 1980 and retire in 2007, that figure will be more than $170,000 for purposes of calculating your Social Security benefits.

Your monthly benefit is calculated by applying a formula to your average indexed monthly earnings. You



can estimate your benefits using the information provided on your annual Social Security Statement, which you should receive a few months before your birthday, or the online benefit calculator at www.socialsecurity.gov.

The amount of your monthly payment is based on when you begin to collect benefits. Normal retirement age ranges from 65 to 67, depending on when you were born. (See "Normal retirement ages and reduced benefits" on page 4.) You can start collecting benefits as early as age 62, but your monthly benefit will be reduced. You can also wait until you reach normal retirement age and receive a higher monthly payment or wait longer and receive an even larger payment.

Normal retirement ages and reduced benefits

Year of birth	Normal retirement age	Benefit reduction at age 62
1937 or earlier	65	20.00%
1938	65 and 2 mos.	20.83%
1939	65 and 4 mos.	21.67%
1940	65 and 6 mos.	22.50%
1941	65 and 8 mos.	23.33%
1942	65 and 10 mos.	24.17%
1943-1954	66	25.00%
1955	66 and 2 mos.	25.84%
1956	66 and 4 mos.	26.66%
1957	66 and 6 mos.	27.50%
1958	66 and 8 mos.	28.33%
1959	66 and 10 mos.	29.17%
1960 and later	67	30.00%

Source: U.S. Social Security Administration

When to pull the trigger

So, how do you determine the right time to begin collecting Social Security benefits? Unfortunately, there's no one right answer. It depends on several factors, including your health, future work plans and other sources of income, such as personal savings and employer-provided retirement plans.

If your current income isn't enough to meet your needs, collecting benefits early may be a good idea. Your monthly benefit will be discounted, but because Social Security pays out for the rest of your life — regardless of when you start taking payments — you'll receive payments for more years and thus may ultimately receive more total benefits.

If you plan to keep working and your income is sufficient to meet your day-to-day needs, it's usually best to put off collecting benefits at least until you reach normal retirement age. If you take the benefits earlier, your payments will be reduced if your earnings exceed a specified threshold.

Say, for example, that you reach age 62 and elect to begin collecting Social Security immediately. Your annual benefits will be reduced by $1 for every $2 you earn over $12,960 (for 2007). Once you reach normal retirement age, however, you can continue to work without reducing your benefits, though earnings above certain amounts may subject your Social Security benefits to federal income taxes.

If you can postpone receiving Social Security benefits beyond normal retirement age, you'll receive higher payments. (The amount increases each year until you reach age 70.) Plus, if you continue to work, waiting to collect Social Security until after you retire may reduce your income taxes on the benefits. On the other hand, waiting too long will reduce your lifetime benefits if you don't reach your life expectancy, or even cause you to lose the benefits altogether if you die before payments begin.

Breaking even

When deciding whether to take a reduced benefit at age 62 or to wait until normal retirement age or beyond, a useful exercise is to calculate the breakeven point. Suppose, for example, that your normal retirement age is 66 and that your monthly benefit at that age would be $1,281. If you started collecting Social Security at age 62, your monthly benefit would be reduced to $961. If you waited until age 70, it would be increased to $1,691.

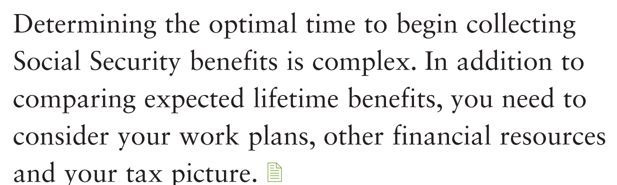
When comparing collecting at age 62 vs. age 66, your breakeven point is age 78 years, 4 months. At that time, your total benefits measured from either starting point would be about the same (just over $189,500). If you lived beyond that age, your total lifetime benefits would be greater if you had started collecting at 66. If you don't live that long, your total lifetime benefits would be greater if you had started at 62.

When comparing collecting at age 62 vs. age 70, the breakeven point is 80 years, 8 months. And when comparing collecting at 66 vs. 70, the breakeven point is 82 years, 6 months.

To determine the best strategy, you need to predict whether you'll live beyond the breakeven age, based on factors such as average life expectancy for your age, your health and your family history.

A tricky decision

Determining the optimal time to begin collecting Social Security benefits is complex. In addition to comparing expected lifetime benefits, you need to consider your work plans, other financial resources and your tax picture.



What have you got to lose?

Maximizing deductions for partnership and LLC losses

The deductibility of business losses is one of the most complex and misunderstood areas of federal taxation. Many partners and limited liability company (LLC) members mistakenly believe that, provided they have adequate tax basis in their interests, they can deduct their distributive share of an entity's losses.

Yet basis is only one of a triad of tax rules that limit losses. To determine whether your losses are deductible, you must also consider the passive loss and at-risk rules.

Partnering up

Partnerships offer several important tax advantages. As pass-through entities, they avoid the double taxation associated with traditional C corporations. Partnerships also provide a business with greater flexibility in allocating income, gain, loss, deductions and tax credits among owners.

One of the partnership's most attractive features is that its tax basis is increased by certain partnership debt, such as a business loan or line of credit. This allows partners to deduct losses in excess of their cash investments in the partnership.

At one time, obtaining the benefits of partnership tax treatment meant giving up the liability protection of the corporate form. But the advent of hybrid entities, such as S corporations and LLCs, has provided the opportunity to combine limited personal liability with many of the tax advantages of a partnership.

In recent years, the popularity of LLCs has soared. LLCs aren't subject to the restrictions on the number and type of shareholders that apply to S corporations, and they have greater flexibility in allocating gains, losses and other tax attributes. And, unlike an S corporation shareholder's basis, an LLC member's basis can be increased by certain company debt even if he or she hasn't lent the money to the company.

3 rules for deducting losses

If you have an interest in a partnership or LLC, you can deduct losses in excess of your investment in the business. When doing so, however, you must follow three rules:

1. You may deduct losses only up to your tax basis in your partnership or LLC interest. Generally, your initial basis is the amount you paid to acquire your interest plus the adjusted basis of any property you contributed to the partnership or LLC. During the life of the business, your initial basis is increased by your share of the company's income, certain liabilities and any subsequent capital contributions.

Special challenges for LLCs

The at-risk rules present special challenges for limited liability companies (LLCs). Unlike general partners, who are personally liable for most partnership debts, LLC members are generally shielded from personal liability beyond their capital contributions.

To fully deduct losses, LLC members may need to take additional steps to ensure their share of debt is at risk. They can do this by pledging nonbusiness property as collateral, by structuring debt as qualified nonrecourse financing or by assuming personal liability for the debt (for example, by borrowing the money individually and then contributing it to the LLC).

Guaranteeing the LLC's debt, however, generally is not enough to assume personal liability.

Your basis is decreased (though not below zero) by your share of any distributions, taxable losses, nondeductible noncapital expenditures and certain other items.

2. You may deduct losses only up to the portion of your basis that's "at risk." Generally, the amount you have at risk includes:

- Your cash investment in the business plus the adjusted basis of any contributed property,
- Your share of debt used in the company to the extent you're personally liable or have pledged nonbusiness property as collateral, and
- Your share of "qualified nonrecourse financing."

Qualified nonrecourse financing means a loan secured by real estate used in the business, provided no person is personally liable for repayment and additional requirements are met.

It can be more difficult for LLC members to meet the at-risk requirements. See "Special challenges for LLCs" on page 5.

3. You may deduct passive losses only from passive income. Yes, you may have more than enough at-risk basis yet still be unable to deduct partnership or LLC losses.

Why? Generally under the passive loss rules, you can't deduct business losses against nonpassive income — such as wages, interest, dividends and capital gains — unless you materially participate in the business. Otherwise, the business activity will be considered "passive," which means you can offset losses only against income from other passive activities.

To satisfy the material participation requirement, you must participate in the business for more than 500 hours a year, perform substantially all of the work for the business, or meet one of several other IRS tests.

Disallowed passive losses may be carried forward until you can offset them against passive income or until you sell your partnership or LLC interest.

Planning to save

As you can see, even if you have sufficient tax basis, losses may still be disallowed under the at-risk or passive loss rules. That's why it's important to understand the rules for deducting losses. You not only can avoid having your deduction disallowed, but you also can identify valuable tax planning opportunities.

You may have more than enough at-risk basis yet still be unable to deduct partnership or LLC losses.

For example, Pat and Chris form an S corporation called XYZ Inc., contributing $100,000 each in exchange for 50% of the stock. XYZ buys a building for $2 million, paying $200,000 in cash and taking out a $1.8 million mortgage on the property to finance the balance.

In its first year of operation, XYZ reports a $300,000 loss, allocated equally between Pat and Chris ($150,000 each). Because each shareholder's basis is only $100,000, however, they can deduct only $100,000 of the loss. The remaining $50,000 is carried forward to future tax years.

If XYZ were set up as a partnership, however, Pat and Chris could deduct the entire loss. That's because each shareholder's basis would be increased to $1 million ($100,000 cash contribution plus 50% of $1.8 million in debt).

This assumes that both Pat and Chris materially participate in the business and that they satisfy the at-risk rules. Their basis is at risk if they're personally liable to repay the mortgage or if the loan is structured as qualified nonrecourse financing.

Weighing your options

Of course, the deductibility of losses is just one of many factors to consider when choosing the right type of entity for your company and structuring business debt. Among other things, you'll need to weigh the potential tax advantages against the risk of expanded personal liability.

TAX TIPS

Greater longevity for 529 plan tax breaks

Recent legislation makes Section 529 plans — already one of the most powerful college funding tools — even more attractive. 529 prepaid tuition plans and savings plans offer generous contribution limits and significant tax and estate planning benefits.

One of the biggest advantages of a 529 savings plan is that you can make tax-free withdrawals to pay for qualified higher education expenses. This benefit was scheduled to expire at the end of 2010, but the Pension Protection Act of 2006 (PPA) permanently extends the favorable tax treatment.

Taxes and emotional distress

Historically, personal injury damage awards and settlements were tax-free. However, 10 years ago Congress amended the tax code regarding damage awards, excluding only damages received for personal *physical* injuries or sickness. Since then, damages for emotional distress, mental anguish and loss of reputation — without a corresponding physical component — have been taxable. These damages are common in employment discrimination and wrongful termination cases, in which a plaintiff's injuries may be purely nonphysical.

Recently, the U.S. Circuit Court of Appeals for the D.C. Circuit found this provision unconstitutional. The court reasoned that damages for emotional distress and loss of reputation do not fall within the constitutional definition of "income" for tax purposes, because they don't compensate for lost wages or earnings.

Although the ruling applies only within the D.C. Circuit, it's likely to be appealed to the U.S. Supreme Court. If you've received damages for nonphysical injuries or currently are involved in employment-related litigation, keep an eye out for future developments in this area.

Claiming a long-distance excise tax refund

Several months ago, the IRS and Treasury Department announced that, in light of a string of court losses on the issue, they would stop collecting excise taxes on long-distance telephone services and would refund an estimated $13 billion in excise taxes paid over the last three years. If you paid these taxes between Feb. 28, 2003, and Aug. 1, 2006, you may be entitled to a refund on your 2006 business or individual tax return. Contact your tax advisor for information about refund procedures.

Give away your IRA?

If you're age 70½ or older, PPA allows you to make tax-free distributions from your traditional IRA to eligible charities. The distributions must be made by the end of 2007, are limited to $100,000 per year and must go directly to a qualified charitable organization.

Without this provision, you would need to take a taxable withdrawal, donate the funds to charity and then claim a charitable income tax deduction. But if your ability to deduct charitable contributions is restricted by adjusted gross income (AGI) limitations, the PPA provision offers a definite advantage because AGI limits don't apply to such donations.

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good works partner

Dear reader:

Among other issues of interest, this current issue discusses the rules for deducting business losses. Contrary to many business owners' beliefs, business losses are not always deductible. Fortunately, action can sometimes be taken in order to implement a tax strategy to enable the deduction of business losses. This is an important aspect of tax planning.

For more information on rules for deducting business losses and how it might affect your own tax situation, please contact me or any of our highly qualified members of the Tax Department.

Sincerely,

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