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TAX IMPACT

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CUTTING-EDGE TAX STRATEGIES FOR THE UNDERDEPRECIATED

To survive and thrive in today's highly competitive business environment, you must constantly be on the lookout for strategies that can give your business an edge. One opportunity you shouldn't overlook is depreciation. The rate at which you recover fixed asset costs can have an enormous impact on your finances. And recent IRS guidance makes it easier to correct past depreciation mistakes — which can give your cash flow a much-needed boost.

BUILDING A CASE

If you're planning to acquire, construct or renovate a building or have done so in the last several years, you should have a cost segregation study done. These studies apply engineering, tax and accounting principles to identify building components that are eligible for accelerated depreciation. Based on this information, you can reallocate a portion of your cost to property with shorter recovery periods, dramatically reducing your tax bill.

Ordinarily, the costs associated with a commercial building are depreciable over 39 years. For residential real estate, the recovery period is 27½ years. Often, building owners allocate most or all of their investment to the real estate, even though much of the cost can be



allocated to other types of property and recovered more quickly.

For example, land improvements, such as fences, sidewalks, parking lots and light poles, are depreciable over 15 years. And many building components can be classified as personal property and depreciated over three, five or seven years.

CLASSIFYING PROPERTY

There are no hard-and-fast rules for distinguishing between personal property, which is eligible for accelerated depreciation, and structural components, which must be depreciated as part of the building. The answer depends on a number of factors, including how the property is affixed to the building or the land, whether it's designed to remain in place permanently, and how difficult it would be to move or remove. Personal property may include:

- ⊙ Machinery,
- ⊙ Moveable partitions,
- ⊙ Easily removed wall and floor coverings,
- ⊙ Awnings, and
- ⊙ Light fixtures.

In some cases, an item's classification depends on its function. Building components normally thought of as structural may qualify as personal property if they relate more closely to business processes than to the building's operation. Examples might include reinforced concrete flooring used to support heavy manufacturing equipment, and electrical systems used to operate machinery, medical equipment or internal communication networks.

ADJUSTING DEPRECIATION FOR PREVIOUS YEARS

You can apply cost segregation not only to newly acquired or constructed buildings, but also to buildings you acquired, built or renovated years earlier. Armed with an engineering report that supports your cost

allocation, you can adjust your depreciation for previous years and, under current IRS rules, claim a one-time “catch-up” deduction for all the depreciation deductions you missed. You’ll need to file IRS Form 3115, “Application for Change in Accounting Method.” Consent is granted automatically in most cases.

As the following example demonstrates, the cash flow benefits can be staggering. Lookback Inc. acquired a commercial building in 2003 for \$6 million and placed it in service on Jan. 1, 2004. It allocated \$1 million to land and is depreciating the cost of the \$5 million building over 39 years. Lookback commissioned a cost segregation study, which revealed that \$500,000 of the \$5 million is properly allocable to land improvements and \$1 million is allocable to five-year personal property.

“How Lookback saved with a cost segregation study” at right compares the company’s depreciation deductions with and without cost segregation. By reclassifying the property, Lookback is able to increase its 2006 depreciation deductions by more than \$700,000, including “catch-up” deductions for depreciation it could have claimed in 2004 and 2005. Assuming a marginal tax rate of 35%, this translates into tax savings of almost \$250,000 this year. And cost segregation will continue to reduce Lookback’s tax bill over the next several years.

FREEING YOURSELF FROM A TAX TRAP

Depreciation can also create a dangerous tax trap. Fortunately, in a 2004 ruling, the IRS offered taxpayers some relief. When you sell real estate or other property, you must adjust its cost basis to reflect prior depreciation. The catch is that prior depreciation is the greater of: 1) depreciation you actually claimed on the property, or 2) depreciation you could have claimed on the property.

This so-called “allowed or allowable” rule resulted in some unpleasant surprises for taxpayers who disposed of property and then found themselves with taxable gains based on depreciation deductions they never actually took.

In the past, taxpayers who found themselves in this predicament were out of luck. But under Revenue

HOW LOOKBACK SAVED WITH A COST SEGREGATION STUDY

Year	Depreciation without cost segregation¹	Depreciation with cost segregation²	Increase
2004	\$123,050	\$311,135	\$188,085
2005	\$128,200	\$457,240	\$329,040
2006	\$128,200	\$324,490	\$196,290
Total	\$379,450	\$1,092,865	\$713,415

¹ \$5 million building cost depreciated over 39 years.

² \$3.5 million building cost depreciated over 39 years, \$500,000 in land improvements depreciated over 15 years, and \$1 million in personal property depreciated over five years.

Procedure 2004-11, you can correct past depreciation mistakes, even after you’ve disposed of the property, by filing an amended return for the tax year in which the property was sold. The usual limitation period for amending a return is three years.

LOOKING OUTSIDE THE BOX

Cost segregation studies can uncover a gold mine of hidden cash. And amending a tax return after the sale of real estate in light of depreciation mistakes can protect you from a tax trap, but if you limit your search to buildings you may be overlooking a rich source of tax-saving opportunities. A detailed review of all your fixed-asset schedules, covering vehicles, furniture, computers, tools, equipment and other personal property can reveal missed depreciation deductions you can recapture this year.

Depreciation can be missed for a number of reasons: Property might be misclassified or inadvertently omitted from depreciation schedules, or its cost might have been entered incorrectly.

GETTING THE DEPRECIATION YOU DESERVE

Accelerating depreciation deductions to reduce your tax bill is like getting an interest-free loan from the government. Looking at it another way, failing to recover fixed-asset costs as quickly as possible is like paying your taxes years before they’re due. Cost segregation studies and fixed-asset reviews can help you avoid that decidedly unappealing result while tapping new sources of cash. ■

MAKING THE MOST OF THE HOME-SALE EXCLUSION

Changes over the last several years have caused capital gains tax to be a bigger concern for homeowners. If you're planning to sell your home, you can soften the impact by ensuring you deduct the cost of improvements and other relevant expenses when figuring out your gain.

WHY GAINS ARE NOW A CONCERN

Almost 10 years ago, Congress amended the federal tax code to allow taxpayers to exclude up to \$250,000 (the limit is \$500,000 for married couples) in capital gains on the sale of a principal residence, subject to certain limitations. Previous rules allowed taxpayers to defer capital gains if the proceeds were used to buy a new home. The home-sale exclusion is permanent, so you never pay tax on your gain, even if you pocket the profits.

At the time it was introduced, the home-sale exclusion seemed like a generous gift from the government. But as housing prices have soared over the last several years in many parts of the country, the exclusion has lost some of its punch. Today, it's not unusual for home sellers to rack up profits well in excess of the exclusion limit — and the resulting tax liability can't be postponed by using it to buy a new home.

CUT YOUR GAINS

Simply put, gain is equal to the amount you realize on a sale minus your adjusted cost basis in the home. The amount realized is the selling price less selling expenses, such as commissions, advertising fees, legal fees, and seller-paid points or other loan charges.

To calculate your adjusted basis, start with the amount you paid for your home (including certain settlement and closing costs). You may have to reduce your basis by the amount of any points paid by the person who sold you the home. Special rules apply if you acquired your home by gift or inheritance, or contracted to have it built.

The next step — which home sellers often overlook — is to increase your basis by the amount you spent on improvements, special tax assessments for local improvements (such as streets and sidewalks) and restoring damaged property after a casualty. If your home is a condominium, you can add your share of assessments used for capital improvements.

Generally, improvements such as these add value to your home:

- ⊙ Additions such as a new garage, bedroom or porch,
- ⊙ New roofs,
- ⊙ Swimming pools,
- ⊙ New heating or air conditioning systems,
- ⊙ Modernized kitchens and bathrooms, and
- ⊙ Upgraded plumbing and electrical systems.

For tax purposes, there are many more items that qualify as improvements. Keep in mind, repairs that maintain the home in good condition but don't increase its value or prolong its life are not considered improvements.

Certain items reduce your basis, such as depreciation related to business or rental use of the home, gains from a previous home sale that you deferred under the old law, and insurance payments.

COVER ALL THE BASES

To avoid overpaying capital gains tax on the sale of your home, be sure you take into account all improvements and other expenses that can increase your basis. Most important, keep the receipts and other documents needed to support your calculation. 📄



HOW LONG SHOULD YOU KEEP BUSINESS RECORDS?

If your filing cabinets are bursting at the seams, it may be time to dispose of papers you no longer need. To help you get started, we offer the following record retention guide. Keep in mind that our list is not exhaustive and the recommended retention periods are intended as general guidelines. Depending on your circumstances, you may need to hang on to certain documents longer. So before you get out the shredder, check with your tax and legal advisors.

Business records	1 year	3 years	7 years	Permanent
Accident reports and claims (keep current documents until settled, then archive for seven years)			X	
Accounts payable/receivable ledgers and schedules			X	
Audit reports (external)				X
Audit reports (internal)		X		
Bank statements and reconciliations			X	
Canceled checks for important payments				X
Canceled checks (other)			X	
Capital stock and bond records				X
Cash books and charts of accounts				X
Contracts and leases (current)				X
Contracts and leases (expired)			X	
Corporate articles, bylaws, minute books, etc.				X
Correspondence (legal and other important matters)				X
Correspondence (routine)		X		
Deeds, mortgages, bills of sale				X
Depreciation schedules				X
Employee applications		X		
Employee personnel records (after termination)			X	
Financial statements (year end)				X
General ledgers, journals and year end trial balances				X
Insurance policies and records (keep current documents until expired, then archive for three years)		X		
Inventory records			X	
Invoices from vendors			X	
Payroll records			X	
Property records (including appraisals)				X
Purchase orders (purchasing department copies)			X	
Purchase orders (other copies)	X			
Receiving sheets	X			
Retirement and pension records				X
Sales commission reports			X	
Sales records			X	
Subsidiary ledgers			X	
Tax returns, worksheets and other documents used to determine tax liability				X
Trademark registrations, patents and copyrights				X
Training manuals				X
Union agreements				X
Voucher register and schedules			X	
Vouchers for vendor and employee payments			X	

MARRIAGE OF EQUALS

To reduce estate taxes, share the wealth

It's not unusual for one spouse to own a disproportionate amount of a couple's wealth.

But this type of fiscal imbalance can prove costly when the estate tax bill arrives. Affluent couples that "equalize" their estates can cut their taxes considerably.

A BALANCED APPROACH

The federal estate tax exemption currently shields \$2 million in assets from estate taxes — it increases to \$3.5 million in 2009. The estate tax is scheduled to be repealed in 2010, only to return in 2011 with a \$1 million exemption.

If the value of your combined estate is less than the exemption amount, the distribution of wealth isn't a big concern. But if your estate is worth substantially more than the exemption amount, you and your spouse have a lot to gain by equalizing your estates.

SPREADING THE WEALTH

Equalizing estates is simple in theory: The "wealthier" spouse transfers at least enough assets to the "poorer" spouse to fund his or her estate tax exemption. (There's no gift tax on transfers between spouses, as long as both are U.S. citizens.)

COMMUNITY RELATIONS

To a certain extent, community property laws equalize a couple's estates automatically. By law, each spouse has the right to half of their community property, even if the property is titled in the name of one spouse. Community property generally consists of assets acquired during your marriage and while residing in a community property state.

But even in community property states, one spouse may hold a substantial amount of wealth as separate property. This may include wealth accumulated before the marriage or property received by gift or inheritance during the marriage and not commingled with community property. If that's the case, equalizing estates remains a valuable estate planning strategy.

For instance, Sally and her husband, Ted, have \$4 million in assets, all in Sally's name. Ted dies in 2006 with no assets, so his estate tax exemption is wasted. When Sally dies in 2008, her exemption shelters \$2 million of her estate from taxes — but the remaining \$2 million is subject to a 45% estate tax.

An alternative is for Sally and Ted to create an estate plan that provides for their assets up to the available exemption amounts to go into a bypass trust, with the balance going into a marital trust. This would allow them to both take advantage of their exemption amounts and avoid the estate tax altogether.

In practice, transferring assets can be challenging. A significant portion of your wealth may be tied up in, for example, retirement plans, which aren't readily transferable.

Ideally, you'll have sufficient assets that are easy to value and simple to transfer, such as cash or publicly traded stock. You can also divide real estate by converting it into tenancy-in-common property.

There may be an advantage to transferring more than the amount needed to fund the poorer spouse's exemption: A larger transfer may shrink the wealthier spouse's estate enough to bring it into a lower tax bracket, reducing the couple's overall estate tax liability.

CONTROL ISSUES

Despite the tax advantages that can be gained by equalizing estates, the wealthier spouse may not want to relinquish control over his or her property. If so, there are other estate planning techniques that can help leverage the estate tax exemption while retaining some control over your wealth.

A qualified terminable interest property (QTIP) trust is one such vehicle. It allows you to transfer property for your spouse's benefit while retaining control over how the assets are distributed after your spouse dies.

EQUAL OPPORTUNITY

Equalizing estates isn't right for every couple, but for many people it's a simple, inexpensive technique for reducing and even eliminating estate taxes. ■

CHARGING EMPLOYMENT TAXES: PRICELESS

Starting this year, most businesses can use a credit card to pay their federal employment taxes through an online service. Not only can this ease the strain on your cash flow, but it can also earn you bonus points and frequent-flyer miles on your credit card. Keep in mind that there is a convenience fee of approximately 2.5% of use tax services. You can't use a credit card, however, to make employment tax deposits at your local bank. For that, you'll still need to write a check. 📄



IRS FEELING CHARITABLE

Last year, the IRS stunned the tax community by announcing that a common estate planning tool, the charitable remainder trust (CRT), would be disqualified unless the grantor's spouse waived certain inheritance rights. In many states, your spouse has a "right of election" to receive a portion of your estate — which may include assets earmarked for charity — regardless of your estate plan's terms.

Earlier this year, after a barrage of complaints, the IRS suspended the new rule. Pending further guidance, a

CRT will not be disqualified unless a right of election is actually exercised. 📄

RETIREES WANT TO KNOW

A great way to reduce your tax bite in your golden years is to retire to a state with no or low income tax. Up until 10 years ago, this strategy didn't work, because retirement benefits generally were taxed by the state where you earned your living. But in 1996, federal lawmakers barred states from taxing qualified plan and IRA benefits paid to nonresidents.

Currently, these states have no income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

New Hampshire and Tennessee limit their income taxes to dividends and interest income. Many of the states with personal income taxes provide exemptions for all or a portion of retirement plan assets or Social Security benefits.

When comparing the tax burdens in various states, don't limit your examination to income tax. You should also look at other state and local taxes, such as sales, property and inheritance taxes. 📄

TAKE STOCK OF YOUR INVENTORY METHOD

If your inventory costs are rising, consider switching to the last-in, first-out (LIFO) inventory method. LIFO allocates your most recent and, presumably, higher expenses to the cost of sales, reducing your taxable income.

If you already use the dollar-value LIFO method, you may be able to enjoy additional savings by electing to use the inventory price index computation (IPIC) method. IPIC enables you to reduce administrative costs — and, in many cases, generate greater tax benefits — by relying on government indexes to calculate LIFO values rather than developing an internal index. 📄

MORRISON, BROWN, ARGIZ & FARRA, LLP

Certified Public Accountants

Dear reader,

President Bush has just signed the "Tax Increase Prevention and Reconciliation Act of 2005" (TIPRA) which had been passed earlier by both houses of Congress. The measure will provide approximately 70 billion of tax relief to a variety of taxpayers. It offers tax reductions for individuals by extending through 2010 the 15% preferential tax rates on long term capital gains and qualified dividends. It also increases the Alternative Minimum Tax exemption and also has IRA related provisions. TIPRA also offers tax reductions for businesses, extending through 2009 the election to expense (rather than depreciate) as much as \$100,000 of property used in a trade or business, and make off-the-shelf computer software eligible for such immediate expensing. Unfortunately, TIPRA also adds tax-raising provisions to the Tax Code.

Morrison, Brown, Argiz & Farra takes great pride in offering comprehensive tax counseling to preserve wealth, optimize taxes and maintain state and federal compliance.

We offer much more than standard compliance work.

Our goal is to work closely with our clients to make sure that they are taking advantage of the many tax planning strategies available. We also want to ensure that they are in compliance with income tax laws and assist in preparing all necessary tax returns.

We would be pleased to discuss the provisions of TIPRA and invite you to contact us with any questions you may have.

Sincerely,



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Bakhai is regarded in the professional community as one of the best tax minds in South Florida. He deals with such topics as the tax benefits of LLCs, year-end tax planning, and qualified subchapter S subsidiaries, the innocent spouse relief provision under Section 6015, and IRS regulations on valuing and substantiating charitable contributions.



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