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TAX IMPACT

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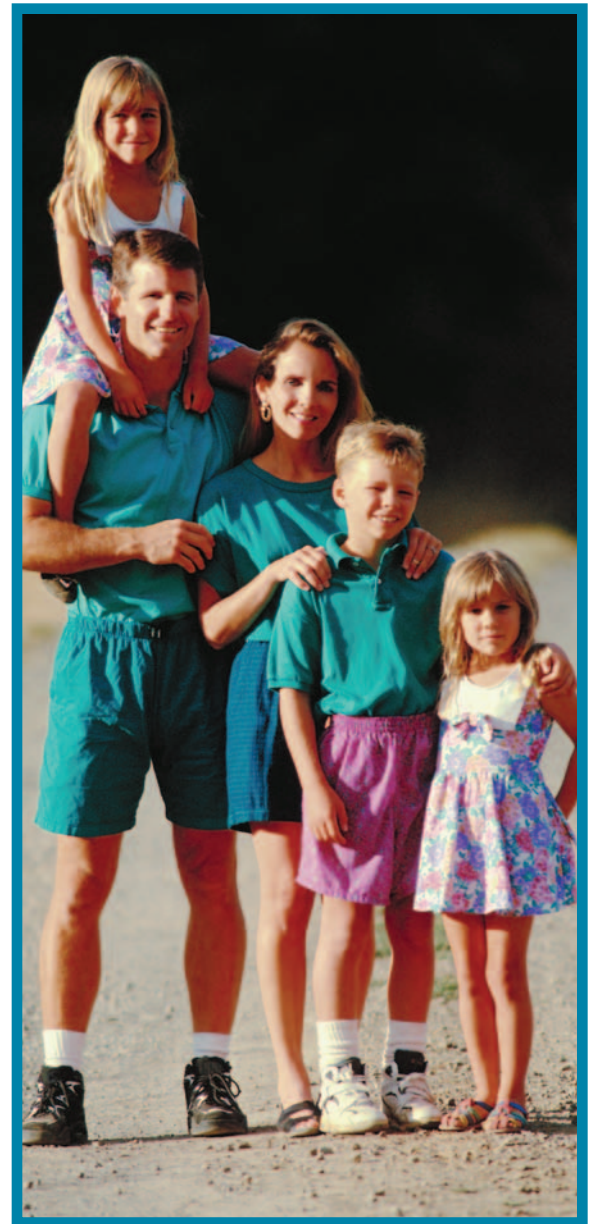
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GENERATING INTEREST WITH INTRAFAMILY LOANS

Lending money to family members may be personal, but it pays to treat loans like business. If you don't, you could owe taxes on income you never received and gifts you never intended to make.

Structured properly, however, an intrafamily loan can be a great way to help your kids or other family members buy a home, start a business or meet any number of financial needs. It can also be an effective estate planning tool for you.

THE IMPORTANCE OF DOCUMENTATION

Regardless of your loan's terms, it's important to put it in writing. The IRS is likely to view an undocumented loan to a family member as a gift, which may eat up some of your lifetime gift tax exemption (currently \$1 million) or create a taxable gift if you've already used your lifetime exemption.

To avoid this result, document the loan with a promissory note. It should outline the terms of repayment, including when payments are due, and the interest rate for the loan.

A HIGHER RATE'S ADVANTAGE

It may be tempting to offer your loved ones low-interest or even no-interest loans, but there can be significant tax advantages to charging a higher rate. If you lend money

PAY MORE THAN LIP SERVICE

Documenting a loan is one thing. Actually adhering to its terms is another. To make sure the IRS doesn't characterize a loan as a disguised gift, treat it as a legitimate transaction: Require regular payments and make a genuine effort to collect if the borrower defaults. Also, be sure to document receipt of payments and collection efforts.

Should you ever want to write off the loan as a bad debt, this evidence will help you demonstrate that the transaction was a bona fide loan gone bad and not a gift.



to family members at less than the applicable federal rate (AFR), the shortfall will be imputed to you.

In other words, you'll be treated as if you charged the borrower the AFR and that amount will be included in your taxable income — whether or not you collect it. What's more, this forgone interest will be treated as a taxable gift to the borrower. The borrower may be able to deduct the interest, depending on the purpose of the loan.

2 LOAN OPTIONS

Two exceptions allow you to make no-interest or low-interest intrafamily loans without generating imputed interest:

- 1. The \$10,000 exception.** You can lend a family member up to \$10,000 without negative tax consequences, provided the money isn't invested in income-producing assets. For example, you could make a \$10,000 interest-free loan to your daughter for a down payment on a condo. But the exception won't apply if she puts the money in a savings account.
- 2. The \$100,000 exception.** Imputed interest on family loans up to \$100,000 is limited to the borrower's net investment income and is eliminated if net investment

income is \$1,000 or less. Thus, in such situations, there is no taxable gift for the forgone interest.

GIFT CALCULATIONS

Gifts are calculated differently depending on the type of loan. If the loan is a term loan, for instance, you can calculate the gift as the difference between the present value of the forgone interest for the life of the loan and the present value of the loan's stated interest. For a demand loan, the gift is recalculated annually based on the forgone interest for that year.

With a demand loan, there is the opportunity to take advantage of the annual gift tax exclusion each year. (The annual gift tax exclusion allows you to give up to \$11,000 annually to a relative or friend gift-tax free.) On the other hand, if you exceed your annual gift tax exclusion in the year of a term loan, you'll have to use some of your lifetime gift tax exemption, which is \$1 million in 2005.

ESTATE TAX BENEFITS

In addition to helping out your loved ones, an intrafamily loan can also be a tax-efficient tool for removing wealth from your estate. Let's look at an example.

David loans \$200,000 to his daughter, Mary, charging 5% interest (the long-term AFR for the month he made the loan). Because the interest rate is equal to the AFR, there is no imputed interest for income or gift tax purposes. The note provides for payments of interest for 20 years, with the principal

due at the end of the term. Mary invests the money in mutual funds that yield an 8% annual return.

At the end of the term, the funds have grown to more than \$930,000. Mary pays David the \$200,000 principal, which is included in his estate. But the remaining \$730,000 passes to Mary outside David's estate, generating substantial tax savings.

If you lend money to family members at less than the applicable federal rate, the shortfall will be imputed to you.

To further assist Mary, David could forgive some or all of her \$10,000 interest payments. Although he would still have to include the interest in his income, the forgiven payments would qualify as tax-free gifts under the annual gift tax exclusion.

COMPLEX RULES, COSTLY MISSTEPS

Intrafamily loans provide many benefits for both lenders and borrowers. But the imputed interest rules are complex, and missteps can be costly. Plan carefully to structure a loan that meets your needs and avoids unintended consequences. [▶](#)

FEELING EXPERIMENTAL?

Discover the R&E tax credit before it expires

The research and experimentation (R&E) tax credit may conjure up images of white lab coats and test tubes. In reality, any type of business — not just science-oriented firms — can qualify for this credit, which is available for a surprising variety of activities.

For example, service companies have obtained the credit for software development while manufacturers' product and process improvements have also qualified. Let's see what requirements your business must meet.

WHO QUALIFIES?

Congress introduced the R&E credit more than 20 years ago as an incentive for U.S. businesses to invest

in research and development. The dollar-for-dollar tax-reduction potential of a credit, as opposed to a deduction, can be substantial.

Still, many companies haven't claimed the credit because they've been unsure which expenses qualified and 1998 regulations imposed a restricted definition of qualified research. But changes over the past year, which we discuss below, are more business friendly.

If your company invests in new product development, process improvement or software development (even for internal use), it pays to determine whether you're eligible for the R&E credit. Organizations in a broad

range of industries have qualified, including those in manufacturing, distribution, construction, health care, technology, finance, agriculture and retail.

HOW MUCH CAN YOU SAVE?

The R&E credit applies to qualified research expenditures (QREs) such as:

- ⊙ Salaries of employees conducting research (or at least a portion thereof),
- ⊙ A portion of salaries or fees paid to workers or consultants supporting those activities,
- ⊙ Supplies, and
- ⊙ Computer leasing or time-sharing costs.

The credit is generally equal to 20% of the amount by which QREs exceed a base amount. Under a complex set of rules, the federal tax benefit of the credit is generally capped at 6.5% of current-year QREs. You can carry forward unused credits for up to 20 years and carry unused amounts back one year. State credits may be available, too.

You can carry forward unused credits for up to 20 years and carry unused amounts back one year.

WHAT ACTIVITIES QUALIFY?

To qualify for the R&E credit, an activity must:

- ⊙ Qualify as a deductible business expense,
- ⊙ Be aimed at discovering information that is technological in nature — for instance, it involves research in the physical or biological sciences, engineering or computer science,
- ⊙ Relate to a new or improved “business component,” such as a product, process, computer software, technique, formula or invention, and
- ⊙ Involve a process of experimentation.

Several types of activities are excluded, including research:

- ⊙ Conducted after commercial production begins,
- ⊙ Used to adapt or reproduce existing business components,



- ⊙ Related to style, taste, cosmetic or seasonal design factors,
- ⊙ Performed outside the United States, or
- ⊙ Funded by grants or contracts.

Keep in mind that this credit has been extended only through 2005.

IS THE DISCOVERY TEST STILL REQUIRED?

Regulations finalized in 2003 help businesses qualify for the R&E credit. For example, the changes eliminated the restrictive “discovery test,” under which a company could qualify only if its research was intended to discover information that “exceeds, expands or refines the common knowledge of skilled professionals in a particular field of science or engineering.” This standard made it very difficult for ordinary businesses to claim the credit.

The changes also affected these areas:

Process of experimentation. Previously, experimentation was limited to scientific laboratory research, typically excluding commercial and industrial research. The 2003 regulations more broadly define the experimentation process, making it easier for businesses conducting commercial and industry research to qualify.

“Substantially all” test. For the IRS to consider activities related to a business component as qualified

research, substantially all — at least 80% based on cost or another appropriate measure — of the activities must be elements of an experimentation process related to a qualified purpose. The regulations also clarify that if a business meets the “substantially all” test, all of the activities will be eligible for the credit.

WHERE SHOULD YOU START?

If you’ve never claimed the R&E credit before, analyze your business activities in light of the changes to determine whether you may qualify in

the current and previous tax years. If you’re already claiming the credit, or have done so in the past, review your activities to identify additional areas that may now qualify and make sure you have the documentation required under the new regulations.

By doing so, you may be able to reduce your taxes for the current year and future ones — and even get refunds for years past. A qualified tax advisor can help you with this. 📄

DOUBLE UP ON TAX SAVINGS

Combine the home-sale exclusion with a like-kind exchange

Homeowners can qualify to exclude from income up to \$250,000 (\$500,000 for joint filers) in gain when they sell or exchange their principal residences. This is a very attractive tax break, but it doesn’t go as far as it used to. In many parts of the country, real estate prices have increased dramatically, so home-sale profits that exceed the exclusion are more common.

In some cases, homeowners can reduce their tax bite by combining the benefits of the home-sale exclusion with a like-kind exchange. The IRS gave the green light to this strategy in a ruling earlier this year.

GET THE LAY OF THE LAND

Internal Revenue Code (IRC) Section 121 allows you to exclude gain from the sale or exchange of property (up to the limits described above) if you used the property as your principal residence for at least two years during the five-year period preceding the sale. You can claim

the exclusion as many times as you want, so long as you satisfy the residency requirements and don’t use it more than once every two years.

IRC Sec. 1031, on the other hand, lets you exchange one property for another without recognizing any gain, provided you use both properties in a trade or business or for investment purposes. To qualify, you must meet a number of requirements, including identifying replacement property within 45 days after the relinquished property is sold and completing the exchange within 180 days.

There are two key differences between the provisions. Sec. 121 permanently excludes the gain from income while Sec. 1031 defers the tax until you sell the replacement property. Also, the former applies to principal residences and the latter is limited to investment and business properties.

APPLY BOTH BREAKS

It’s not unusual for homeowners to meet the qualifications for both the home-sale exclusion and a like-kind exchange. You may have lived in your house for two years, for example, and then rented it out for three years. Or perhaps you used part of your home as a home office and the rest as your principal residence.

If you find yourself in either situation, the IRS has good news. Earlier this year, it issued Revenue Procedure 2005-14, which allows you to boost your tax savings by applying both tax breaks to the same property. The IRS offers a number of



examples to help you determine whether you qualify, including this one:

Joe buys a house for \$210,000 in 2000 and uses it as his principal residence until 2004. From 2004 to 2006, he rents the house to tenants, claiming \$20,000 in depreciation deductions. In 2006, Joe exchanges the house for \$10,000 in cash and a townhouse worth \$460,000 that he also intends to rent to tenants. According to the example, Joe's realized gain is \$280,000: \$460,000 + \$10,000 cash – adjusted basis of \$190,000 (\$210,000 purchase price – \$20,000 in depreciation).

Joe qualifies for the \$250,000 home-sale exclusion because he used the house as his principal residence for two out of the five years before the exchange. He also qualifies for Sec. 1031 treatment because he converted the house into investment property and exchanged it for another investment property.

Under the Revenue Procedure, Joe applies Sec. 121 first to exclude \$250,000 of the \$280,000 gain. Then he defers the remaining \$30,000 gain under Sec. 1031 (including the \$20,000 gain attributable to depreciation, which isn't excludable under Sec. 121).

CHECK THE HOLDING PERIOD


Until recently, Joe could have used a popular technique to avoid tax on the \$30,000 deferred gain. All he would have had to do is rent out the townhouse for at least

a year (to establish his intent to hold the property for investment), move in and use it as his principal residence for two years, and then sell or exchange the townhouse. Doing so would have allowed him to claim another \$250,000 exclusion.

You can claim the exclusion as many times as you want, so long as you satisfy the residency requirements and don't use it more than once every two years.

But last year's American Jobs Creation Act increased the holding period from two years to five years for property acquired in like-kind exchanges. Although this doesn't eliminate the technique altogether, it hampers your ability to reap this benefit — especially if the property appreciates substantially during the five-year holding period.

REVIEW YOUR OPTIONS

If you're planning to sell highly appreciated real estate, and its gains will exceed the home-sale exclusion, explore your tax-saving options. One to consider is combining the exclusion with a like-kind exchange. With some resourcefulness and a little patience, you may be able to qualify. 

4 ESTATE PLANNING STRATEGIES

In addition to creating a will and ensuring assets are titled properly, looking for ways to trim your taxable estate is an important part of the estate planning process. Here are four strategies to consider:

- 1. Make gifts to family and friends.** Giving to your loved ones while you're alive can reduce your taxable estate. In 2005, you can give up to \$11,000 (\$22,000 for married couples) per person without incurring gift tax. In addition, you can make tax-free gifts under your \$1 million lifetime gift tax exemption, but such gifts reduce the estate tax exemption available at your death.
- 2. Give to charity.** Gifts to charity during your lifetime or at death will reduce your taxable estate. Lifetime donations may also result in current income tax benefits.
- 3. Form family partnerships.** These are often used to share business income with children in lower tax brackets and thereby increase the family's discretionary income. Partnerships may also help keep future growth out of your taxable estate. Keep in mind that the IRS has scrutinized this strategy, so be sure to study it carefully before proceeding.
- 4. Create trusts.** For individuals, title to assets can be held in various kinds of trusts. Assets held in trust for your heirs bypass the probate estate and, depending on the trust's structure, may not be included in your taxable estate. Also, in some circumstances, these assets may be used to pay estate taxes, debts and administrative expenses.

SHOULD YOU DEDUCT SALES TAX OR INCOME TAX?

Last year's American Jobs Creation Act gave taxpayers who itemize the option of deducting state and local *sales* taxes instead of state and local *income* taxes on their federal returns. The deduction is available only through 2005, but legislators are considering making it permanent.



Deciding which state taxes to deduct is simple in theory: Whichever taxes you paid more of will yield the biggest federal tax savings. If you live in a state that has a sales tax but no income tax, the answer is obvious. For everyone else, however, it's a closer call.

For most people, the income tax deduction will continue to be the better choice, unless you make a large number of taxable purchases this year or buy big-ticket items, including luxury vehicles and mobile homes.

You have two options for calculating your sales taxes:

1. You can track your actual expenses — which means holding on to sales receipts and register tapes for every purchase you make this year, or
2. You can use the IRS's *Optional State Sales Tax Tables* (Publication 600), which estimate average consumption by taxpayers in each state according to income level and number of exemptions.

Even if you rely on the IRS tables, you can still add in actual sales taxes for certain items the IRS has authorized, such as:

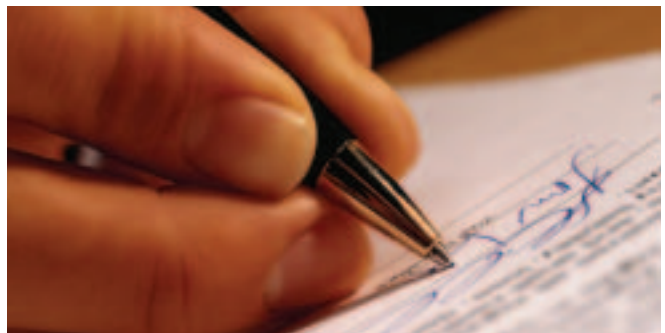
- ⊙ Motor vehicles,
- ⊙ Boats,
- ⊙ Aircraft,
- ⊙ Homes, and
- ⊙ Home-building materials.

If you live in a state without an income tax, figure out how much sales tax you paid so you can deduct these taxes on your federal income tax return. Even if you didn't itemize last year, adding in sales taxes may be enough to allow you to itemize this year.

If you pay state and local income taxes, track your sales taxes as well — at least on big-ticket items — to see whether the sales tax deduction would improve your tax outlook. 📄

BEWARE OF NEW TAX REQUIREMENTS FOR SIGNING BONUSES

If you require workers to sign an employment contract and give them a bonus for doing so, you must now pay employment taxes and withhold income taxes on the bonus amount. Payments made to workers when employment contracts are canceled must also be treated as wages. Some payments made before Jan. 12, 2005, will not be subject to these new rules. 📄



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With the complexity and continuous changes in tax rates and laws, strategic and proactive tax planning is the key to consistently minimize the amount of income, estate and other taxes your business or family pays. Formulating effective tax strategies for corporations, business owners and high net-worth individuals is an important component of MBAF's portfolio of client services. Our team of tax specialists has extensive experience with federal and state tax issues regarding the taxation of individuals, corporations, S corporations, partnerships, and Estate Planning.

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- Timely completion and thorough understanding of all tax reporting requirements
- Coordination of correspondence with tax authorities
- Timely advice on acquisition-related tax issues
- Coordination of personal and business tax issues with a focus on minimizing global taxes
- Representation in tax controversies

Sincerely,



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