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# TAX IMPACT

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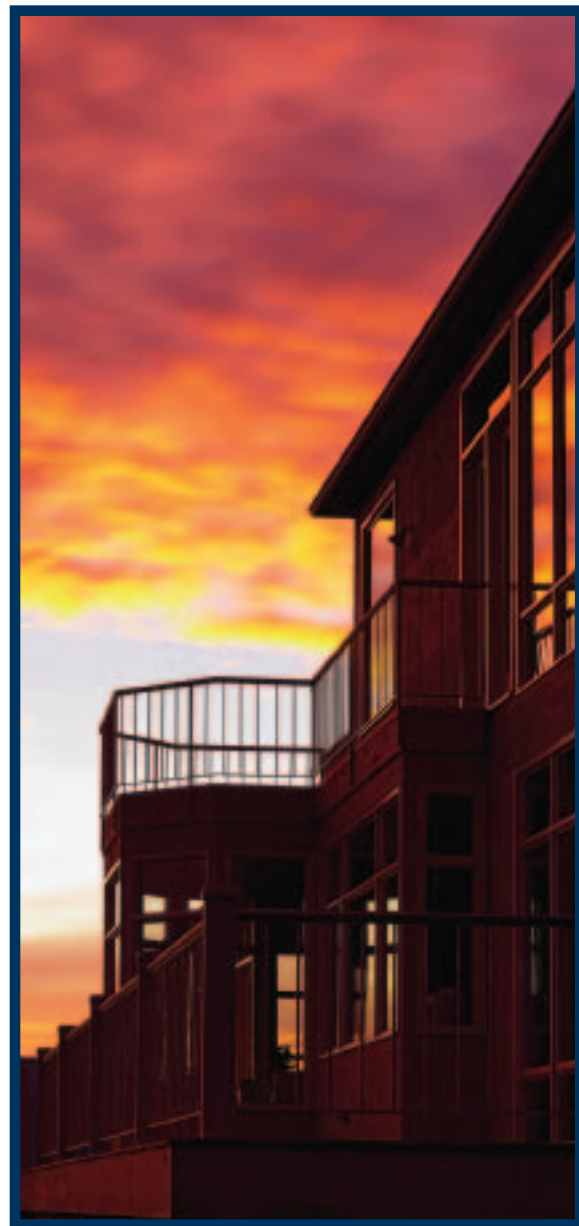
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# WHY REAL ESTATE INVESTORS SHOULD RETHINK LIKE-KIND EXCHANGES

**L**ow capital gains tax rates may have you, like many investors, rethinking your investment strategies, particularly if you own real estate. Depending on your goals and circumstances, this may be a good opportunity for you to exit the real estate market gracefully — and relatively inexpensively.

Although like-kind exchanges are particularly advantageous because you can defer tax, they've lost some of their appeal because capital gains tax rates are lower than they've been in years.

## REVIEW THE RATES

The 2003 tax act reduced the 20% and 10% long-term capital gains tax rates to 15% and 5%, respectively. (The 5% rate will drop to zero in 2008.) Unless Congress makes the tax cut permanent, both rates will return to their previous levels in 2009. The act also suspended, until 2009, the 18% capital gains tax rate for certain assets held more than five years (8% for lower-income taxpayers).

But the tax law made no changes to the treatment of recaptured depreciation. Real estate gains attributable to previous depreciation deductions are still taxed at either a maximum rate of 25% or your top tax bracket.

**Under a like-kind exchange, you can defer tax on the original gain from the relinquished property until you sell the replacement property.**

In light of the current tax law, investors should re-examine tax-deferral strategies, such as like-kind exchanges. Although they are a valuable tool, the current lower capital gains tax rates diminish the benefits of tax deferral.



## LEARN THE RULES

Usually, when you sell or exchange property, you must recognize a gain or loss. But you may be able to defer the tax by exchanging real estate for other “like-kind” property. Both must be: 1) located in the United States, and 2) used in a trade or business or held for investment.

For example, you could carry over the tax basis from an apartment building in New York City to a shopping center in Montana. And you can defer tax on the original gain from the relinquished property until you sell the replacement property. Keep in mind that some states will tax you on this transaction.

You may be able to eliminate capital gains taxes if the property is in your estate at your death when the estate tax is in effect. The beneficiary will receive an unlimited step-up in basis. If he or she sells the property immediately, no capital gains tax will be due because his or her basis will equal the selling price

(assuming no discounts were taken in the valuation of the property).

Additional rules apply to partially tax-free and mortgaged property exchanges. You must trade up in fair market value and equity or gain is recognized.

#### CONSIDER THE IMPACT

Evaluating a like-kind exchange used to be more straightforward. When capital gains rates were higher, deferring tax was typically a wise strategy — under the theory that a dollar today is worth more than a dollar tomorrow. But now that the rates are lower, the benefits of tax deferral may be outweighed by the costs. There are more factors to consider, such as:

**Alternative investments.** Other investments, such as stock, may be more attractive because the tax rate on qualified dividends is only 15%. Evaluate whether higher potential returns on other investments are more advantageous than deferring capital gains taxes on real estate.

**Future depreciation.** When the tax basis of the relinquished property becomes the tax basis of the replacement property in a like-kind exchange, it usually



results in lower depreciation deductions than would be available if you purchased the replacement property.

**Unused capital losses.** If you can use capital losses from prior years to offset current capital gains, now may be a good time to sell. (Please note that it may be better to match short-term capital losses with short-term capital gains.) You can reduce or even eliminate capital gains taxes and reinvest in property with a higher tax basis. This would minimize future gains if you sell the property when capital gains rates are higher.

**Recaptured depreciation.** Carefully analyze the amount of gain attributable to prior depreciation because it can greatly affect your cost-benefit analysis. Recaptured depreciation is taxed at 25%, while gain in excess of depreciation is taxed at 15%. But certain depreciation may be recaptured at ordinary rates.

#### WEIGH YOUR OPTIONS

Like many investors, you've probably changed your financial strategy to benefit from the 2003 tax law changes. But you may not have re-evaluated your real estate strategies. Now is a good time to do so because capital gains tax rates are low.

Although the tax impact is an important factor in any decision, you should consider additional elements including costs and other financial advantages. Before deciding, weigh your options and speak with an accountant in our firm. 📄

#### THE NUTS AND BOLTS OF DEFERRED AND REVERSE EXCHANGES

It's rare to find someone with whom you can simply trade properties, so most like-kind exchanges are deferred exchanges. In a deferred exchange, you sell your property first and then identify and acquire a replacement property. Once you sell the relinquished property, you must identify a replacement property within 45 days and complete the exchange within 180 days.

To qualify the transaction as an exchange, you can't receive cash or nonqualified property — otherwise, gain will be recognized. And you must use a qualified intermediary, such as a title company or bank. The intermediary sells the relinquished property and uses the proceeds to buy the replacement property.

Another option is a reverse exchange, where you acquire the replacement property first and then sell the relinquished property. Reverse exchanges also involve a qualified intermediary, and they're subject to other requirements.

# 7 WAYS TO CUT YOUR BUSINESS'S TAX BILL

There are many ways to streamline your business costs. And taking advantage of strategies to trim your tax bill is a great example. Let's look at some tips you must implement by year end to enjoy 2004 tax savings.

## 1. MAKE EQUIPMENT PURCHASES

To take advantage of the 50% bonus depreciation deduction that expires this year, you must buy qualifying property (depreciation life of 20 years or less) and place it in service (or make certain leasehold improvements such as lighting, signage, furnishings and carpeting) before Jan. 1, 2005. By doing so, you can write off 50% of the new asset's cost and recover the remaining 50% under regular depreciation schedules.

## 2. SCHEDULE IMPROVEMENTS

Do you have major improvements planned for the next few years? If so, schedule them for this year or next to benefit from the large Section 179 expense election for those years. In 2004, you can deduct up to \$102,000 for new and used equipment, including off-the-shelf software, costing \$410,000 in total and placed in service before year end. These amounts will be inflation-indexed for 2005, but the deduction will return to \$25,000 in 2006.

## 3. REVIEW YOUR INVENTORY

### ACCOUNTING METHOD

It may make sense for your business to switch its method of inventory accounting. When the costs of goods are increasing, the last in, first out (LIFO) method is beneficial because the last items you bought or produced are assumed to be sold first. This may entitle you to a larger deduction and create lower taxable income, though it may also increase your tax bill if you're hit by the alternative minimum tax.

Meanwhile, if you're experiencing price decreases, you may want to use the first in, first out (FIFO) method because you'll match inventory items with the costs of the same type of items you most recently bought or produced.

## 4. WRITE OFF MINOR PURCHASES, REPAIRS AND MAINTENANCE

If equipment has a useful life substantially beyond the taxable year, it generally must be capitalized rather than deducted. An exception is the de minimis rule,

## DOING WELL TAX-WISE BY DOING GOOD

Businesses can make charitable contributions and not only generate goodwill but also get a tax break as long as they follow the rules. For instance, C corporations may deduct contributions only up to 10% of their taxable income. Meanwhile, partnerships, limited liability companies (LLCs) and S corporations do not have this limit. Rather they must pass through the deduction for the business's charitable contributions to the owners and partners, who will take the deduction on their personal income tax returns.

which allows current deductions for minor expenditures as long as they clearly reflect income.

Amounts paid for equipment repairs and maintenance are not considered capital expenditures and may be deducted currently. Expenditures that add to an asset's value, prolong its life or make it adaptable to a different use, however, must be capitalized.

## 5. DEDUCT BAD DEBTS

Customers who never pay are frustrating. But rather than letting bad debts irritate you, write them off — including fully or partially worthless receivables. To get the tax break, you must write them off as assets in your records and be able to demonstrate your efforts to obtain payment.

## 6. COMPARE MILEAGE TO ACTUAL EXPENSES

The mileage allowance for owned and leased automobiles increased to 37.5¢ in 2004 — up from 36¢ in 2003. Although many businesses have benefited from this change, you may want to forgo the deduction and take advantage of a different strategy. You may be able to further decrease your business's tax bite by deducting actual expenses for your vehicles, such as:

- ⊙ Depreciation,
- ⊙ Insurance,
- ⊙ Interest,
- ⊙ Registration fees,
- ⊙ Maintenance and repairs, and
- ⊙ Gas and oil.

## 7. MAXIMIZE THE BUSINESS

### GIFT DEDUCTION

Although the deduction for business gifts is limited — only \$25 per gift is deductible — you can take advantage of a few exceptions to this tax break. Usually, the \$25 limit applies to gifts to individuals. But if you present an item directly to a business and don't know which employees may use it, you can typically write off the entire expense.

If you have business ties to both members of a married couple and give them a joint gift, you can deduct up to \$50. Keep in mind that presents to your employees

operate under different rules and may be treated as compensation.

Also, you may benefit by classifying some gifts, such as theater or sports tickets, as entertainment costs. But these expenses are generally subject to the 50% disallowance rule and the deduction is contingent on your accompanying the recipient to the event.

### TAKE TIME NOW

Like many business owners, you may forgo tax planning for other, more pressing matters. But by procrastinating or forgoing it altogether, you may be missing out on valuable tax savings now and later. ■

# PASS ASSETS TO THE SKIP GENERATION

*Effectively using the GST tax exemption and trusts to reduce transfer taxes*

**T**he generation-skipping transfer (GST) and estate tax exemptions are at an all-time high — \$1.5 million in 2004 and 2005. And they will continue to increase over the next few years, reaching \$3.5 million in 2009 before being repealed the following year.

In 2011, they'll return to \$1 million (plus the GST tax exemption will be indexed for inflation), unless Congress takes further action. (The gift tax exemption remains at \$1 million through 2011.) Plus, the highest estate, gift and GST tax rates will decrease until 2010 and return to 55% in 2011.

With lower tax rates and higher exemptions, now is a good time to review your estate plan — especially your GST tax strategy. You want to ensure you're not only leveraging the GST tax exemption's benefits to the fullest, but also controlling when it's used. After all, the government can now automatically allocate this exemption for you.

### THE GST TAX AND EXEMPTION

The GST tax is a flat tax imposed at the highest marginal estate tax rate (48% in 2004) on gifts made directly to a "skip person" — such as a grandchild or nonfamily member more than 37½ years younger than the transferor — and on trust distributions to such a person. The tax is in addition to any estate and gift taxes imposed on assets.

Fortunately, you can minimize your exposure to the GST tax by using the GST tax exemption. It allows you to transfer up to the exemption amount to skip persons before your assets are subject to the GST tax. (Married couples can use double the exemption on joint transfers.)



### 2 TRANSFER METHODS

Two tax-efficient ways to leverage your GST tax exemption are by transferring assets to a:

**1. Dynasty trust.** You can allocate assets up to your unused GST and estate tax exemptions to the dynasty trust to benefit your grandchildren and their descendants free of GST and estate taxes. Plus, the property's future appreciation will be shielded from tax. But if you make the transfer during your lifetime, you must

## REMEMBER THE ANNUAL GIFT TAX EXCLUSION

Outright gifts that qualify for the annual gift tax exclusion are usually exempt from the generation-skipping transfer (GST) tax to the extent of the exclusion amount. This means that you can give up to \$11,000 (the annual gift tax exclusion limit in 2004) per recipient each year gift-tax free — and without using your gift, estate or GST tax exemptions.

pay gift tax on any amount exceeding your lifetime gift tax exemption.

**2. Irrevocable life insurance trust (ILIT).** An ILIT owns and is the beneficiary of life insurance policies. It also pays the premiums. When you die, the insurance proceeds pass into the trust and are not included in your taxable estate. You may use the lifetime gift and GST tax exemptions to cover your contributions for insurance premiums. But if the trust has a Crummey provision, you may use your \$11,000 annual gift tax exclusion and avoid allocating part or all of your GST tax exemption on transfers to the trust.

### THE DANGERS OF BLENDED TRUSTS

To avoid unintended tax consequences and maximize the leverage of the GST tax exemption, use your GST tax exemption for trusts that will benefit only grandchildren and other skip persons. If you name your child and grandchild as beneficiaries of the same trust — creating a blended trust — you may trigger the GST tax.

Let's look at an example. George created an irrevocable trust for his daughter and granddaughter, Joan and Sally, respectively. He transferred \$1 million to it and applied \$500,000 of his GST tax exemption to it. This resulted in the trust having an "inclusion ratio" of 0.5, which means that the GST tax would be owed on 50% of distributions to Sally. To avoid the GST tax, George could have allocated \$1 million of his GST tax exemption to the trust, which would increase the inclusion ratio to 1.0. But that would have been wasteful because only 50% of the trust benefits a skip person.

George could have avoided this problem by setting up two separate \$500,000 trusts for his daughter and granddaughter. By applying \$500,000 of his GST tax exemption to Sally's trust, he could ensure all its distributions to her would be GST-tax free.

### THE AUTOMATIC ALLOCATION

Until 2001, the tax law required an affirmative election on gift tax returns to allocate the GST tax exemption to trusts benefiting both children and grandchildren. But people often neglected to make the election and

inadvertently generated huge GST tax bills.

To avoid this dilemma, the 2001 tax act created an automatic allocation of the exemption to certain trusts that may result in a GST — for example, an asset transfer to your grandchildren from a trust created to benefit your children — unless the transferor opts out.

Although this change protects taxpayers who forget to file the election, it can lead to other problems. Suppose you set up a trust to benefit your children but included a provision that your grandchildren could become beneficiaries if one of your children died unexpectedly. Under the 2001 tax act, your GST tax exemption would be automatically applied to the trust. If the trust operated as intended and benefited only your children, you would waste the GST tax exemption because nothing would have gone directly to your grandchildren. Opting out might have been advisable in such a situation.

### FORMULAS IN YOUR WILL

Some people use formulas in their wills to determine bequests to grandchildren — or to trusts for their benefit — based on the maximum available GST tax exemption.

But this may result in a larger gift than intended if, for example, you prepare your will when the GST tax exemption is \$1.5 million but die in a later year when the GST tax exemption is higher. If you were to die during the year when the GST tax is repealed (2010), all of your property could pass to your grandchildren, possibly disinherit your spouse or children.

You can avoid these issues by providing more details in your will. For instance, specify a specific dollar amount or percentage of your estate and cap it by the amount of any unused GST tax exemption.




### YOUR TAX BITE

With the estate tax rates and exemptions changing through 2011, estate tax planning is complex. But don't let that stop you from taking advantage of the GST tax exemption and other strategies to reduce your tax bite. By understanding upcoming changes and talking with a qualified tax professional in our firm, you can avoid or at least minimize the GST tax. 📖

## DON'T DISCOUNT YOUR 401(K) PLAN

Feeling they could put their assets to better use in other vehicles, such as savings accounts and bonds, some people may not realize the tax breaks they are passing up by not using 401(k) plans. You not only can make pretax contributions, which reduces your taxable income, but you can also grow your assets tax deferred until you receive distributions.

To ensure your retirement account keeps growing, evaluate where you are investing your assets. For instance, many Enron employees depleted their nest eggs because they held too much of their investments in one area — their employer's stock. Also, contribute the maximum to qualify for your employer's matching contribution. In 2004, the 401(k) limit is \$13,000; \$16,000 if you are age 50 or older. 

**What do households pay more of: income tax or payroll tax? About 41% paid more in payroll tax, according to the Congressional Budget Office.**

## A WILL CAN EASE MATTERS FOR YOUR LOVED ONES


Many people put off writing a will for various reasons. They may be reluctant to plan for their deaths or unsure about how to divide their assets among relatives. Whatever the reason, putting off this task can be costly — a probate court will decide how to split your possessions and who will care for your children if they are minors.

When creating a will, inventory your assets including:

- ⊙ Savings,
- ⊙ Retirement plan funds,

- ⊙ Investments,
- ⊙ Insurance proceeds, and
- ⊙ Property.

Once you decide who will get what, check that the beneficiaries of your retirement accounts and insurance policies are the same as you named in your will.


Finally, remember to update your will when there's an important change in your life — such as a move to another state, a birth or death, and a marriage or divorce. 

## WHEN CAN YOU DEDUCT YOUR CHILD'S TUITION AND FEES?

You may be able to deduct up to \$4,000 (in 2004) in tuition and fees for your children's higher education but:

1. They must qualify as dependents,
2. You must have paid the expenses, and
3. The costs must be qualified.

Income limits also apply: Your adjusted gross income (AGI) plus tax-exempt interest (modified AGI) can't exceed \$65,000 if you are single and \$130,000 if you are married filing jointly. (Married couples filing separately aren't eligible.) Single taxpayers with modified AGIs up to \$80,000 and married couples with modified AGIs up to \$160,000 can deduct \$2,000.

Keep in mind that you can't deduct tuition and fees used to claim the Hope or Lifetime Learning credit or funded with a Coverdell Education Savings Account. 



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