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TAX AND BUSINESS Alert™

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Deducting Real Estate Taxes

State and local real estate taxes levied for the general public welfare are deductible for regular tax, but not for the AMT, if the tax is based on the assessed value of the property and charged uniformly against all property in the taxing authority's jurisdiction. To be deductible, taxes must be imposed by a governmental body. Thus, payments to a development company for maintaining streets, parks, fire and police protection, and garbage collection generally are *not* deductible. Likewise, payments to homeowner associations are not deductible.

Example: Deducting municipal utility district taxes. Lonnie paid $1,250 in municipal utility district taxes. The taxes were imposed on all property in the district to pay off revenue bonds used to build a sewage disposal system and to pay for maintaining the sewage system. Are the taxes deductible real estate taxes?

Yes. The taxes were levied by a governmental body for the general public welfare at a uniform rate on all the property in the district. Therefore, the taxes are deductible real estate taxes, not a tax charged to benefit individual property owners. Lonnie can deduct the $1,250 as an itemized deduction if itemizing is more beneficial than using the standard deduction.


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Taxes charged for local benefits or improvements that tend to increase the taxpayer's property value are not deductible. A tax is considered assessed for local benefits when property assessed with the tax is limited to property benefited. It is not necessary for the property's value to actually increase. Thus, local or special assessments charged only against benefited property are not deductible if the benefit generally tends to increase property values.

Applicable state law determines when property taxes are assessed. This is a factor to consider, for example, when the taxpayer wants to prepay property taxes at the end of the year (i.e., the exact amount is not known, and the taxpayer simply pays an estimate in order to obtain the deduction during the tax year). If the taxes have not yet been assessed, deductibility presumably is not allowed.

The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Direct IRA Contribution Provision Set to Expire

Time is running out on a beneficial tax provision that allows direct contributions from IRA accounts to a charitable organization. Under this provision, qualified taxpayers can donate up to $100,000 to an eligible charity without first being taxed on the distribution. However, unless Congress extends this provision, it will expire at the end of 2007. So, there's an incentive to take action before year-end.

This provision is available to taxpayers age 70½ or older who have one or more IRAs and a desire to make charitable contributions. It allows eligible taxpayers to make charitable contributions *directly* from their IRAs for up to $100,000 to an eligible charity. These nondeductible direct charitable distributions, which can replace otherwise required minimum distributions, are tax-free to the IRA owner.

Patron's Gifts and Athletic Tickets

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The cost of tickets to a charitable event is eligible for a contribution deduction to the extent the purchase price exceeds the fair market value of admission and privileges associated with the event.

Tickets to a charitable event are not necessarily deductible simply because they are not used by the taxpayer, even if the donor had no intention of using the tickets upon purchasing them. However, certain unused tickets (e.g., a single theater or symphony ticket by the holder of season tickets) may qualify as charitable contributions if returned for resale to the sponsoring charitable organization. The purchase of raffle, bingo, or lottery tickets is not a charitable contribution.

A special exception exists for sports fans. They can deduct 80% of donations to colleges or universities for the right to buy tickets to an athletic event in the institution's stadium, regardless of whether the tickets would have been readily available without the payment. However, the amount paid for other benefits such as the cost of the tickets, the right to use the skybox, guest passes to visit the skybox, and reserved parking privileges are not deductible as charitable contributions.

New Online EIN Application Process

Taxpayers can now request an Employer Identification Number (EIN) through a Web-based system that instantly processes requests and generates identification numbers in real time. A taxpayer accesses the Internet EIN system through *www.irs.gov* and enters the required information. If the information passes the automatic validity checks, the IRS issues a permanent EIN to the taxpayer. If the information does not pass the validity checks, it is rejected. The taxpayer then has an opportunity to correct the information and resubmit the application.

The Internet EIN application is interactive and asks questions tailored to the type of entity the taxpayer is establishing. The system provides help screens throughout the application process. This means taxpayers will no longer have to print the EIN instructions and separately search for answers while requesting an EIN.

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In many cases, a corporation experiences tax advantages if it issues debt, rather than stock, to investors because interest paid on the corporation's debt is deductible, while dividends paid to shareholders are not. Furthermore, the creditor receives principal repayments on corporate debt tax-free, while distributions to shareholders are normally taxable as dividends.

If third-party debt is used as part of the initial capital structure, the shareholders do not need to invest as much of their personal funds, but can still obtain the same amount of ownership and control. Since less of the shareholders' money is invested, it is less likely the shareholders will need to take cash withdrawals that might be dividends to the shareholders and nondeductible by the corporation. The third-party loans can be repaid with cash flow generated by the business. Also, these repayments will not affect the shareholders' ownership interests and voting rights.

> **Example: Borrowing capital from third parties.** Chloe Jones contributed $100,000 to her new corporation, CJ Inc., (CJ). She needed an additional $200,000 in capital to operate the business. CJ borrowed the required $200,000 from Chloe's friend Stan Smith. Stan insisted on an interest rate of 8% and monthly payments that will result in full repayment of the loan over 10 years.
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> Even though CJ incurred a substantial amount of interest expense over the 10-year period, it was able to fully repay the $200,000 debt. By leveraging capital with outside debt, the shareholder's rate of return on capital exceeded the 8% interest rate paid on the borrowed funds. Chloe now owns 100% of all corporate stock with a personal investment of only $100,000. This option is clearly preferable to providing other individuals with stock that has voting rights or dividend preferences. Of course, the difficulty lies in finding an outside party willing to loan funds to a start-up company.

Because corporate debt in reality may be disguised equity to achieve better tax results, the IRS might treat debt securities issued by the corporation as equity for tax purposes.

Use Third-party Debt to Raise Corporate Capital


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Over the years, the IRS and the courts have looked beyond the face of a debt instrument, particularly in connection with loans to shareholders, to determine the true substance of an obligation. In many situations, the courts also have held that debt is actually disguised equity and required it to be reclassified as such.

Using third-party debt can help avoid this result. Since such debt instruments are normally negotiated in an arm's-length manner, the debt versus equity question is not as critical as with shareholder debt. A third-party investor will normally insist on a bona fide debt instrument, market interest rate, and regular payments, thereby nullifying most of the points indicating disguised equity arrangements. To ensure that the debt to the outside investors is not reclassified as equity for income tax purposes, the debt should be properly substantiated as such. A written promissory note should be drawn up, and a repayment schedule should be specified and followed.

New Online EIN

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When the EIN application process is complete, a taxpayer has the option to view, print, and save his or her confirmation notice, as opposed to waiting for the IRS to mail it. Third parties authorized by the taxpayer can also be provided with the EIN, but the third party cannot view, print, or save the confirmation notice. Instead, the confirmation notice is mailed to the taxpayer.

An EIN assigned through Internet submission is immediately recognized by IRS systems. Taxpayers can begin using the EIN immediately for most business purposes.

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Year-end Kiddie Tax Strategy

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In 2007, the kiddie tax can affect children under age 18. This tax imposes the parents' marginal tax rate (as high as 35% for regular taxes and 15% for long-term capital gains) on an under-age-18 child's unearned income in excess of $1,700 (in 2007), unless the child's rate is higher than the parents' rate. Starting in 2008, however, children whose earned income (e.g., wages) does not exceed one-half of their support and are either age 18 or a full-time student age 19–23 *can* be subjected to the kiddie tax.

Since the age increase does not take effect until 2008 for most individuals, taxpayers with children not subject to the kiddie tax in 2007 (generally age 18 or older), but who will be subject to it in 2008, have one last opportunity to avoid the negative impact of the kiddie tax. (This normally will include college students and some high school seniors.) Investment (unearned) income recognized by these children in 2007 is not subject to the kiddie tax. Therefore, long-term capital gains will likely be taxed at the child's 5% capital gain rate in 2007 versus a possible 15% rate that can apply in 2008 when the parents' rate is used.

So whether parents or grandparents gift appreciated securities to the child in 2007, or the child has a custodial account with appreciated securities, it is important to consider selling these securities before year-end to take advantage of the child's potential 5% capital gains rate. Otherwise, waiting until 2008 or later could result in an applicable tax rate of 15% being applied because of the kiddie tax.

A word of caution is warranted, however, when planning to avoid or minimize the kiddie tax using this strategy. An increase in income can have a detrimental impact on the amount of financial aid a student might receive. So, if the student is currently receiving or expects to receive financial aid, it is important to assess the impact that implementing this strategy will have on a child recognizing additional income in 2007.

Please call us to discuss ways to eliminate or minimize the kiddie tax or other personal and business tax minimization strategies.

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