Tax and Business Alert™

February 2009

Welcome to this month's edition of the *Tax and Business Alert.* Our goal is to provide you with current articles on various tax and business topics. The articles are intended to keep you up to date on trends and issues that may impact your business and personal financial affairs.  Please contact us if you have questions about any of the issues discussed.

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Tough economic times often lead to an increased number of divorces. We hope it won't happen this time around, but it very well could. When a divorce occurs, one ex-spouse is often obligated to make continuing payments to the other.

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**Deducting 529 Plan Losses**

Thanks to their beneficial tax treatment, qualified tuition programs (QTPs—commonly referred to as 529 plans) have become the plan of choice for many taxpayers trying to save enough money to cover the ever-escalating costs of getting their child or grandchild through college.

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**Purchase of a Taxpayer's Home by an Employer**

Sometimes, when an employee is transferred to a new location, the employer will purchase his or her home. The amount paid can be fair market value (FMV) as established by appraisals, a guaranteed percentage of the employee's cost basis in the home if the appraisal is less than the basis, or any other amount agreed to.

**Repossessing Real Estate Sold on the Installment Basis**

Recognizing real estate sales gains using the installment method is a popular way to defer taxation when seller-financing is provided.

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## Deducting 529 Plan Losses

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Thanks to their beneficial tax treatment, qualified tuition programs (QTPs—commonly referred to as 529 plans) have become the plan of choice for many taxpayers trying to save enough money to cover the ever-escalating costs of getting their child or grandchild through college. Over the last several years, many folks have invested a considerable amount of money in these plans. Unfortunately, the market has not been any kinder to these plans than to the rest of us. So, we venture to say there are more than a few taxpayers out there who have QTPs worth less than what they put into them. That begs the question: Are the losses deductible? Better yet, can I liquidate the account, claim a loss, and then reinvest the proceeds in another QTP for my child or grandchild?

Yes—according to the IRS, a loss on a QTP is deductible by the account owner (the person who controls the account—typically the contributor), but only when all amounts from that account have been distributed and the total distributions are less than the contributor's unrecovered basis (contributions made to the account less any prior withdrawals of those contributions). Unfortunately, the loss must be deducted as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit. Also, the funds can't be reinvested too soon. The IRS indicates that distributions rolled over to another QTP for that or another related beneficiary within 60 days of the distribution are not taxable. Thus, if an account that is worth less than what was put in it is rolled over within 60 days, there are no tax consequences, meaning no loss deduction.

The bottom line is this, if you liquidate a QTP account, wait more than 60 days to reinvest the proceeds, and get back less than you put in it; the loss is deductible as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income floor. Not so great—at least for most taxpayers! Therefore, we suggest you use this strategy carefully.

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## Purchase of a Taxpayer's Home by an Employer

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Sometimes, when an employee is transferred to a new location, the employer will purchase his or her home. The amount paid can be fair market value (FMV) as established by appraisals, a guaranteed percentage of the employee's cost basis in the home if the appraisal is less than the basis, or any other amount agreed to. A relocation service company (RSC) may be retained by the employer to manage the sale of the employee's home for a fee. The carrying costs incurred between the time the employee receives the check and the time the house is sold (as well as closing costs at the time of sale) are generally borne by the employer. The employer benefits from (or pays the price for) any fluctuations in FMV during that period.

Generally, an employer (or RSC) purchase of an employee's home at FMV (unreduced by closing costs) is more advantageous for the employee than a direct sale of the property coupled with employer reimbursement of closing costs because the reimbursement is taxable compensation income to the employee. Closing costs paid by the employee reduce the gain on the sale of the former residence, but the gain is often excluded (generally, up to $250,000 for single filers and $500,000 for joint filers). And, if the employee sustains a loss on the sale of the former residence, the nondeductible closing costs give him or her no tax benefit, even though the reimbursement is included in income.

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If an employer hires an RSC to buy an employee's home for FMV unreduced by closing costs that are incurred in a normal sale, the tax consequences to the employee are usually more favorable. If the price paid for the home does not exceed FMV, no taxable income accrues to the employee, although the arrangement, in effect, pays him or her for otherwise unavoidable closing costs. The employee's gain on the sale of the former residence is higher, but the gain likely is excluded.

**Example:** Sale of residence by employee to an RSC.

Dan was transferred from California to Texas. His employer hired an RSC that purchased Dan's home for its FMV of $275,000. The amount paid to Dan was not reduced for the closing costs that he would have paid in a normal sales transaction (approximately $22,000). Dan's basis in the home was $120,000. He purchased a new home in Texas for $300,000.

Assuming Dan can exclude the entire $155,000 ($275,000 – $120,000) gain from income, he need not report the sale of the residence on his return. The fact that the price paid by the RSC was not reduced by normal selling expenses has no tax consequences to Dan.

Variation: Had Dan sold the house himself for $275,000 and incurred $22,000 of selling expenses, he would have netted $253,000. If Dan's employer then reimbursed him for the $22,000, that amount would have been reported as income. The $22,000 of selling expenses reduced Dan's gain on the sale, but this is of no tax consequence to him if he is able to exclude the entire gain. Thus, the reimbursement results in Dan's recognizing $22,000 of taxable income that he can neither exclude from gain under the sale of a residence rules nor claim as the reimbursement of a deductible moving expense.

Given the current housing market, there are obvious benefits to having an employer purchase the home of a transferring employee. But, how the transaction is structured can have a significant impact on the resulting tax liability. Please contact us to discuss this issue or any other tax compliance or planning
issue.

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**Repossessing Real Estate Sold on the Installment Basis**

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Recognizing real estate sales gains using the installment method is a popular way to defer taxation when seller-financing is provided. The installment method allows the seller to recognize any gain over a stated period of time as payments are received. But, given the tough current economic situation we have encountered, some of those previous installment sales may be unwound by repossession of the previously sold property.

If a taxpayer sells real property on the installment basis and later repossesses the property, a mandatory rule for reporting gain due to the repossession may apply. Generally, the result is that the seller reports all interim installment payments (i.e., principal payments received before repossession) as gain to the extent they exceed the amount of gain reported periodically as income before the repossession. However, the gain that must be reported upon repossession is limited to the seller's gross profit calculated for the original sale less the amount of gain previously reported as income before the repossession and any repossession costs. Typically, the seller's tax basis in the repossessed real estate is the same as when the property was originally sold, but is increased by any expenses incurred in repossessing the property. The fair market value (FMV) of the repossessed property is generally irrelevant.

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Taxpayers repossessing property often view the transaction as an economic loss (since the buyer has not performed on his or her debt) and may be surprised to learn that they must recognize a taxable gain. The fact that they receive no additional cash in the repossession transaction makes gain recognition particularly onerous. Taxpayers should realize as early as possible that repossession may trigger a taxable gain and quantify the gain to the extent possible before the transaction is completed.

The repossessed property's holding period (for purposes of any subsequent sale) includes the period when the taxpayer owned the property before the original sale plus the period after the repossession. It does not include the period that the buyer from whom the property was repossessed owned the property. Repossessed property is depreciated as if it had never been sold. Special rules may apply when repossessing real estate previously used as the taxpayer's principal residence.

Unwinding an installment real estate sale can have a negative tax effect in addition to the problems associated with the foreclosure. Please call us to discuss this or any other tax compliance or planning issue.

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## Standard Mileage Rates for 2009

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Beginning January 1, 2009, the standard mileage rates for the use of an automobile (including vans, pickups, or panel trucks) are 55 cents per mile for business miles, 24 cents per mile for medical or moving purposes, and 14 cents per mile for service to a charitable organization.

The 2008 rates were 50.5 cents for business miles and 19 cents for medical and moving through June 30, and 58.5 cents for business miles and 27 cents for medical and moving beginning July 1. These rates are based on an annual study done by an independent contractor of the fixed and variable costs of operating an automobile. The charitable rate is unchanged because it is set by statute.

A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System, after claiming a Section 179 deduction for that vehicle, for any vehicle used for hire, or for more than four vehicles used simultaneously.

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## Tax-Deductible Alimony Payments

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Tough economic times often lead to an increased number of divorces. We hope it won't happen this time around, but it very well could. When a divorce occurs, one ex-spouse is often obligated to make continuing payments to the other. Payments that meet the tax-law definition of alimony can be deducted by the payer for federal income tax purposes, and must be reported as gross income by the recipient. In fact, alimony deductions, when allowed, are above-the-line deductions. So, there is no requirement to itemize deductions to benefit from these payments. The tax savings from alimony payments can provide some comfort to financially stressed-out payers.

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A number of specific requirements must be met for payments to meet the tax-law definition of deductible alimony. Despite the amount of litigation on this issue, these requirements are apparently unknown to some divorce attorneys. What happens when payments to an ex fail to meet the tax-law definition of alimony? They are generally treated as either child support payments or as payments to divide the marital property. Both of these payments are nondeductible personal expenses for the payer and tax-free income for the recipient. This is not good news for the payer.

To obtain the expected tax benefits from alimony payments, taxpayers should seek professional tax advice before signing the divorce papers. After that, it's generally too late to salvage any deductions for failing to mind the details. Here's the key point: Whether payments qualify as tax-deductible alimony is determined strictly by the applicable language of our beloved Internal Revenue Code. It doesn't matter what the divorce decree might say or what the divorcing couple might have intended. The one exception to this general rule is when the divorcing individuals stipulate that amounts that would otherwise qualify as deductible alimony won't be deducted by the payer or included in the payee's gross income.

As mentioned earlier, payments to an ex-spouse that do not meet the tax-law definition of alimony will generally be considered child support or part of the division of marital property. Of course, it's also possible (although unlikely) for payments that are not intended to be alimony to meet the tax-law definition, in which case they are deductible by the payer and taxable income to the recipient.

Please contact us to discuss the tax aspects and IRS requirements involved in a divorce and explore the most tax-favorable structure for alimony payments.