Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

Tax-Free Gains From Home Sales

March 2013

The National Association of Realtors recently reported that the median sales price of an existing single family home was around $180,000 in late 2012. That's down from the peak years of 2005–2007, when such prices were near $220,000 but still up from 2002, when the median price was $167,600. Therefore, if you sell a home you've owned for 10 years or more, you may well have a gain on the sale. (The same might be true if you sell a house bought in late 2009 or early 2010, the low point of the recent cycle.)

Thanks to some of the most generous breaks in the tax code, you may owe little or no tax on such a gain. In brief, you can exclude up to $250,000 of housing profits from capital gains tax, or up to $500,000 of gains if you are married and file a joint tax return. However, you must pass several tests in order to qualify for either tax exclusion.

Owned and occupied

The $250,000 and $500,000 tax breaks apply only to sales of your principal residence. You can't claim these exclusions for sale of a vacation home or an investment property. What's more, you must have owned and used the home as your primary residence for at least two of the five years before the sale. (Some exceptions apply in cases of poor health, job changes, and unforeseen circumstances.)

The two years do not have to be an unbroken time period.

Example 1: Pete Roberts bought a house for $200,000 in April 2008. He moved in right away and lived there until February 2009. At that point, Pete took a new job and relocated to a different state. He put his home on the market but was not able to sell it.

Pete's new job didn't work out, so he moved back into his home in January 2011. On June 15, 2012, he sold the home for $250,000. In this scenario, the five-year period before the sale stretched from June 16, 2007, to June 15, 2012. Pete had owned the home since April 2008, so he exceeded the two-year requirement.

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Ramped-up Retirement

Average retirement assets per U.S. household, in constant dollars, has grown from $27,300 in 1975 to $153,100 in 2012.

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Coming in April: Highlights Of The New Tax Law

Be on the lookout for special coverage of the American Taxpayer Relief Act of 2012, the tax law passed in January to take effect this year. In the April 2013 issue of the CPA Client Bulletin, you'll find incisive articles about the key provisions.

You'll learn whether you'll face higher income tax rates this year and if so, what steps you can take to reduce your tax bill. Some people will owe higher taxes on dividends and long-term capital gains...but others won't. Under the new law, income shifting to lower bracket family members will have a greater payoff.

You'll also discover which estate tax provisions are permanent, enabling you to execute your estate plan with confidence. Business owners can find out about permanent new rules for first year deductions of equipment purchases.

Look forward to all this and more in our next issue.

During the five-year period, Pete lived in the house as his main home for 10 months (April 2008 to February 2009) and for 17 months (January 2011 to June 2012). Therefore, he passed the residency requirement as well. Pete is able to exclude the $50,000 gain from tax because it is less than the $250,000 maximum exclusion.

Regarding rentals

The tax rules are more complicated if you sell a house that has had some business use.

Example 2: Assume that Laura Martin has the same housing experience as Pete Roberts in example 1. However, when Laura moved out of her house for nearly two years, she rented it to a tenant. Then, Laura moved back into the house, sold it, and qualified under both two year tests.

Again, Laura can exclude up to $250,000 of gain on the house sale. However, Laura cannot exclude the part of the gain equal to the depreciation she claimed while her house was rental property. If you are in this type of situation, our office can help you calculate the taxable gain you will need to report.

Another two-year rule

You can claim the $250,000 or $500,000 tax exclusion multiple times, without limit. If you claim either of these exclusions, though, you generally cannot claim another one within two years. In the previous examples, both Laura Martin and Pete Roberts claim exclusions for a house sale on June 15, 2012. Therefore, if either of them sells a house before June 16, 2014, he or she cannot claim any exclusion on that sale.

Married couples

Married couples can exclude up to $500,000 of gain from the sale of their principal residence as long as either spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse is ineligible to take the exclusion because they had already excluded the gain on a different primary residence during the two-year period ending with the date of the current sale. ■

Do Well While Doing Good With a Charitable Gift Annuity

You may want to "give something back," with a substantial charitable donation but fear relinquishing assets you'll need for living expenses. In this situation, consider funding a charitable gift annuity (CGA). Many charities and other nonprofit organizations offer these arrangements.

How they work

As the name suggests, you fund a CGA with a charitable donation. In return, you get a stream of income that can last the rest of your life or for the lives of two people, such as yourself and your spouse.

Example: Ann and George Wilson want to support their favorite charity, which offers CGAs. The Wilsons decide to contribute $200,000.

Their chosen charity, like many others, uses tables from the American Council on Gift Annuities to set payout rates. Those rates vary by the age of the donors. When they fund their gift annuity, Ann is 58 and George is 66. The relevant table shows a 4% payout rate. Therefore, the Wilsons will

Did You Know?

The number of publicly listed companies in the U.S. declined 43.5% from the peak in 1997 through 2011. During that time period, maintaining the number of public companies would have required nearly 388 initial public offerings (IPOs) a year. Instead, the actual annual number of IPOs has been only 128 per year since the dot-com bubble burst in 2000.

Source: Grant Thornton LLP

receive $8,000 (4% of $200,000) a year as long as either is alive.

More or less

If the Wilsons receive 4% cash flow from their CGA, they'll get more spending money than they would get from a bank account or money market fund, given today's low yields. They'll be tapping principal in order to do so, which means they won't have access to the donated assets, and they won't be able to leave those assets to their heirs. The Wilsons are willing to fund their CGA because they have other assets for lifetime needs and eventual bequests.

On the other hand, the Wilsons probably would be able to get a higher lifetime payout by buying a commercial annuity from an insurance company. Again, the Wilsons are aware of the tradeoffs involved. They accept reduced cash flow in return for knowing they've benefitted a worthy cause; the Wilsons also will receive recognition from the charity as well as several tax advantages.

Multiple benefits

In this example, the Wilsons will be receiving a partial return of principal with every payment from the charity. Consequently, the money they receive from the CGA will be partly taxable and partly tax-free. The Wilsons funded the CGA with appreciated assets held more than one year, so they can treat some of the taxable portion of their payments as long-term capital gains, which probably will be taxed at favorable rates.

Also, the Wilsons will receive a tax deduction for their contribution. They contributed appreciated assets held more than a year, so their deduction will be based on the full $200,000 market value of those assets. Depending on interest rates in effect at the time of the contribution, the Wilsons might receive an upfront tax deduction around $20,000 to $25,000. (However, if the value of the annuity was more than the amount contributed, the Wilsons would not get a deduction.)

The older you are when you fund a CGA, the larger the portion of your contribution you can deduct. Also, an individual funding a single life annuity will receive a larger tax deduction than a couple of similar age requesting a joint CGA.

CGAs tend to be straightforward, with a definite payout for your investment. Charities and other nonprofits offering CGAs can walk you through the details. Nevertheless, you should keep in mind that a CGA is secured only by the issuer's assets, so you should do your homework in order to be comfortable that the charity is financially sound. ■

Passing the Tests for Entertainment Deductions

If you're a business owner, you probably entertain customers, prospects, employees, suppliers, and others. Such outlays may be deductible, whereas others are in a grey area. If you know the rules, you can support your deductions and withstand IRS scrutiny.

Direct action

To be deductible, entertainment expenses must pass either the so-called "directly related" or "associated" tests. Either way, expenses must be both ordinary and necessary to your business. Typically, activities that are commonly used and helpful in some way will be considered ordinary and necessary.

Example 1: Eli Smith, who owns the Smith Co., takes his marketing vice president, Carol Jones, to lunch at a local restaurant to discuss the launch of a new product. Because this lunch takes place in a clear business setting, the cost probably is tax deductible. However, like most entertainment expenses, Smith Co. can deduct only 50% of the total cost.

Even if you merely take someone out to lunch, you should be able to show that the main purpose of the outing was related to your business. The IRS says that you must have talked about business matters during the meal, and you must have had a specific business benefit in mind. In order to demonstrate your actions and your intent, in case you're ever questioned, you should keep some type of log in which you record all the details right after you entertain, including your business purpose. For example, your business purpose could be taking long-term and newly hired employees out to lunch in order to build interpersonal relationships.

Note: You don't have to show a successful result, such as closing a deal, but you need to have a valid business reason for entertaining.

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Associated activity

The IRS states that business entertaining in a setting that offers "substantial distractions" won't meet the directly related test. Such settings include nightclubs, ball games, golf courses, and so on.

In those situations, you may qualify for tax deductions if the entertainment is associated with your trade or business. You must have a "substantial business discussion" directly before or after the outing.

In order for a business conversation to be substantial, you must be able to show that you were actively engaged with the other party or parties to get a specific business benefit. The business discussion must be substantial, in relation to the entertainment, so a brief request for an order may not justify deducting hundreds of dollars in basketball tickets. As long as the conversation takes place on the same day as the entertainment, the IRS considers it to be held directly before or after the entertainment. Again, you should keep a log to record such activities.

What if the entertainment and the business discussion are not held on the same day? A deduction might still be justified, depending on the specific facts and circumstances. You may have more leeway if you are entertaining people who traveled to meet you.

Example 2: Three top executives from the Collins Co. come in from out of town to discuss a proposed business venture with the Smith Co. They arrive Monday afternoon, and Eli Smith takes all three to a basketball game Monday night. On Tuesday, Eli

has a substantial conversation with the visiting executives, going over the proposal. The IRS has said that the game generally may be considered to have taken place directly before the discussion, so the ticket costs can meet the associated test. Here, Eli probably is on solid ground for deducting 50% of his outlays.

Our office can help you create a recordkeeping plan to support your entertainment deductions. ■

TAX CALENDAR

MARCH 2013

March 15

Corporations. File a 2012 calendar year income tax return (Form 1120), and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2012 calendar year income tax return (Form 1120S), and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553 to choose to be treated as an S corporation beginning with calendar year 2013. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2014.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B) or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

APRIL 2013

April 15

Individuals. File a 2012 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868. Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2013 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2013 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of $1,800 or more in 2012 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2011 or 2012 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2012 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 16.

Electing large partnerships. File a 2012 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2013.

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