

March/April 2011

tax **IMPACT**

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Tax Tips
Uncertain tax positions, maintenance vs.
capital improvement and more



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Need to purchase BOLI?

Here's how to avoid being taxed

Life insurance proceeds are generally exempt from income tax, but special rules apply to business-owned life insurance (BOLI). This type of insurance is also known as *employer-owned* life insurance (EOLI) or *corporate-owned* life insurance (COLI). Whatever moniker you attach to this insurance, if your company owns policies on owners, directors, officers or other employees — or plans to purchase such insurance — be sure to comply with the BOLI rules to avoid an unexpected tax bill.

The many benefits of BOLI

BOLI offers many benefits to a business and its owners. It can fund buy-sell agreements and other estate and succession planning vehicles, as well as retiree health benefits or deferred compensation plans. It can also help protect the business against the loss of a key employee.



To take advantage of BOLI, you purchase policies on the lives of the employees you wish to insure. The business can pay the premiums itself or use split-dollar arrangements to share the costs and benefits with covered employees.

itself or use split-dollar arrangements to share the costs and benefits with covered employees. Life insurance is an effective investment vehicle because a policy's cash value grows on a tax-deferred basis and, with careful planning, the death benefits are income tax free.

Cleaning up so-called "janitors insurance"

In 2006, Congress added Section 101(j) to the Internal Revenue Code to combat perceived abuses of BOLI. Although insuring owners and certain employees serves a number of legitimate business purposes, some companies were purchasing policies on the lives of rank-and-file workers, in many cases without the workers' knowledge.

To take advantage of BOLI, you purchase policies on the lives of the employees you wish to insure. The business can pay the premiums

Sec. 101(j) was designed to prevent companies from using what has become known as “janitors insurance” to make money off of employees in whom they have no insurable interest.

Under Sec. 101(j), net BOLI proceeds (that is, the proceeds minus the policy’s adjusted cost basis) are *presumed* to be taxable unless the business complies with strict notice and consent requirements (see “Putting employees on notice” below) and the insurance falls within one of two exceptions:

1. It covers specified owners or employees.

This applies to insurance on the life of a person who was 1) an employee at any time during the 12 months before his or her death or 2) was a director or highly compensated employee/individual at the time the policy was issued. Highly compensated employees/individuals include:

- ⊙ Your company’s five highest-paid officers,
- ⊙ The top 35% of employees in terms of compensation,
- ⊙ All employees whose compensation exceeds a specified threshold (\$110,000 for 2010 and 2011),
- ⊙ Shareholders who hold more than 10% ownership in the company, and
- ⊙ Owner-employees who hold more than 5% ownership in the company.

2. It’s used for certain estate or succession planning purposes.

This applies when insurance proceeds are paid to (or used to acquire an equity interest in the company from) an insured employee’s estate or heirs, or a trust for their benefit. Under IRS rules, the amounts must be paid and an equity interest must be acquired by the due date, including extensions, of the company’s income tax return for the year in which the death benefit is paid.

What you need to do

If your company uses BOLI, be sure that new life insurance policies comply with Sec. 101(j) whenever possible to avoid being taxed on death benefits. In addition, review existing policies for compliance with Sec. 101(j), which applies to policies issued after Aug. 17, 2006, as well as to older policies that are “materially modified” after that date.

For any noncompliant policies, consider replacing them with new ones for which you can satisfy applicable notice and consent requirements. To determine whether this strategy makes sense, you’ll need to weigh the cost of purchasing new policies against the potential tax savings.

If you have at least one BOLI policy, you must file annual returns with the IRS (Form 8925, “Report of Employer-Owned Life Insurance Contracts”) showing the total number of employees at year end, the number insured by BOLI, the total amount of BOLI in force, and certain other information. ⊙

Putting employees on notice

To ensure that business-owned life insurance (BOLI) proceeds are tax free, falling into one of the exceptions discussed in the main article isn’t enough. You must also do the following *before* the policy is issued:

- ⊙ Notify the employee or owner in writing that you intend to insure his or her life and of the policy’s maximum face amount,
- ⊙ Notify the employee or owner in writing that the company will be a beneficiary under the policy, and
- ⊙ Obtain the employee’s or owner’s written consent, both to being insured and to continuation of the coverage after termination of employment.

Once these requirements are met, the policy must be issued within one year after the insured signs the consent form or, if earlier, before his or her employment with the company ends.

Filing for bankruptcy may keep the tax collector at bay

There's a common misconception that bankruptcy can never be used to wipe out tax debts. In fact, tax liabilities that meet certain requirements can be discharged in bankruptcy. Here's a brief introduction to bankruptcy's impact on taxes.

What are your options?

Depending on whether the debtor meets the applicable requirements, there are, in general, two options in bankruptcy: 1) liquidation under Chapter 7 of the Bankruptcy Code, and 2) reorganization under Chapter 11 or 13.

In a liquidation, the bankruptcy trustee converts a debtor's nonexempt assets into cash and distributes the proceeds among his or her creditors. At the conclusion of the proceeding, any dischargeable debts — including certain taxes — are wiped out. Secured creditors generally retain their right to foreclose on the collateral.

In a reorganization, a plan is adopted for paying a portion of a debtor's unsecured debt (for example, five or 10 cents on the dollar) — as well as the full amount of any secured or priority debt — typically over a five-year period. “Nondischargeable” taxes

are usually considered priority debts, while “dischargeable” taxes are treated in the same way as other unsecured debts. Once the plan is completed successfully, the debtor receives a discharge similar to that in a Chapter 7 case.

Keep in mind that, even if a debtor is relieved of personal liability for taxes, any prebankruptcy tax lien recorded against the debtor's property will stay intact. So, if the debtor sells the property, taxes may be collected from the proceeds.

Which taxes are dischargeable?

Taxes are dischargeable in bankruptcy if the following requirements are satisfied:

1. Your liability is for *income* taxes. Bankruptcy relief isn't available for other types of taxes, such as payroll or sales taxes.
2. You haven't committed tax fraud or tax evasion.
3. The tax debt is more than three years old. That means the original due date (including extensions) of the tax return that generated the tax liability precedes the bankruptcy filing by more than three years.
4. You filed a tax return for the relevant tax debt more than two years before the bankruptcy petition.
5. In the event of an assessment from audit adjustments or an amended return, the tax was assessed at least 240 days before the bankruptcy filing.

Note that the periods described above may be extended by prior bankruptcies and certain other events.



What are the alternatives?

Given the negative impact of bankruptcy on a debtor's credit rating, it's a good idea to explore alternative strategies for resolving existing tax issues, such as an offer-in-compromise (OIC), a collection due process (CDP) hearing or an installment payment arrangement. (Note, however, that a federal or state tax lien can be just as harmful to a debtor's credit rating as a bankruptcy proceeding.)

An installment arrangement may be the best option, because it buys the debtor some time without delaying his or her ability to discharge taxes in bankruptcy. If the debtor submits an OIC, on the other hand, it will extend the 240-day period while the OIC is pending (and 30 days thereafter).

So, for example, if taxes are assessed on Jan. 1, the debtor submits an OIC on Aug. 1 and the IRS responds to the OIC on Sept. 1, he or she won't be able to discharge the tax liability in bankruptcy

unless the petition is filed after Oct. 1 (and meets the other requirements discussed above). A CDP hearing will extend both the 240-day period and the three-year period.

Reviewing your situation

As the effects of the recession linger, many people are contemplating filing for bankruptcy. If you're among them, consult your tax advisor and a bankruptcy attorney to determine whether filing for bankruptcy would be an appropriate strategy for resolving your tax liabilities. They can examine your tax situation and determine the extent to which any tax liabilities are dischargeable.

Be sure that you understand when the time periods discussed above expired or will expire, taking into account any events that extend those periods. If appropriate, delay the bankruptcy filing to ensure that you meet the requirements for wiping out past tax liabilities. ☺

Don't let your good deeds go unrewarded

Americans are known for giving generously to organizations and to those in need. Just remember the outpouring of money, services and items donated after the devastating earthquake in Haiti.

U.S. tax law is just as generous in providing tax deductions for charitable gifts — but the donor must be able to substantiate each dollar or asset given in order to receive a deduction. Unfortunately, many donors don't fully grasp the importance of such substantiation. Or they simply aren't aware of everything that's required.



Know the rules

You can substantiate cash donations of less than \$250 with a canceled check, a receipt from the charity or another reliable written record that

shows the name of the charity and the date and amount of your contribution. Separate contributions of less than \$250 to a single charity aren't combined in determining whether you exceeded the \$250 threshold. So, if you donate \$200 a month to a local food bank, you can substantiate your donations with canceled checks.

However, if you make even just one cash donation of \$250 or more to that food bank, you'll need a "contemporaneous written acknowledgment" from the charity describing the amount you contributed and the value of any goods or services you may have received from the charity in exchange for the donation.

Noncash contributions

If you donate an asset that's worth less than \$250, you'll need to obtain a receipt that shows the charity's name, the date and location of the contribution, and a description of the asset.

Noncash gifts of \$250 or more require a contemporaneous written acknowledgment from the charity containing the information described above for cash gifts as well as a description of the property.

For noncash property donations of more than \$500, in addition to the above substantiation requirements, you must maintain written records

that document the date you acquired the property, the manner in which you acquired it (for example, via purchase, gift or inheritance), and your adjusted basis in the property (except for certain publicly traded securities). Note that there are special rules for donating cars.

If your noncash gifts for the taxable year exceed \$500, you also must file Form 8283, "Noncash Charitable Contributions." This \$500 threshold is an aggregate of all noncash contributions; it's not an entity-by-entity calculation.

When an appraisal is needed

If you donate property valued at more than \$5,000 (\$10,000 for closely held stock), you'll need a qualified appraisal, signed by the appraiser and the charity on Form 8283. You don't need an appraisal for publicly traded securities. For noncash contributions exceeding \$500,000 or gifts of art worth \$20,000 or more, include a copy of the signed appraisal with your return.

The appraisal must be prepared by a qualified appraiser, as defined by IRS regulations, and must include specific information required by the regulations. Moreover, the appraisal must be prepared no earlier than 60 days before the property is contributed and generally no later than the tax return due date, including extensions.

The appraisal can't involve a prohibited appraisal fee. This generally means that the fee can't be based on a percentage of the appraised value of the property and/or a percentage of the allowable deduction. (Such a fee gives the appraiser the incentive to place a higher value on the property.)

Get the deductions you deserve

Although the above requirements may seem stringent, following them to a T is necessary in order to receive the tax deductions you deserve. With tax day just around the corner, now is the time to get your charitable giving documentation in order. If you have any questions regarding the deductibility of a donation, please consult your tax advisor. ☺



tax TIPS

IRS rethinks position on uncertain tax positions

Early last year, the IRS unveiled controversial rules requiring many companies to report uncertain tax positions (UTPs) on their tax returns using Schedule UTP. The rules required corporations that file Form 1120 (as well as certain insurance companies and foreign corporations) to report any UTPs, beginning with the 2010 tax year, if their total assets amounted to \$10 million or more.

The IRS has now revised its UTP plan. Only corporations that issue or are included in audited financial statements and that have total assets of \$100 million or more must file Schedule UTP for the 2010 tax year. The threshold drops to \$50 million starting with 2012 tax years and \$10 million starting with 2014 tax years. ☺

Maintenance vs. capital improvement: Are you overpaying taxes?

The line between maintenance and capital improvement can be a fine one, but the distinction can have a big impact on your tax bill. Maintenance and repair costs are currently deductible business expenses, while the cost of capital improvements can be recovered only through depreciation over several years.

In general, maintenance and repairs keep property in good operating condition. Capital improvements adapt property to a new or different use, substantially prolong its useful life, or materially add to its value.

Suppose a manufacturer rebuilds sections of its concrete floor each year because of damage caused by heavy equipment. It's likely that this would be considered deductible maintenance or repairs. But if the manufacturer replaces the floor with a longer-lasting steel-reinforced concrete floor, this work would likely be considered a capital improvement. ☺

The tax rules on this issue are complex and confusing, so it's no surprise that many businesses and real estate owners misclassify maintenance or repairs as capital improvements. If you believe you may have done so, consult your tax advisor to explore opportunities to reduce your tax bill by claiming missed deductions for the current and previous years. ☺

Don't overlook reinvested dividends

Most investors instruct their mutual funds to automatically reinvest dividends, but they often overlook this fact at tax time, which can result in unnecessary taxes. When you use dividends to purchase additional mutual fund shares, you increase your tax basis in the fund, which, in turn, reduces your gain or increases your loss when you sell shares.

If you don't track reinvested dividends and include them in your basis, you'll end up paying tax on them twice: once when they're paid and again when you sell your shares and they're included in the proceeds. ☺

New Jersey Gross Income Tax vs Federal Income Taxes – The Differences

By Glenn Schwier, CPA, JD

Many states base their tax laws on the Federal rules with slight modifications. While New Jersey follows Federal law in some areas, New Jersey is considered a Gross Income Tax state. What does this mean? The tax is based primarily on gross income with very few deductions. Here are some key areas where New Jersey and Federal tax law differ.

Retirement Contributions

Contributions to traditional IRAs are not deductible in New Jersey. However, on the flip side, distributions from IRAs are taxable in New Jersey only to the extent they exceed the nondeductible contribution. It's a common error for taxpayers to overlook this and wind up paying tax on this same money again at distribution time. 401k contribution treatment is similar for both New Jersey and Federal tax. Therefore, unlike traditional IRAs, 401K distributions are fully taxable in New Jersey. Note 401K plans which are transferred to IRA accounts retain the same tax treatment as the initial 401K and therefore, would be fully taxable to New Jersey upon distribution.

Buckets — One of the most confusing areas of New Jersey tax law is the concept of “buckets”. New Jersey requires all similar income to be put into buckets. (i.e. all partnership income goes together, all rental income goes together, etc.) New Jersey doesn't allow a net loss in any bucket. Therefore, unless you have gains from within the same bucket, you will lose the tax benefit of losses in that bucket. To add to this, New Jersey doesn't allow carryover losses. Therefore, any losses not allowed in one year will be lost.

Social Security, Unemployment and Pensions — Under the Federal rules, Social Security income may be taxable if your income exceeds \$25,000. New Jersey does not tax Social Security benefits. In addition New Jersey doesn't tax unemployment benefits, nor military pensions. Taxable pen-

sions, IRA distributions and annuities qualify for New Jersey pension exclusion. The exclusion applies if you are at least 62 years of age or disabled and your total income for the year is \$100,000 or less. The excludable amount is limited to lesser of the taxable pension or \$20,000 married filing joint (\$15,000 single/head of household).

Business meals — Federal allows a deduction of only 50% of business meals and entertainment. New Jersey allows 100% of these expenses.

Itemized Deductions — New Jersey does not allow most itemized deductions with the following exceptions: Medical Expenses are deductible on New Jersey tax return if to the extent they exceed 2% of your income rather than Federal 7.5% of AGI. New Jersey also allows a limited deduction of up to \$10,000 for real estate taxes. New Jersey and the IRS limit gambling losses to gambling winning. But if you are lucky enough to win the New Jersey lottery, you get to exclude the first \$10,000 from your state return.

Civil Unions — Same sex couples who file for recognition of civil union status in New Jersey can file a joint return and are taxed at same rates as married filing jointly. The Feds don't recognize the marriage for tax purposes and each partner must file their own 1040.

Conclusion

The above highlights only a few of the many differences between the New Jersey and Federal taxes. New Jersey and Federal income tax laws have their differences but are similar in one respect. You pay, they collect.

This article is intended for general informational purposes only and is not intended to be relied upon or considered a substitute for qualified tax advice.