

# tax IMPACT

November/December 2011

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## Tax treatment of debt forgiveness

# Watch out for tax bills delivered “COD”

As many people struggle to keep up with their payments on mortgages, credit cards and other debts, some creditors are willing to reduce interest rates, extend repayment terms or even forgive a portion of debt. But for many debtors receiving such help, the initial feeling of relief from financial pressure is quickly replaced by surprise and confusion when they discover they owe taxes on cancellation-of-debt (COD) income.

That doesn't mean you shouldn't explore debt restructuring opportunities. Even after taking additional taxes into account, you'll likely be better off. But it's important to understand the tax consequences.

### What is COD income?

Income tax applies to all forms of income, including COD. Think of it this way: If a creditor forgives a debt, you avoid the expense of making the payments, which increases your net income.

Debt forgiveness isn't the only way to generate a tax liability, though. You can have COD income if a creditor reduces the interest rate or gives

you more time to pay. Calculating the amount of income can be complex, but essentially, by making it easier for you to repay the debt, the creditor confers a taxable economic benefit.

You can also have COD income in connection with a mortgage foreclosure, including a short sale or deed in lieu of foreclosure. Here, the tax consequences depend on whether the mortgage is “nonrecourse” or “recourse.”

Nonrecourse means the lender's sole remedy in the event of default is to take possession of the home. In other words, you're not personally liable if the foreclosure proceeds are less than your outstanding loan balance. Foreclosure on a nonrecourse mortgage doesn't produce COD income.

Foreclosure on a recourse mortgage, however, can trigger COD tax liability if the lender forgives the portion of the loan that's not satisfied. In a short sale, the lender permits you to sell the property for less than the amount you owe and accepts the sale proceeds in satisfaction of your mortgage. A deed in lieu of foreclosure means you convey the property to the lender in satisfaction of your debt. In either case, if the lender agrees to cancel the excess debt, the transaction is treated like a foreclosure for tax purposes — that is, a recourse mortgage may generate COD income.

Keep in mind that COD income is taxable as *ordinary* income, even if the debt is related to long-term capital gains property. And, in some cases, foreclosure can trigger *both* COD income and a capital gain or loss (depending on your tax basis in the property and the property's market value).



## What are the exceptions and exclusions?

Several types of canceled debt aren't taxable. "Exceptions" are canceled debts that don't generate COD income. "Exclusions" are those that ordinarily would be included in taxable income, but that are wholly or partially excluded under certain circumstances.

Exceptions include:

- ⦿ Debt cancellations that are considered gifts, such as forgiveness of a family loan,
- ⦿ Certain student loans, if they're canceled in exchange for the recipient's commitment to public service,
- ⦿ Debts owed by a cash-basis taxpayer, if the payments would have been tax-deductible (for example, forgiveness of accrued deductible interest),
- ⦿ Debt reduced as a result of certain postpurchase price reductions, and
- ⦿ Certain mortgage reductions under the federal Home Affordable Modification Program.

Exclusions include:

- ⦿ Debts canceled by a bankruptcy court,
- ⦿ Debts canceled to the extent you're insolvent — that is, up to the amount by which your total liabilities exceed your total assets immediately before cancellation,
- ⦿ Business debts that meet the requirements for qualified real property business indebtedness or qualified farm indebtedness, and
- ⦿ Certain mortgage-related COD income. (See "Temporary relief for mortgage forgiveness" at right.)

One significant difference between exceptions and exclusions is that, while exceptions allow you to avoid taxes altogether, exclusions require

## Temporary relief for mortgage forgiveness

Under the Mortgage Forgiveness Debt Relief Act of 2007, homeowners can exclude up to \$2 million in cancellation-of-debt (COD) income (\$1 million for married taxpayers filing separately) in connection with qualified principal residence indebtedness (QPRI). The exclusion is available for debts forgiven (via foreclosure or restructuring) through 2012.

QPRI means debt used to buy, construct or substantially improve your *principal* residence, and it extends to the refinance of such debt. Relief isn't available for a second home, nor is it available for a home equity loan or cash-out refinancing to the extent the proceeds are used for purposes other than home improvement (such as paying off credit cards).

If you exclude COD income under this provision and continue to own your home, you must reduce your tax basis in the home by the amount of the exclusion. This may increase your taxable gains when you sell the home.

you to reduce certain "tax attributes," which can increase your taxes down the road. For example, exclusion of certain business debts may require you to reduce net operating losses, credit or loss carryovers or the tax basis of certain assets (subject to recapture as ordinary income when the assets are *sold*).

## Avoid surprises

If you're considering restructuring your debt, be sure you understand the tax implications so you can 1) plan for them, and 2) determine whether you qualify for one of the exceptions or exclusions that allow you to avoid tax on COD income. Moreover, because the rules surrounding COD income are complex, consult your tax advisor so you know what to expect on your next tax bill. ⦿

# Lending to or borrowing from your company the *right* way

It's not unusual for owners of closely held businesses to move money into and out of the company for various purposes. If the company is having trouble meeting its obligations, for example, an owner might advance personal funds to keep it afloat. Or if an owner is facing unusual personal expenses, he or she might withdraw funds from the business to cover them.

There are significant tax advantages to characterizing these transactions as loans. But to enjoy those advantages, you must treat advances and withdrawals as bona fide loans and document them as such.

## Why loans are preferable

When an owner withdraws funds from the company, the transfer can be characterized as compensation, a distribution or a loan. Loans aren't taxable, but compensation and distributions, of course, are.

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*Whether a transaction is a loan is a matter of intent.*

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And if the company is a C corporation, distributions trigger double taxation — in other words, corporate earnings are taxed once at the corporate level and again when they're distributed to shareholders (as dividends). Compensation is deductible by the corporation, so it doesn't result in double taxation. (But it is subject to payroll taxes.)



If the company is an S corporation or other pass-through entity, there's no entity-level tax, so double taxation isn't an issue. Still, loans are advantageous because 1) compensation is taxable to the owner (and incurs payroll taxes), and 2) distributions reduce an owner's tax basis, making it harder to deduct business losses.

There are also advantages to treating advances from owners as loans. If they're treated as contributions to equity, any reimbursements by the company will likely be taxed as distributions.

Loan payments, on the other hand, aren't taxable, apart from the interest, which is deductible by the company. A loan may also give the owner an advantage in the event of the company's bankruptcy, because debt obligations are paid before equity is returned.

## How to ensure loan treatment

It's important to establish that an advance or withdrawal is a loan. If you don't, and the IRS decides that a payment from the company is really a distribution or compensation, you (and, possibly, the company) can end up owing back taxes, penalties and interest.

Whether a transaction is a loan is a matter of intent. It's a loan if the "borrower" has an unconditional intent to repay the amount received and the "lender" has an unconditional intent to obtain repayment.

Unfortunately, even if you intend a transaction to be a loan, the IRS and the courts aren't mind readers. So it's critical to document loans and treat them like other arm's-length transactions. Among other things, you should:

- ⦿ Execute a promissory note,
- ⦿ Charge a commercially reasonable rate of interest — generally, no less than the applicable federal rate (AFR),
- ⦿ Establish and *follow* a fixed repayment schedule,

- ⦿ Secure the loan using appropriate collateral (this will also give the lender bankruptcy priority over unsecured creditors),
- ⦿ Treat the transaction as a loan in the company's books, and
- ⦿ Ensure that the lender makes reasonable efforts to collect in case of default.

Also, for borrowers who are owner-employees, ensure that they receive reasonable salaries, to avoid a claim that loans are disguised compensation.

### **Actions speak louder than words**

Calling an advance or a withdrawal a "loan" doesn't make it so. To avoid an IRS challenge, put it in writing and make sure your actions are consistent with the desired treatment. ⦿

## **Why jointly owned property may not be a good idea**

Many well-meaning parents think they can avoid estate planning by simply jointly owning their property with their children. The thought process might go like this: If I add my son, Josh, to the deed to my home, he'll automatically receive the property when I die.

While it may seem like a good idea, in reality it may not be. Here's why.

### **Estate planning issues**

Property held in joint tenancy with right of survivorship is co-owned and automatically passes to the surviving owner upon the death of the other party. But that doesn't mean there aren't other estate planning issues to consider.



For example, a gift tax return will most likely have to be filed to report what's essentially a transfer of assets. The value of the gift (such as the value of the interest in your home that Josh receives) will be counted toward your lifetime



gift/estate tax exemption — currently \$5 million but scheduled to drop to \$1 million in 2013. This may not be the best use of your exemption.

Joint bank accounts also can present estate planning issues. They're often set up for convenience purposes to help the true owner with his or her financial matters. But such arrangements are a poor substitute for a power of attorney and can result in unintended consequences for distributing assets to your heirs after your death.

### Unexpected income tax cost

When a joint tenancy interest is transferred, the property's tax basis is "carried over" to the recipient. So, for example, Josh, the joint-tenant child, will have a carryover tax basis in one-half of your residence. The carryover basis could result in an unanticipated income tax cost if the property is sold during your lifetime.

Let's say you had a tax basis of \$70,000 in the home that's later sold for \$320,000. Josh's one-half interest received by gift (worth \$160,000) would have a \$35,000 tax basis.

When Josh receives the \$160,000 proceeds, he'll owe federal and possibly state income tax on a capital gain of \$125,000 (the \$160,000 proceeds minus the \$35,000 tax basis). Note that the \$250,000 capital gain exclusion for a personal residence (\$500,000 for joint returns) won't apply to the sale of a nonoccupant owner's share of the property.

If the residence is sold *after* your death, however, the property will receive a "stepped-up" tax basis equal to the fair market value of the property at death — effectively reducing or eliminating potential capital gains taxes upon sale of the property. The entire property — not just your half — will get a basis step-up because it's all included in your estate. (Note that an adjustment is made in computing the estate tax liability that offsets any prior gift tax reporting, so there's no double tax.)

### Factoring in Medicaid

Suppose, after you add Josh to your home's title, your health declines and you require long-term care. Even if you have little money, you may not qualify for Medicaid benefits as a result of the transfer to Josh.

Although an individual's residence is usually exempt from treatment as a "countable resource" for Medicaid qualification purposes (for as long as there's an intent to return to the residence), adding Josh to your home deed will trigger a disqualifying period based on the value of the interest conveyed. Or, it may even convert the entire value of the residence into a countable resource for Medicaid purposes.

### Irrevocable is forever

Keep in mind that a joint tenancy interest in real estate is irrevocable: Once you've named a joint tenant, you can't remove him or her from the property's title.

You'll also need the joint tenant's consent for any future sale of the property. Moreover, you can be adversely affected if the joint tenant's interest in the property is an asset that becomes subject to his or her creditors or part of a divorce property settlement.

### Avoiding pitfalls

We've focused on the pitfalls of jointly owned property. But when it comes to estate planning, there are many others as well. Your tax advisor can help you avoid them. ☺

# tax TIPS

## Return required even for tax-exempt gifts

Even though the current gift tax exemption is a healthy \$5 million, that doesn't mean you can avoid filing gift tax returns. All gifts that exceed the annual gift tax exclusion (\$13,000 per recipient, \$26,000 for gifts "split" by married couples) must be reported on IRS Form 709, even if you don't owe any tax.

There are good reasons to file beyond just compliance, particularly if you make gifts of difficult-to-value assets, such as real estate or business interests. A gift tax return that meets "adequate disclosure" requirements triggers the three-year limitations period for audits. If you don't file, the IRS will have unlimited time to challenge your valuation and, if the adjusted value brings your total gifts over the exemption amount, the agency will assess taxes, penalties and interest. Also, to qualify for gift-splitting for annual exclusion purposes, you'll need to file a gift tax return with your spouse's written consent. ©

## Watch out for charities that lose their exemption

If you're charitably inclined, you know that the charitable income tax deduction is available only for gifts to *qualified* charities. Unfortunately, almost 275,000 organizations automatically lost their tax-exempt status recently because they failed to file required annual reports for three consecutive years. Many of the organizations simply went out of business, but the list also includes some smaller organizations that were unaware of their filing obligations. A list can be found in the IRS's "Automatic Revocation of Exemption" article found on its website's "Charities & Non-Profits" tab.

The IRS has established procedures for these organizations to reinstate their tax-exempt status, often retroactively. In the meantime, monitor the list and avoid making gifts to organizations that appear on it. Deductions for gifts made *before* an organization appeared on the list, however, aren't affected. ©

## IRS to eliminate "high-low" method?

In July, the IRS announced its plan to discontinue the "high-low" method as an alternative for substantiating business travel expenses. The change would require some employers to keep more detailed records.

Instead of reimbursing employees for their actual expenses for lodging, meals and incidentals while traveling, employers may pay them a per-diem amount, based on IRS-approved rates that vary from locality to locality. To simplify record keeping, the high-low method allows employers to rely on just two rates, one for "high-cost localities" and one for "low-cost localities."



In August, an IRS representative said that the agency was reconsidering its decision based on feedback from taxpayers who use the high-low method. Check with your tax advisor for the latest information. ©

## S Corporation Compensation — Will your company survive an audit?

By Harlene Stevens, CPA

In these difficult economic times, the IRS is seeking to increase tax revenues. One of the most lucrative areas for additional taxes is salaries paid to officers of S corporations. As a tax advisor it is my goal to save my clients money while abiding by IRS regulations. One of my most frequent conversations with my S corporation shareholders is the concept of “reasonable compensation”.

The Internal Revenue Code establishes that any officer of an S Corporation is an employee of the corporation for federal income tax purposes. S corporations should not attempt to avoid paying employment taxes by having shareholders treat their compensation as cash distributions, personal expense payments or loans.

The reason that the IRS will scrutinize S corporation compensation is fairly simple. Although all earnings of S corporations flow through to the shareholder and are taxed at the individual tax rates, salaries to shareholders are also subject to employment taxes (FICA, Medicare, Withholding and New Jersey state unemployment tax). For example, a salary of \$100,000 would amount to an additional \$15,300 of FICA and Medicare tax. If the IRS is triumphant in classifying distributions as wages, not only would the corporation and employee be subject to employment taxes, but the corporation may be assessed penalties and interest both for underpayment of tax and failing to file payroll tax returns.

My clients often ask, “How much salary is reasonable”? Unfortunately this is a vague issue without any clear guidelines. However, the IRS usually looks at the following factors in determining reasonable compensation:

⊙ **Training and experience** — what is your educational training, prior experience and qualifications?

- ⊙ **Duties and responsibilities** — what is your position and involvement in the business?
- ⊙ **Time and effort devoted to the business** — how many hours per week are spent working on business issues?
- ⊙ **Dividend history** — how much has been paid as cash distributions?
- ⊙ **Salary payments to non-shareholder employees** — are employee salaries greater than the shareholder salaries? Has there been a consistent history with regard to shareholder salary payments?
- ⊙ **Timing and manner of paying bonuses to key people** — do your employees receive an annual bonus?
- ⊙ **What do comparable businesses pay for similar services** — In today’s economy what would your salary be if you worked as an employee?
- ⊙ **Compensation agreements** — do you have a written compensation policy? It is a good idea to keep a documentation of reasonable salary in the corporate minutes.
- ⊙ **An evaluation of shareholder salaries to net income** — What is the percentage of salaries paid to the net income of the corporation?

It is important for S Corporation shareholders to be aware that the IRS may scrutinize salaries and cash distributions. By working carefully with your CPA, you should be able to set up compensation that will be deemed reasonable in the event of an IRS audit.

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