



## **Celebrating our 20th Anniversary**

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We are pleased to provide you our online informational newsletter which we believe you will find of interest. Each month brief articles on relevant topics will be included, along with a tax calendar for the current and following months.

**March 2007**

### **In This Issue**

Help Your Grandchildren Pay for College  
Bargain Priced Home Sales to an Adult Child  
Gift Taxes  
Documenting Charitable Contributions  
Tax Calendar

### **Help Your Grandchildren Pay for College**

Contributing to a 529 plan is a great way for grandparents to help their grandchildren pay for college. It is also an effective way to remove assets from the grandparent's estate without paying the gift tax. Grandparents can contribute up to \$60,000 per person to a 529 plan without incurring gift tax and still maintain control of the account. As an added feature, money in a 529 plan owned by a grandparent is not assessed by the federal financial aid formula.

## **Bargain Priced Home Sales to an Adult Child**

As part of an estate and gift planning strategy, a taxpayer may consider transferring ownership of a family home to an adult child. Since many residential properties have gone up substantially in value over the last few years, the tax implications of such transfers can be very significant. When a taxpayer sells a home (or any other asset) for a bargain price to a relative (or any other person), they are actually treated as making a two-portioned transaction. The first portion is considered a sale for an amount equal to the bargain sale price. Their entire basis (cost) in the transferred property is offset against the sale proceeds. The second portion is considered a gift equal to the difference between the fair market value (FMV) of the property and the bargain sale price. The following example illustrates the tax consequences for the seller.

**Example:** Gwen, an unmarried taxpayer, sells her \$600,000 home in 2007 to her unmarried adult son, Fred, for a bargain price of \$350,000. Gwen is treated as selling the property to Fred for \$350,000 and making a related \$250,000 gift (\$600,000 FMV – \$350,000 sale price).

Gwen's taxable gain from the sale portion equals the difference between the \$350,000 sale price and her entire basis (cost) in the transferred property. For the gift portion, Gwen can use her \$12,000 annual gift tax exclusion to reduce the potentially taxable gift amount to \$238,000. The \$238,000 gift then reduces her \$1 million federal gift tax exemption dollar-for-dollar. It also reduces her separate \$2 million federal estate tax exemption dollar-for-dollar.

Assuming the parent has most or all of their \$1 million federal gift tax exemption available to shelter the gift portion of the bargain sale transaction, this type of transaction generally works out quite well for the parent because it removes an appreciating asset from their estate. Also, assuming the parent lives long enough to benefit from future increases in the federal estate tax exemption, the hit to that exemption will be partially or completely restored.

The sale portion of the bargain sale transaction obviously has income tax implications for the parent. The parent's capital gain is determined by subtracting his or her entire basis in the home from the sale price. Of course, if the home is the parent's principal residence, the \$250,000/\$500,000 federal gain exclusion privilege will usually be available to offset some or all of the gain.

In a bargain sale scenario, the child's tax basis in the home will generally be the sale price plus the amount of any federal gift tax triggered by the transaction. When the home has appreciated significantly in value (as will often be the case), the child may be stepping into a substantial built-in taxable gain that can cause future problems. This is not a great tax outcome for the child, but complaining about the tax results of an otherwise favorable bargain sale deal seems petty.

On a more positive note, if the child uses the home as a principal residence for at least two years, the federal home-sale gain (\$250,000/\$500,000) exclusion privilege will become available. Also, if the child is able to arrange purchase-money mortgage financing for the purchase portion of the transaction, the mortgage interest will generally be deductible as qualified residence interest.

The bargain sale scenario can produce great tax results for the parent. However, as the analysis illustrates, it may produce less-than-great income tax results for the child if the home has appreciated significantly.

## **Gift Taxes**

If you gave any one person gifts in 2006 that valued at more than \$12,000, you must report the total gifts to the Internal Revenue Service by filing a gift tax return. Normally, such returns do not produce tax, unless the giver has previously used his or her \$1,000,000 exemption.

Gifts include money and property, including the use of property, without expecting to receive something of equal value in return. If you sell something at less than its fair market value or make an interest-free or reduced-interest loan, you may also be making a gift.

There are some exceptions to the tax rules on gifts. For example, the following gifts do not count against the annual limit:

- Tuition or Medical Expenses that you pay directly to an educational or medical institution for someone's benefit
- Gifts to your Spouse
- Gifts to a Political Organization for its use
- Gifts to Charities

If you are married, both you and your spouse can give separate gifts of up to the annual limit to the same person without making a taxable gift. Also, the person who receives your gift does not have to report the gift to the IRS or pay gift or income tax on its value.

## **Documenting Charitable Contributions**

When it comes to charitable contributions, giving may be better than receiving, but receiving a tax deduction now requires a little more effort, in light of new substantiation rules introduced in the summer of 2006 (but not effective until 2007 for calendar taxpayers). To ensure that you can claim the charitable deductions to which you're entitled, we want to make you aware of these new recordkeeping rules.

Cash Contributions of Less than \$250 in Single Donation. For cash contribution, it's not unusual to give small amounts without expecting a receipt, such as when you drop a \$20 bill into the collection plate at church. These amounts may accumulate to a sizeable sum by year-end. Previously, if the donation was less than \$250, you could either keep cancelled checks or reliable records, such as a list that you've prepared showing the dates, amounts donated, and charity name. Under the new rules, however, it's no longer sufficient to simply keep good records of these donations. When you tally up the amount to claim as deductible you must have a bank record (most likely a cancelled check, wire transfer acknowledgement, or credit card record) or written acknowledgement from the charity (donee) showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

If you are likely to itemize deductions on your income tax return and typically make cash contributions of less than \$250, you should make donations by check rather than cash, because that will easily satisfy the documentation requirements. Simply keeping good records of the donations will no longer be enough to claim the deduction.

Cash and Property Contributions of More than \$250 in Single Donation. Substantiation of larger contributions of cash or other property (those that are more than \$250) were not changed by the new rules, but as a reminder, they require a little more effort to substantiate. A written acknowledgement from the charity must be obtained showing the description of the property or amount of cash donated and a statement as to whether the donor received any goods or services (with a good faith estimate of value) for the property donated. A cancelled check or other reliable records are not sufficient proof (you can obtain one written acknowledgement for multiple gifts of \$250 or more to the same charity). The acknowledgement must be received contemporaneously; that is, it must be obtained no later than the due date (or extended due date, if applicable) of the tax return for the year the contribution was made.

Contributions of Used Clothing and Household Items. If you typically donate used clothing or household items to charities, such as Goodwill, the items must be in “good condition or better” unless the items were worth more than \$500 and a qualified appraisal report is attached to your tax return. The IRS has not yet defined what is meant by “good condition or better.” Thus, you might consider keeping a detailed list and photos of contributed items (unless the property is appraised). No new documentation is required, but to protect yourself in case of an IRS audit, you should, at a minimum, document that the donations were in good condition. Furthermore, the use of unattended drop-off sites should be reserved for items of minimal value. It may be difficult to substantiate the contributions without a receipt.

Contributions Via Payroll Deductions. For any amount (even if it’s less the \$250) of contributions made by payroll withholding, you’re now required to keep an official pledge card from the charity and a document from your employer (for example, a pay stub or Form W-2) showing the amount donated.

Vehicle Contributions. If you’re planning to donate a car, boat, or plane that’s valued over \$500, you have to follow strict substantiation rules in order to claim the contribution deduction. Under these rules, you must receive, and attach to your tax return, a written acknowledgement from the charity within 30 days after the donated vehicle is sold (or within 30 days of the contribution if the charity uses the vehicle significantly in its exempt purpose, makes major improvements to the vehicle, sells it for a significantly discounted price, or gives it to a needy person in furtherance of the charity’s exempt purpose). The information needed in the written acknowledgement from the charity should include the (a) name and taxpayer identification number of the donor and (b) vehicle identification number (or similar number) of the vehicle.

The IRS has just issued new rules that require donors of vehicles valued at more than \$500 to attach a special form (Form 1098-C – Contributions of Motor Vehicles, Boats and Airplanes), which is received from the charity and reports the necessary information about the vehicle donation (the form is optional for vehicle donations of \$500 or less). To claim the deduction for a vehicle valued at more than \$500, you should attach Copy B to your tax return.

Property Contributions of More Than \$5,000. If you’re planning to contribute property (other than publicly traded securities) valued at more than \$5,000 (\$10,000 for closely held stock), please discuss these plans with us as soon as possible. Although the rules for substantiating this type of property haven’t changed, there are now stricter rules for what is considered a “qualified appraisal” and who is considered a “qualified appraiser.” You must have the appraisal done not earlier than 60 days before the donation and received by the due date (including extensions) of your tax return.

To claim a deduction, it’s important to dot all the “i’s” and cross all the “t’s” in following the requirements of a qualified appraisal. Furthermore, stiffer penalties now apply to both appraisers and taxpayers for substantial valuation misstatements.

We hope this information is helpful as you plan for your charitable contributions. It's important to follow these recordkeeping requirements if you hope to claim a deduction for your donations, because the IRS can and will disallow charitable deductions if these requirements are not met. If you would like more details about these or any other aspects of the new rules, please don't hesitate to contact us.

## TAX CALENDAR

### MARCH 2007

#### March 15.

**Corporations.** File a 2006 calendar year income tax return (Form 1120 or 1120-A) 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. Be sure to use the Form 7004 with the revision date of December 2006.

**S corporations.** File a 2006 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., 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, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2007. If Form 2553 is filed late, S treatment will begin with calendar year 2008.

#### March 31

**Electronic filing of Forms 1098, 1099, and W-2G.** File Forms 1098, 1099, and W-2G with the IRS. This due date applies only if you file electronically (not by magnetic media). The due date for giving the recipient these forms remains January 31. For information about filing Forms 1098, 1099, or W-2G electronically, see Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically.

### APRIL 2007

#### April 10

**Employees who work for tips.** If you received \$20 or more in tips during March, report them to your employer. You can use Form 4070.

#### April 17

**Individuals.** File an individual income tax return for 2006. If you want an automatic six-month extension of time to file your return, file Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. Alternatively, you can get an extension by phone or over the Internet if you pay part or all of your estimated income tax due with a credit card. Then file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2007 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2007 estimated tax. Use Form 1040-ES.

Note that April 17 is also the deadline for making contributions to IRAs or Roth IRAs for 2006.

**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 \$1,500 or more in 2006 to a household employee, file Schedule H (Form 1040) with your income tax return and report any 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 2005 or 2006 to household employees. Also report any income tax you withheld for your household employees.

**Partnerships/LLCs.** File a 2006 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return and provide Schedule K-1, file Form 7004. Then file Form 1065 by October 15.

**Electing large partnerships.** File a 2006 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.

**Trusts and Estates.** File a 2006 calendar year return (Form 1041). Provide each beneficiary with a copy of Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return and provide Schedule K-1, file Form 7004. Then file Form 1041 by October 15.

**Corporations.** Deposit the first installment of estimated income tax for 2007.

**Gift Tax Returns.** If you made taxable gifts in 2006, file Form 709.