Legacy M&A ADVISORS LLC

M & A UPDATE®

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The Boat / Second Home / Cabin in the Woods / Downtown Condo Deduction

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Introduction

Why buy one home and deduct a small amount of mortgage interest, when you can buy two homes and deduct double the amount of mortgage interest? A not-so-well-known rule exists regarding second homes.

Most people focus on one home, their first home, also known as their primary residence. Many tax and investment advantages are utilized because of a primary residence. For the most part, real estate tends to rise over time, making it a fair and stable investment. Mortgage interest is deductible on Schedule A of the Individual Form 1040. Insurance and taxes are deductible as well. Once the primary residence is paid for in full, it is a dwelling in which the resident can live rent and mortgage free, freeing up the available cash for other investments such as stocks, bonds, and closely held business ventures. Further, when the primary residence is sold, the gain is excludible up to $500,000 tax free under section 121 of the Internal Revenue Code. A primary residence, despite the recent drawback in value for real estate, stands as a good investment.

A Second Residence

To quote the Internal Revenue Code, "Whether property is a residence shall be based upon all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer that contains sleeping space, toilet and cooking facilities. A residence does not include personal property such as furniture or a television, that in accordance with the applicable local law, is not a fixture."

A second home also has its advantages. Any dwelling with a kitchen facility, sleeping accommodations, and a washroom qualifies as a second residence for tax purposes. Second homes are eligible for interest and tax deductions as well. For the boater, this deduction is a windfall. Not only does the boater get to deduct the value of their house, but their boat as well. Most boats 25 feet in length qualify for second home treatment. While portable toilets generally don't qualify, those with installed "heads" fit the rule. As far as a galley area is concerned look for more

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A CASE STUDY

The Tax Court ruled that payments made by a corporation to a married couple were repayments of a loan made by the wife. In this case, the wife loaned money to a corporation, in which her husband was the sole shareholder. This corporation later dissolved and a new corporation was later formed to continue the business. The new corporation made payments of $95,000 and $70,000 to the wife, which the couple treated partly as taxable interest and partly as nontaxable repayment of the wife's loan. The IRS ruled that the payments were nondeductible constructive dividends to the husband. The Tax Court ruled against the IRS, finding that while there was not a written assumption of the loan between the new and old corporations, the new corporation had purchased a software working model from the old corporation that had been developed with the money borrowed from the wife. The Court found that if these payments were not considered repayments, then the new corporation would have been unjustly enriched. As a result, the payments made to the wife were not treated as constructive dividends to her husband.

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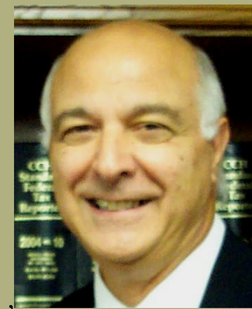
than a microwave to justify the galley requirement. An installed stove of gas or alcohol fuel fits nicely. As far as sleeping quarters, most boats 25 feet in length with an enclosed cabin and a front birth will suffice under the definition. Bringing all the comforts of home is not only necessary for creature comfort, but carries tax advantages as well being a second home.

Vacation Homes

A decade ago, there used to be a lot of controversy as to whether vacation homes were considered personal property or business property capable of being properly exchanged in a Section 1031, like–kind exchange. There was the argument that because they are used for personal use, they did not qualify. On the other hand, there was the argument that because this asset is a capital asset and subject to capital gains, it is by default an asset subject to 1031 deferral. Fortunately, as of 2006, the tax law made this more clear. If the property is rented for 14 for 14 days or more per tax year, the asset qualifies for like-kind exchange. If the asset is being used 13 days or less, it does not qualify as a like-kind asset. There is now a relatively clear answer to vacation homes and their existence. Remember interest and taxes, together with all operating expenses are deductible if the 14 day rule applies.

Conclusion

Many people invest their extra money in stocks, retirement accounts, CD's and other worthwhile endeavors. In America, we have the opportunity to purchase second homes. Whether they are a permanent structure on land, drive over highways, or float on water, they qualify for mortgage interest deduction if they have washroom, kitchen, and bedding facilities. Not only does the taxpayer get to own the assets and enjoy them with their families and clients, they get to enjoy financial and tax advantages as well. Anyone desiring a second home would be well advised to consider the purchase seriously.



Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **Mortgage interest (for primary residences) is deductible on Schedule A of the Individual Form 1040. Insurance and taxes are deductible as well.**
- **Second homes are eligible for interest and tax deductions as well.**
- **Not only does the taxpayer get to own the assets (a second residence) and enjoy them with their families and clients, they get to enjoy financial and tax advantages as well.**

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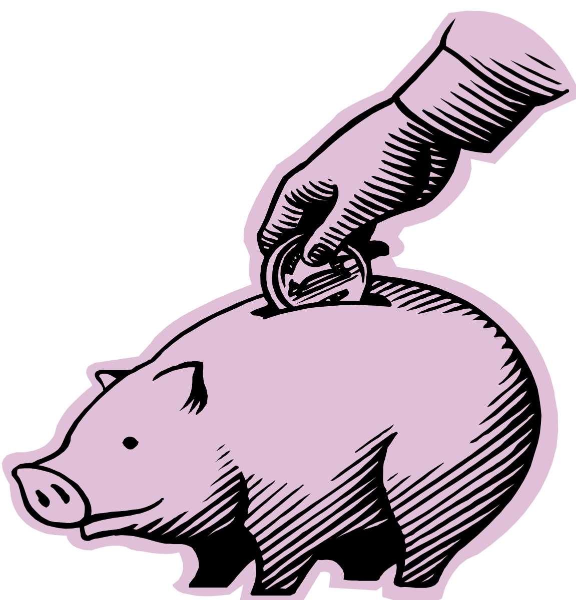
A CASE STUDY CONTINUED:

Editor's Comment: The Tax Court appears to have taken an equitable approach in this case that worked out in the best interest of the taxpayers. However, better tax planning at the time the loan was made and when the new corporation was formed may have avoided this conflict altogether, saving the couple court costs and attorney's fees. A written loan assumption agreement between the old and new companies may have provided more clarity as to how the repayments were to be classified later.

Remember, to prevent such problems, when loaning money to a private, closely-held company, you should always have a loan agreement, a repayment schedule and interest stated. In addition, a corporate resolution should be placed in the corporate records to approve and verify the fact that an actual loan has taken place.

If you have loaned funds to your company, contact the professionals at The Center to review the transaction and determine whether or not you have handled all aspects of the transaction properly.



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VALUE DRIVERS TO MAXIMIZE THE SELLING PRICE OF YOUR BUSINESS – PART 1

This is the first in a series of articles outlining the steps any business owner can take to maximize the value of his/her business when it comes time to sell it.

1. Optimize Cash Flow

It probably comes as no surprise that the primary driver in determining the value of any ongoing business is its provable cash flow. Cash is the lifeblood of any business and the more successful a business has been at generating cash, the more valuable it will be to any buyer. Cash flow can be increased by (a) Increasing Sales, (b) Decreasing Costs, or (c) a combination of both.

Also, a savvy buyer will almost always ask a prospective seller, what his/her ideas are on how to continue growing the cash flow of his/her business. You will want to consider your answer to this question very carefully. A business without any growth prospects is not worth as much as one that has immediate growth opportunities. On the other hand, if the opportunities are that obvious, and that immediate, a savvy buyer will want to know why you haven't pursued these opportunities already.

2. Separate and Optimize Real Estate

If you lease the commercial real estate your business operates from, this might be a good time to re-negotiate a lower lease rate in exchange for a longer lease term. Also, consider negotiating several short options to renew your lease so that the total term equals or exceeds ten years. Most commercial lenders will cap the buyer's loan term at ten years, or the maximum remaining term of the lease. Having ten years to pay it off makes the monthly payment that much more affordable for the buyer.

If you own the real estate inside your business, this would be a good time to separate the real estate into a separate entity still owned by you, and have the business pay fair market rent to the new entity. Since the current selling price multiple for $100,000 of business cash flow is ~3-5x, the multiple for the same amount of net operating income from real estate is ~10-12 times. Thus, while this will lower the business' cash flow, and the business' selling price, it will substantially raise the combined value.

Separating the real estate and offering the business for sale with the option of either renting or acquiring the real estate will also substantially increase the pool of buyers who might be interested in your business.

To be continued…

If you know of someone who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at: mertel@legacymandaadvisors.com.

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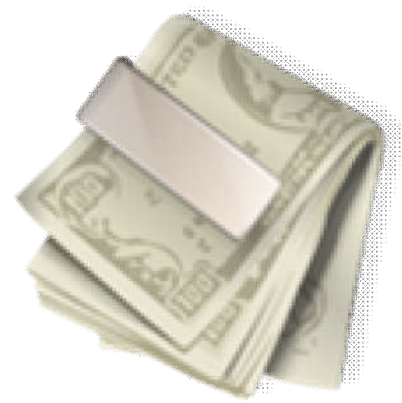

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Frequently Asked Questions…

Q: I am a sole proprietor. Must I have a tax identification number?

A: The sole proprietor is the only classification of business entity that does not need a tax ID number. However, if the sole proprietor has employees or a pension plan he or she must report, it must have a taxpayer identification number. In the case of the proprietor having no employees or reportable pension obligation, the proprietor's number is his or her social security number.

Q: What is included in an estate for estate tax purposes?

A: All the assets the decedent owned are included in the value of the estate. The value is calculated as the sum total of the fair market value of assets which are includible. The total value of all the assets are what is referred to as the gross estate. The gross estate for IRS purposes can include probate property as well as non-probate property.

Q: Is my business worth more or less this year due to the dampened economy?

A: Generally, most businesses will see a slight dip in their value this year due to the slow down in the economy. The silver lining to this is that the depressed value allows business owners to transfer more stock to their successors on a tax free basis, as opposed to when the economy and their business value is inflated. This fact makes 2012 a great time to begin estate planning and business succession planning.