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Executive Compensation ■ Succession ■ Wealth Transfer Planning

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in this issue:

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To Buy or Not to Buy: Exploring the Leasing Option

Automobile leasing has grown in popularity over the past decade, but many people still hesitate to enter into a lease. This may be because there are so many factors to consider that it seems easier to buy a vehicle. Under the right circumstances, however, leasing an automobile can save you considerable money, and even taxes. No one can tell you which option is better without knowing your particular situation, but these factors may impact your decision.

How Does Leasing Work?

When you lease an automobile, you only pay for the portion of it that you use, or the amount by which it depreciates. Many people hesitate because, at the end of the lease, they don't own anything. But, that's exactly why lease payments are lower than loan payments. You're not buying the leftover value in the car—you're buying only what you use.

A lease payment consists of a depreciation charge and a finance charge. The finance charge is much like the interest you would pay on a car loan. The depreciation charge is determined by dividing the value of the car that you use by the number of months in the lease. Without considering the tax effects, the short-term cost of leasing compared to buying is about the same. This assumes that you sell your car after the loan is paid off for its full market value. But as you well know, this is often not the case, especially if the car is used as a trade-in. If you are apt to keep your car for 10 years, then buying may be your best option. What about the tax effects? Ultimately, the *tax cost* of leasing versus buying may be about the same. However, the timing of when you get the deductions can be greatly impacted by your decision.

Claiming Tax Deductions on Leases

Because you do not own a car that you lease, you are not allowed to depreciate it. You can, however, deduct at least some of the cost of operating a car leased primarily for business purposes. Keep in mind that you are only allowed to deduct the business portion of the costs of a lease if the car is also used for personal purposes, such as commuting.

You have two options for figuring your deductible expense on a business vehicle that is leased for more than 30 days: the standard mileage rate allowance or actual expenses method. The standard mileage rate allowance

continued on page two

to buy or not to buy: exploring the leasing option

continued from page one

is easier to calculate, but it may provide less tax relief than the actual expenses method if you do not drive a lot of miles or if your car is relatively expensive.

The standard mileage allowance is a cents-per-mile allowance that takes the place of deductions for lease payments; vehicle registration fees; and the expenditures on gas, oil, insurance, maintenance, and repairs. The standard mileage allowance rate for business use of a car—leased or owned—is 54.5 cents a mile in 2018. To figure out your deduction, simply multiply the rate by the number of miles driven.

The actual expenses method generally allows you to deduct all out-of-pocket expenses for operating your car for business, from lease payments to repair costs. If the car you have leased has fair market value in excess of the luxury vehicle threshold according to the IRS, your deduction is reduced by a so-called "inclusion amount," which is added to your gross income. This additional sum brings your deduction roughly in line with the depreciation you would have been able to claim as the car's owner.

Inclusion amount tables in IRS Publication 463 can help you determine the inclusion amount that applies in your case. Because the inclusion amounts increase from year to year in the course of a lease, you may want to consider taking out a lease with a term of no more than two years.

Any advance payments on the lease must be deducted over the entire lease period. If you take out a lease with an option to buy, you can deduct the payments if the arrangement is set up as a lease. If, however, the arrangement amounts to a purchase agreement, the payments are not deductible.

Leases—Hidden Traps

Despite the limits on deductions for luxury vehicles, the available tax breaks for business owners are generous enough to make leasing an attractive alternative to buying—especially if you want to change cars frequently. Before you sign on the dotted line, consider the potential pitfalls involved in leasing:

Mileage limits: All leases have mileage limits, usually 12,000 or 15,000 miles. If it's probable that you'll rack up more miles, you could face costly penalties. Try to negotiate the mileage limit up in exchange for higher lease payments. Or, buy the car.

Open-end leases: In an open-end lease, the residual value is redetermined at the end of the lease. If the residual value is lower than initially projected, you have to make up the difference. Closed-end leases avoid this problem, but your payments may be higher.

Early termination: When leasing, be sure to keep the car for the entire lease period. Penalties for early termination are severe and are usually difficult to get out of. If you're not sure how long you'll keep the car, consider a shorter lease term or purchase it.

While laws require dealers to disclose more information on leases, key information can be buried in the fine print or omitted completely, like the interest rate that you are being charged. Be sure you completely understand the terms before signing on the dotted line. Leasing your next automobile can either make a lot of sense, or it can be a big mistake. Your tax professional can help you consider all of the factors and make the right choice. ■

Maintaining a Successful Banking Relationship

Your bank constantly evaluates you and your business. They examine your financial statements, but also notice subtleties, such as your current financial health and well-being.

Remember, the nature of the banking business is to *evaluate risk*. As a business owner, your bank needs to know that all is well with your personal and business finances. If you provide them with information or signals that suggest you are having financial difficulty—and you do nothing to make them think otherwise—you might as well ask them to turn down your next loan request, raise your interest rate, or call your loan.

Appearances Matter

Obviously, your bank wants to continue a positive relationship, and they look to you to provide assurance for doing so. The fact is that while you or your business may be prospering, you may be sending them conflicting information. The following are some signals that may attract attention:

- **Making the Daily Review Lists.** Most banks review daily lists of checks drawn on uncollected funds, overdraft accounts, and large transactions. If your account regularly appears on one of these lists, it could suggest that you are out of cash or otherwise headed for trouble.

  They also review daily lists of past-due loans, loans with incomplete collateral documentation, and late financial statements. You may not consider late statements significant, but bankers do. They have learned that people are seldom late when they have good news. If you are slow to pay, banks may assume the worst.

- **Experiencing Cash Flow Problems.** When you frequently request small loans to cover incidental expenses, banks may begin to assume that your business is not generating enough cash. Or, if you maintain high balances on your bank credit cards, a banker has the right to wonder why you are willing to pay high interest rates rather than pay off the balances. When your financial statement shows a large net worth and a small amount of cash, banks may worry that your debt service is exceeding your cash flow.

- **Changing Your Proposal.** When you change your mind too often in your dealings with a bank, you may leave a negative impression. One fairly common situation that bankers encounter is a customer coming to the bank with a request for a specific loan amount. The banker gets it approved, and the customer then says more money is needed. Thus, the loan officer may need to take a proposal back to the loan committee.

- **Becoming Rough Around the Edges.** When bankers evaluate the risk of a loan, they take a long, hard look at the borrower's current condition. In loan committee meetings, it is important to make certain you are sending the proper message. If loan officers notice a drastic change in your appearance or behavior, they may justifiably wonder what is wrong.

  In addition, if the company's building site looks run-down, with peeling paint or disheveled landscaping, someone from the bank may notice. To the bank, it may look like you are not paying attention to the details of running your business or that you are unable to pay for basic maintenance.

Reflect, Then Act

If any of these descriptions sound uncomfortably familiar, consider developing a strategy for implementing changes *now*. Maintaining a good relationship with your bank is crucial to executing your business's financial plan. Whenever possible, eliminate minor problems today that could become roadblocks on your path to success tomorrow. ■

Can a Living Trust Replace Your Will?

When planning your estate, you may consider setting up a **revocable living trust**. A properly managed revocable living trust can provide unique benefits; however, it does not completely replace a **will**. In determining whether this type of trust is appropriate for you, it helps to understand the overall benefits and tradeoffs of this estate planning tool.

A revocable living trust is created during your lifetime, and you can alter it in any way, and at any time. One key feature is that it allows you to retain control of the management and distribution of your assets.

The Probate Connection

Many people establish a revocable living trust to avoid **probate**, which is the legal process of settling your estate. Assets distributed from a trust upon your death *do* avoid probate. However, the probate process itself is not as burdensome for many estates as in the past. Many states have adopted the Uniform Probate Code, which greatly simplifies the process for many small- to medium-sized estates.

But, even with these improvements, the probated assets in your estate still become a matter of public record, which may raise privacy concerns. Avoiding probate may also be appropriate if you own properties outside your state of domicile, which may involve multiple probate proceedings.

Once you set up a revocable living trust, you must transfer your assets into the trust. Failing to do so will subject your assets to probate. Simply signing a trust document *without* retitling assets renders your living trust useless.

Do I Still Need a Will?

The short answer is yes. Generally, a revocable living trust cannot entirely replace the need for a will. There are some assets you may not wish to place in a trust. For example, it may be impractical to transfer tangible personal property such as automobiles, furniture, and jewelry to a trust. Consequently, some of your assets will remain outside your trust, making a will necessary to name your intended beneficiaries of those particular assets. If you have minor children, a will may also be used to designate a **guardian** for them.

Other assets may require special consideration. For example, retirement plan accounts (Individual Retirement Accounts (IRAs), 401(k)s, and profit-sharing plans) cannot be retitled to a living trust, although you could change the beneficiary designation to the trust. However, naming someone other than a spouse as beneficiary of a qualified retirement plan often requires spousal consent, because in many states, spouses now have rights to retirement plan benefits. In addition, naming your trust, rather than your spouse, as the beneficiary of your qualified retirement plan may have income tax consequences at the time of your death.

Trusts and Taxes

Your legal professional can help you examine all the variables affecting your property—the *type* of assets (e.g., real estate, life insurance, bank accounts, savings, business interests, and personal property), *where* they are located, and *how* they are titled to determine if a revocable living trust can help you meet your short- and long-term estate planning goals. ■

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