tax IMPACT

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Tax Tips
0% capital gains tax rate, the IC-DISC, and more

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Multistate taxation: How the laws may trip you up

If you split your time between two or more states, watch out for double taxation. Contrary to popular belief, there's nothing in the U.S. Constitution or federal law that prevents more than one state from taxing the same income. And, although many states offer credits for taxes paid to other states, these credits aren't always available.

The laws regarding multistate taxation are complex and they vary from state to state. Here is an overview of some of the concepts, but it's critical to consult a tax advisor about your particular circumstances.

Domicile, residence and income source

Generally, if you're domiciled in a state, that state has the power to tax your worldwide income. Your domicile is the place where you have your "true, fixed, permanent home." It may also be defined as "the principal establishment to which you intend to return whenever absent." Once you establish domicile in a state, it remains there until you establish domicile in another state.

States have the power to tax income derived from a source within the state, even if you're not a domiciliary or resident.

The key to determining your domicile isn't how much *time* you spend in a place, but rather your *intent* to remain there indefinitely or to return there. (See "Where is your domicile?" on page 3.)

States also have the power to tax the worldwide income of statutory residents. You can have only one domicile, but it's possible to be a resident of two or more states. Typically, you're a resident of a state if you maintain a "permanent place of abode" and you spend a minimum amount of time there during the year (such as "more than 183 days" or "more than six months").

Also, states have the power to tax income derived from a source within the state, even if you're not a domiciliary or resident. For example, if you commute across the border for a job in another state, your wages would be taxable by the state where you work.

Double taxation

There are several ways in which the same income can become taxable by more than one state. Suppose, for example, that you're domiciled in state A but commute regularly to state B for business. Assume that the residency threshold in state B is 183 days. If you spend more than 183 days in state B and maintain a permanent place of abode there, state B may tax you as a resident, while state A taxes you as a domiciliary. And keep in mind that partial days are often included as full days. One possible way to avoid this result is to not own or rent an apartment or house (even a vacation home) in state B.

Many states offer credits for taxes paid to other states. For example, suppose state A allows residents domiciled in other states to claim a credit for taxes paid to those states, but only if those states offer a reciprocal credit to their residents domiciled in state A. In the above example, if state B doesn't allow such a credit, your income would be taxable in both states.

Here's another way you might be exposed to double taxation: Suppose you relocate from state A to state B and establish your domicile there. But, state A's taxing authorities conclude that your domicile remains there while state B's taxing authorities treat you as a domiciliary of state B. Both states apply their income taxes to your worldwide income. What's more, although both states offer credits for taxes paid to other states, the credit is limited to taxes that are "properly due" in another state. In this case, each state views you as its domiciliary, so no taxes are properly due to the other state.

To avoid this outcome, study each state's domicile standards and take all steps necessary to abandon your domicile in state A and establish a new one in state B.

A complex issue

These are just a few examples of the many complex issues involved in multistate taxation. If you believe you may be at risk, your tax advisor can analyze your exposure and identify steps you can take to avoid a double tax bill. ◎

Where is your domicile?

Your domicile is the place you intend to stay indefinitely and return to when you're away. Courts and taxing authorities look to a number of factors that demonstrate this intent, including:

- How much time do you spend in the state?
- Do you own or rent one or more residences in the state?
- Are you employed in the state?
- Do you conduct business in the state?
- Are your children, grandchildren or other family members in the state?
- Do you keep your prized personal possessions — such as artwork, furniture and heirlooms — in the state?
- Have you obtained a driver's license and registered your car in the state?
- Have you registered to vote in the state and actually voted in the state?
- Do you have bank accounts and safe deposit boxes in the state?
- Do you use your local address for important documents, such as insurance policies, passports, tax returns, wills and trusts?
- Do you see physicians and dentists in the state?
- Do you attend a local church, synagogue or other religious institution?
- Do you subscribe to local newspapers and other publications?

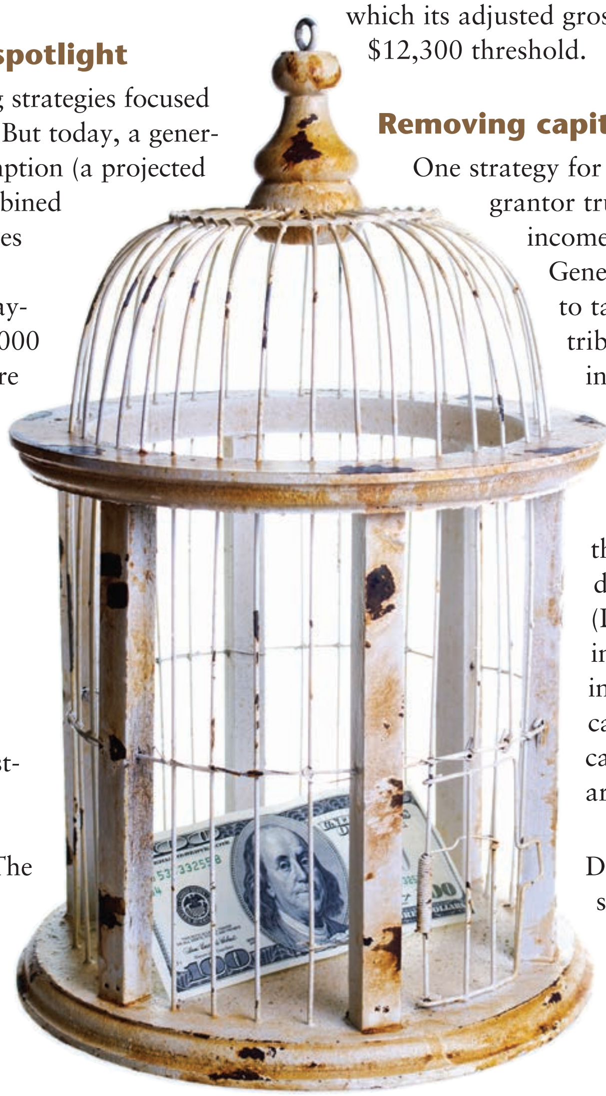
Capital gains may be trapped inside your trusts

Many families today are attempting to reduce their tax bills by distributing trust income to beneficiaries in lower tax brackets. But it's not always possible to distribute capital gains. If long-term gains remain "trapped" inside a trust, they'll be taxed at rates as high as 23.8%. But there may be steps you can take to liberate capital gains from a trust and shift the income to your beneficiaries.

Income taxes in the spotlight

Historically, estate-planning strategies focused on minimizing estate taxes. But today, a generous gift and estate tax exemption (a projected $5.43 million in 2015) combined with soaring income tax rates has shifted the emphasis to income tax planning. Taxpayers with income over $400,000 ($450,000 for joint filers) are now subject to a 39.6% marginal tax rate on their ordinary income and a 20% capital gains tax rate.

In addition, taxpayers whose modified adjusted gross income (MAGI) tops $200,000 ($250,000 for joint filers) are subject to a 3.8% tax on their net investment income (NII), which includes dividends, taxable interest and capital gains. The tax applies to the *lesser* of 1) your net investment income, or 2) the amount by which your MAGI exceeds the threshold.



The impact of higher income taxes on nongrantor trusts is particularly harsh because the top tax rates, as well as the NII, kick in when income exceeds only $12,300. Once a trust's income reaches that threshold, its ordinary income is taxed at 39.6% and capital gains are taxed at 20%. In addition, the trust is subject to NII tax on the lesser of 1) its undistributed net investment income, or 2) the amount by which its adjusted gross income exceeds the $12,300 threshold.

Removing capital gains

One strategy for reducing taxes on nongrantor trusts is to distribute their income to the beneficiaries. Generally, trusts are subject to tax only on their undistributed income, while income distributed to a beneficiary is taxed at the *beneficiary's* marginal rate. Trust accounting rules limit these distributions to distributable net income (DNI), which typically includes dividends and interest but *excludes* capital gains. As a result, capital gains ordinarily are taxed at the trust level.

Depending on applicable state law and the terms of the trust document, however, it may be possible to include capital gains in distributable net income, either by amending the trust or through an exercise of trustee discretion. Consider this example:

The Jones family trust provides for Bridget to receive all of the trust's income, plus distributions of principal per the trustee's discretion. In 2015, the trust will earn $12,300 in qualified dividends, plus $75,000 in long-term capital gains. The trust will distribute its distributable net income (which doesn't include capital gains) to Bridget plus $75,000 in principal. Assuming that Bridget is single, has no other income and takes the standard deduction, her tax bill will be approximately $0. The trust will owe somewhat more than $16,000 in capital gains and NII taxes.

Suppose, instead of principal, the trust distributes the $75,000 capital gain to Bridget. The trust's tax liability would be reduced to zero and Bridget's tax bill would be just over $6,000, for an overall tax savings of more than $10,000.

One strategy for reducing taxes on nongrantor trusts is to distribute their income to the beneficiaries.

Review your trusts

If your trusts are paying capital gains taxes at the highest rates, talk to your tax advisors about whether you can include capital gains in DNI and have them taxed at the beneficiary level. The move could be a wise financial strategy. ◎

Loans between businesses and their owners

Why you need to dot the "i's" and cross all the "t's"

It's quite normal for closely held businesses to transfer money into and out of the company. But it's critical that you make those transfers correctly. If you don't, you might run up against the IRS — the service looks closely at how such transactions are characterized: Are they truly loans or an advance?

Loans might be the best route

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 is and distributions may be taxable. And if the company is a C corporation, distributions can trigger double taxation — in other words, corporate earnings are taxed once at the corporate level and then 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 will be subject to payroll taxes.)

If the business is an S corporation or other pass-through entity, there's no entity-level tax,

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 for a transaction to be a loan, the IRS and the courts aren't mind readers. So it's critical that you document any loans and treat them like other arm's-length transactions. Among other things, you should execute a promissory note and charge a commercially reasonable rate of interest — generally, no less than the applicable federal rate (AFR).

so double taxation won't be an issue. Still, loans are advantageous because:

- The compensation is taxable to the owner (and incurs payroll taxes), and
- The distributions reduce an owner's tax basis, which makes it much harder to deduct business losses.

There are also some advantages to treating advances from owners as loans. If they're treated as contributions to equity, for example, any reimbursements by the company may 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.

Is it a loan or not?

It's important to establish that an advance or a withdrawal is truly a loan. Simply calling an advance or a withdrawal a "loan" doesn't make it so. If you don't make that distinction, and the IRS determines that a payment from the business is really a distribution or compensation, you (and, possibly, the company) could end up owing back taxes, penalties and interest.

You should also establish and follow a fixed repayment schedule and secure the loan using appropriate collateral. (This will also give the lender bankruptcy priority over unsecured creditors.) And you must treat the transaction as a loan in the company's books. Last, you must ensure that the lender makes reasonable efforts to collect in case of default.

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

The bottom line

The IRS keeps a wary eye on businesses that wish to lend or borrow from themselves. So it's critical that you retain a qualified advisor. He or she can lead you through the minefields of borrowing from your company.

tax TIPS

Take advantage of the 0% capital gains tax rate

For high-income earners, long-term capital gains are taxed at rates as high as 23.8% (20% for those in the top tax bracket, plus a 3.8% tax on net investment income). The long-term capital gains rate for taxpayers in the 10% and 15% brackets is 0%. One strategy for taking advantage of tax-free capital gains is to transfer capital assets to your children or other family members in the two lowest brackets. For 2015, that means projected taxable income up to $37,450 ($74,900 for joint filers).

Before you try this technique, consider any potential gift tax consequences. And keep in mind that the 0% rate applies only to the extent that capital gains "fill up" the gap between the taxpayer's other taxable income and the top end of the 15% bracket. Once that level is reached, additional capital gains are taxed at 15%.

This strategy won't be effective if you transfer assets to a dependent child under the age of 19 (24 for a full-time student). Why? The "kiddie tax" will apply *your* marginal income tax rate to the child's unearned income (including capital gains) to the extent it exceeds $2,000.

Don't overlook the IC-DISC

If your business exports American-made goods or performs architectural or engineering services for foreign construction projects, an interest-charge domestic international sales corporation (IC-DISC) can help slash your tax bill.

An IC-DISC is a "paper" corporation you set up to receive commissions on export sales, up to the greater of 50% of net income or 4% of gross receipts from qualified exports. Your business deducts the commission payments, while distributions received from the IC-DISC are treated as qualified dividends, not capital gains.

Essentially, an IC-DISC allows you to convert ordinary income taxed at rates as high as 39.6% into dividends taxed at 15% or 20%. An IC-DISC also allows you to *defer* taxes on up to $10 million in commissions held by the IC-DISC by paying a modest interest charge to the IRS.

Manufacturers' deduction for retailers?

The manufacturers' deduction allows eligible businesses to deduct up to 9% of their net income from "qualified production activities." Although this typically means manufacturing, other types of activities also may be eligible.

In a 2014 legal memorandum, the IRS confirmed that retailers may claim the deduction for certain cooperative advertising payments received from vendors in connection with the retailer's printed flyers. If your business uses cooperative advertising agreements, see if you're eligible for the deduction.

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Card, Palmer, Sibbison & Co. has been serving as a trusted advisor and management consultant to owners and businesses in Northeast Ohio since 1920. We have expertise in both the privately held company and not-for-profit area. As certified public accountants we perform the traditional financial and tax services but also provide a wide array of other business services.

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