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tax IMPACT

It's time for midyear tax planning
Timely tips to help keep your tax bill low

How to make the most of life insurance

Buying or selling a business?
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Tax Tips
IRA rollovers, tax treatment of virtual currency, and more

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It's time for midyear tax planning

Timely tips to help keep your tax bill low

In the quest to reduce your tax bill, year end planning can only go so far. Tax-saving strategies take time to implement, so review your options now. Here are several midyear strategies to consider.

Consider your bracket

The top income tax rate is 39.6% for individuals with taxable income over $400,000 ($450,000 for joint filers). If you expect this year's income to be near the threshold, consider strategies for reducing your taxable income and staying out of the top bracket. For example, you could take steps to defer income and accelerate deductible expenses.

You could also shift income to family members in lower tax brackets by giving them income-producing assets. This strategy won't work, however, if the "kiddie tax" applies. That tax applies the *parents'* marginal rate to unearned income (including investment income) received by a dependent child under the age of 19 (24 for full-time students) in excess of a specified threshold ($2,000 in 2014).

Look at investment income

This year, the capital gains rate for taxpayers in the top bracket is 20%. If you've realized, or expect to realize, significant capital gains, consider selling some depreciated investments to generate losses you can use to offset those gains. It may be possible to repurchase those investments, so long as you wait at least 31 days to avoid the "wash sale" rule.

Another tax higher-income investors need to be concerned about is the 3.8% net investment income tax (NIIT). It applies to taxpayers with modified adjusted gross income (MAGI) over

$200,000 ($250,000 for joint filers). The NIIT applies to your net investment income for the year or the excess of your MAGI over the threshold, whichever is less. So, you can lower your tax liability by reducing your MAGI, reducing net investment income or both.

Contribute to retirement plans

Deductible contributions to traditional IRAs and pretax deferrals to employer-sponsored retirement plans such as 401(k)s save taxes in a variety of ways. First, they reduce your taxable income, and thus your income taxes, for the current tax year.

Second, they reduce your adjusted gross income (AGI) and MAGI, which not only can reduce or eliminate your exposure to the NIIT, but also can help you reap maximum benefit from various tax breaks. The benefit of many deductions and credits is reduced if your AGI or MAGI falls within certain ranges or exceeds certain levels. For example, in 2014, if your AGI exceeds $254,200 (singles), $279,650 (heads of households) or $305,050 (married filing jointly), many of your itemized deductions will be reduced and your personal exemption reduced or even eliminated.

Third, traditional IRAs and employer-sponsored retirement plans grow tax-deferred. So you pay no tax as long as the funds are in the account, which reduces your taxes for years to come. Plus, tax-deferred compounding can help your investments grow more quickly. When you start taking distributions in retirement, they'll be taxable — but if you aren't working, you may be in a lower tax bracket.

Plan for medical expenses

Beginning last year, the threshold for deducting medical expenses went up from 7.5% of AGI to 10% of AGI (unless you're age 65 or older). You can deduct only expenses that exceed that floor.

One way to save taxes even if your expenses don't exceed the floor is to contribute to a tax-advantaged health care account, such as a Health Savings Account (HSA) or a Flexible Spending Account (FSA). Contributions are pretax or tax-deductible, and withdrawals used to pay qualified medical expenses are tax-free. Many rules and limits apply, however.

If an HSA or FSA isn't an option or won't cover all of your medical expenses, take a closer look at the medical expense deduction. Deductible expenses may include health insurance premiums (if not deducted from your wages pretax); long-term care insurance premiums (age-based limits apply); medical and dental services and prescription drugs (if not reimbursable by insurance or paid through a tax-advantaged account); and mileage driven for health care purposes (23.5 cents per mile driven). You may be able to control the timing of some of these expenses so you can bunch them into every other year and exceed the applicable floor.

Get a head start

These are just a few ideas for slashing your 2014 tax bill. To benefit from midyear tax planning, consult your tax advisors *now*. If you wait until the end of the year, it may be too late.

Monitor withholding and estimated tax payments

To avoid underpayment penalties, keep up with required quarterly estimated tax payments. If you've fallen behind, making catch-up *estimated tax* payments late in the year generally won't help you escape the penalties. But you can make up the difference and avoid, or at least reduce, penalties by increasing income tax *withholding* between now and year end.

The withholding could come from salary, IRAs, Social Security and other sources, and it would be treated as if it had been paid ratably over the year, regardless of when it was actually withheld. On the other hand, if you've historically *over*withheld, you may wish to reduce withholding to improve your cash flow throughout the year.

How to make the most of life insurance

Life insurance is a powerful financial and estate planning tool. It allows you to accumulate tax-deferred savings for retirement or other needs. The death benefits provide instant liquidity to pay estate taxes and other expenses as well as provide for your loved ones after you're gone.

Contrary to popular belief, however, life insurance isn't always tax-free. But if you plan carefully, you can avoid or minimize negative tax consequences and maximize the amount available for your family. There are a couple of ways to get the most out of life insurance.

Use an ILIT

Many taxpayers mistakenly believe that life insurance proceeds are tax-free, so long as you name someone other than your estate as beneficiary. But if you own the policy, the proceeds will be included in your taxable estate even if they're paid directly to someone else. And if the benefits are large enough, they can turn an otherwise nontaxable estate into a taxable one.

For an ILIT to be successful, you must survive for at least three years after you transfer your policy to the trust. Otherwise, the proceeds will be pulled back into your estate under the "three-year rule."

If you own any life insurance policies on your life, consider transferring them to an irrevocable life insurance trust (ILIT) to remove the policy, and the death benefits, from your estate. To

ensure that the benefits avoid estate taxes, you can't retain any control over the policy, such as the right to change beneficiaries or borrow against its cash value.

For an ILIT to be successful, you must survive for at least three years after you transfer your policy to the trust. Otherwise, the proceeds will be pulled back into your estate under the "three-year rule." If you don't currently have life insurance but plan to get it, consider funding an ILIT first and then having the trust buy the policy. That way, the policy bypasses your estate, so the three-year rule won't apply.

Avoid the transfer-for-value rule

One of the advantages of life insurance is that the proceeds are tax-free to your beneficiaries. But you can inadvertently lose this advantage if you run afoul of the "transfer-for-value" rule.

The rule provides that, if you transfer a policy (or an interest in a policy), the proceeds are taxable to the transferee (to the extent they exceed any consideration paid by the transferee). There are exceptions to the rule for certain transfers, including transfers to a partnership in which you're a partner (or to one of the other partners), transfers to a corporation in which you're a shareholder or officer, and certain gratuitous transfers.

The transfer-for-value rule was designed to discourage speculation in life insurance policies, but it's broad enough to ensnare innocent transactions. For example, suppose you transfer a $1 million life insurance policy (with a $25,000 tax basis) to your daughter in exchange for $50,000 and her agreement to take over the premium payments. If she pays a total of $100,000 in premiums before you die, she'll have $850,000 in taxable income ($1 million less her $150,000 investment). If she's in the top tax bracket, the transfer-for-value rule will trigger more than $336,000 in federal income taxes, plus the net investment income tax (NIIT) of 3.8%.

It may be possible to structure such a transfer to fall within one of the exceptions to the transfer-for-value rule. For example, if you and your daughter are partners in a partnership, an exception might apply (provided it's a bona fide partnership with a legitimate business purpose).

Handle with care

If you own life insurance or plan to purchase a policy, plan carefully to avoid inadvertently triggering estate or income taxes. Your tax advisors can help you maximize the benefits by setting up an ILIT and avoiding the transfer-for-value rule.

Buying or selling a business?

Here's what you need to know to get the best deal

Thinking of buying a company? Good for you! But be sure you know what you're getting into. For example, you'll need to research a number of business and financial issues as well as certain legal issues. And, of course, there are numerous tax issues that you simply can't ignore. Here are just a few.

Determining the business structure

If the business being sold is a corporation, the parties can structure the deal as a stock sale or an asset sale. As a general rule, however, sellers prefer to sell stock, while buyers prefer to buy assets.

So, why would a seller prefer to sell stock? In general, it's because the shareholders' profits on the sale are generally taxed as capital gains (usually at the favorable long-term rate). Profits from asset sales, on the other hand, are typically taxed as a combination of ordinary income and capital gains.

Moreover, an asset sale will generally cause C corporation sellers to be taxed twice. First, the corporation pays tax on any gains from the asset sale; then, the corporation's shareholders pay tax on their gains when the corporation is liquidated (although it may be possible to defer the second tax by having the corporation hold and invest the sale proceeds).

Fortunately, double taxation generally isn't a concern for an S corporation — unless it was originally organized as a C corporation and then later elected S status. In that case, depending on how much time has passed, there may be a double tax on assets that had built-in gains at the time of the S election.

Looking from the buyer's perspective, purchasing assets is usually more desirable because its basis in assets for depreciation purposes is generally equal to the portion of the purchase price allocated to those assets, typically allowing for greater depreciation deductions. And if the buyer purchases stock, it assumes the seller's basis in the corporation's assets, which may already have been depreciated down to a small amount, or even zero, thereby providing little or even no tax benefit for the buyer.

Allocating the purchase price

In an asset sale, the tax implications — for both buyer and seller — depend on how the purchase price is allocated among various assets. The catch is that the buyer and seller must use the same allocation for tax purposes, yet they often have conflicting interests. The parties do have some leeway to negotiate the allocation, but the IRS may find the allocation to be unreasonable or bear little correlation to asset values and, thus, challenge it.

Double taxation generally isn't a concern for an S corporation — unless it was originally organized as a C corporation and then later elected S status.

The seller will want to allocate as much of the purchase price as possible to assets that generate lower-taxed long-term capital gains, such as goodwill or real property. This allocation is less desirable for the buyer, though: Goodwill and certain other intangibles are amortized over 15 years, and buildings are depreciated over several decades.

Buyers generally prefer to allocate as much of the purchase price as possible to assets that can be depreciated quickly, such as equipment, computers and vehicles. This poses a problem for sellers, however, because often these assets are already fully depreciated, and "recapture" of previous depreciation deductions is taxed at ordinary-income rates.

Understanding the deal

There's much to consider when buying or selling a business. Fortunately, your tax advisor can help you make the best decisions regarding the structure of the deal. And make sure you work with an attorney to ensure everything is fair and square.

tax TIPS

IRA rollovers: Handle with care

Generally, withdrawals from a traditional IRA are taxable, but there's an exception for "rollovers." You can withdraw IRA funds tax-free, so long as you reinvest them in the same or another IRA within 60 days. You're allowed one such rollover in any one-year period.

For years, it was assumed (even in the IRS's own guidance) that the one-rollover-per-year limit applied separately to each of a taxpayer's IRAs. For example, a tax-free rollover from "IRA 1" to "IRA 2" wouldn't prevent a taxpayer from making another tax-free rollover during the same year from IRA 3 to IRA 4. But in a recent decision, which the IRS plans to follow, the U.S. Tax Court held that the rule applies on an *aggregate* basis. This means that, regardless of how many IRAs you have, you're limited to one rollover per year.

The Service says it will begin enforcing the rule for rollovers made after Dec. 31, 2014. The one-rollover-per-year rule doesn't apply to direct transfers from one IRA trustee to another. ◎

Tax treatment of virtual currency

An increasing number of people are using virtual currency, such as Bitcoin, to pay for goods and services and even to compensate employees. Recently, the IRS issued Notice 2014-21, clarifying the tax treatment of virtual currency. The notice provides that virtual currency is *property* for federal tax purposes, which has significant implications for users. Among other things, exchanging property for goods or services can trigger capital gains taxes. Suppose, for example, that you buy two bitcoins for $500 each. A year later, bitcoins are trading for $750 and you use your two bitcoins to buy a $1,500 computer. Because your tax basis in the bitcoins is $1,000, you realize a $500 capital gain. ◎

Supreme Court: Severance pay is subject to FICA taxes

In *U.S. v. Quality Stores, Inc.*, the U.S. Supreme Court ruled that severance payments to involuntarily terminated employees were taxable wages for FICA purposes, resolving a split among the federal appellate courts. Noting that the severance payments in question were based on employment-related criteria, the Court concluded that they fell within FICA's broad definition of "wages."

The Supreme Court observed that IRS rulings provide that severance payments tied to the receipt of state unemployment benefits are exempt from both income tax withholding and FICA taxes. The Court didn't address this issue, so it seems, at least for now, that employers can avoid FICA taxes on severance payments through a carefully designed severance program that links severance pay to an employee's receipt of unemployment benefits. ◎

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