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tax IMPACT

Shifting gears: Tax law changes turn estate planning on its head

Can you defer taxes on advance payments?

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Tax Tips
The alimony gap, year end bonus plans, and more

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Shifting gears: Tax law changes turn estate planning on its head

Recent tax law changes demand new approaches to estate planning. For many taxpayers, traditional strategies, which focus on minimizing estate taxes, may no longer be relevant. In fact, they may result in unnecessary *income* taxes.

A new environment

As recently as 13 years ago, the federal gift and estate tax exemption was only $675,000 and the top gift and estate tax rate was a whopping 55%. Given the unpleasant prospect of forfeiting more than half of one's wealth to Uncle Sam, it's no surprise that affluent families devoted considerable time and resources to minimizing those taxes. Many of the strategies for doing so triggered additional income taxes, but in most cases the estate tax savings outweighed the income tax cost.

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Fast-forward to 2014. The exemption amount has soared to an inflation-adjusted $5.34 million, the top tax rate has fallen to 40%, and exemption "portability" between spouses is now permanent. According to the Congressional Research Service, in the current environment less than 0.2% of all estates are subject to federal estate tax. Meanwhile, taxes on income are higher than they've been in many years. (See "The high cost of taxes on income" on page 3.)

In light of these changes, most taxpayers should concentrate their estate planning efforts on reducing taxes on income.

Stepping up your game

Traditional estate planning techniques focus on removing assets from your taxable estate as early as possible to shield future appreciation from estate taxes. Typically, these techniques involve shifting wealth to children or other heirs, either outright or in trust. Many vehicles, such as family limited partnerships (FLPs) and certain types of trusts, enable you to transfer assets at a discounted value for gift tax purposes.

If your wealth is unlikely to grow beyond the exemption amount, however, there's no federal tax advantage to removing assets from your estate during your life. But there may be a significant tax incentive to *keep* assets in your estate.

When you transfer an asset during your life, the recipient inherits your tax basis, which can generate significant capital gains taxes if the asset is sold. Assets transferred at death, on the other hand,

enjoy a "stepped-up" basis. That means the basis is increased to the asset's date-of-death fair market value, and the recipient can sell the asset without incurring any capital gains tax liability (provided he or she sells it before it appreciates further).

Consider this example: Tony has a net worth of approximately $3 million, including $2 million in real estate with a $400,000 tax basis. He gives the property to his daughter, Annie, who holds the property for 10 years and then sells it for $3.5 million. Annie is in the top income tax bracket, so she's subject to a 23.8% tax (see the sidebar for details on this rate) on the gain: 23.8% × ($3.5 million - $400,000) = $737,800.

Now suppose, instead, that Tony holds on to the property and dies 10 years later, leaving it to Annie in his will or living trust. Tony's estate is within the exemption amount, so there's no estate tax. But Annie's basis is stepped up to the property's date-of-death fair market value, $3.5 million, which means that, if she sells the property immediately, she can pocket the proceeds tax-free.

As you can see, with estate taxes out of the picture, there's a big advantage to retaining assets in your estate and then transferring them at death.

A trust with a twist

There are also some *disadvantages* to holding onto your assets, however. For one thing, you'll continue to be liable for income taxes on their earnings. Also, you may prefer to share some of your wealth with loved ones while you're alive.

One option that can provide the best of both worlds is an estate defective trust (EDT). An EDT is carefully drafted to ensure that all of the trust's income is taxed to your beneficiaries *without* removing the assets from your estate.

It enables you to provide financial benefits to your children or other family members while reducing your family's overall income tax burden (assuming beneficiaries are in a lower tax bracket). At the same time, the trust assets are treated as part of your estate when you die, so you retain the tax advantages of a stepped-up basis.

The high cost of taxes on income

For high earners, taxes on income are at their highest level in years. Recent tax increases include:

- A top income tax rate of 39.6% (up from 35%) for taxpayers with income over $406,750 for singles, $432,200 for heads of households and $457,600 for joint filers (for 2014 — these amounts are annually adjusted for inflation),
- Two new taxes under the Affordable Care Act: 1) an additional 0.9% Medicare tax on wages and self-employment income in excess of $200,000 for single and head-of-household filers and $250,000 for joint filers, and 2) a 3.8% net investment income tax on some or all net investment income of taxpayers with modified adjusted gross income over those same amounts (these amounts are *not* annually adjusted for inflation), and
- A top capital gains rate of 20% (up from 15%) for taxpayers in the top income bracket.

In addition, reductions in personal exemptions and itemized deductions increase the effective tax rate for high-income taxpayers.

Look at the big picture

Focusing on income taxes offers significant benefits, but it's not without risk. If your estate unexpectedly grows beyond the exemption amount, for example, or if Congress reduces the exemption down the road, you could be stuck with a hefty estate tax bill.

Also, before you rule out traditional estate planning vehicles, consider the impact of state estate taxes as well as the potential nontax benefits of certain trusts, such as creditor protection. As you can see, it's critical to enlist the help of a trusted tax advisor.

Can you defer taxes on advance payments?

Many businesses receive payment in advance for goods and services. Examples include magazine subscriptions, long-term supply contracts, organization memberships, computer software licenses and gift cards.

Generally, advance payments are included in taxable income in the year they're received, even if you defer a portion of the income for financial reporting purposes. But there are exceptions.

Deferral opportunities

The IRS allows limited deferral of income related to advance payments for:

- Goods or services,
- Intellectual property licenses or leases,
- Computer software sales, leases or licenses,
- Warranty contracts,
- Subscriptions,
- Certain organization memberships,
- Eligible gift card sales, and
- Any combination of the above.

In the year you receive an advance payment (Year 1), you may defer the same amount of income you defer in an "applicable financial statement." The remaining income must be recognized in the following year (Year 2), regardless of the amount of income you recognize in Year 2 for financial reporting purposes. Let's look at an example.

Fred and Ginger are in the business of giving dance lessons. On Nov. 1, 2012, they receive an advance payment from Gene for a two-year contract that provides up to 96 one-hour lessons. Gene takes eight lessons in 2012, 48 lessons in 2013 and 40 lessons in 2014.

In their applicable financial statements, Fred and Ginger recognize 1/12 of the advance payment in their 2012 revenues, 6/12 in their 2013 revenues and 5/12 in their 2014 revenues. For federal income tax purposes, however, they must include 1/12 of the advance payment in their 2012 gross income and the remaining 11/12 in their 2013 gross income.

The applicable financial statement

An applicable financial statement is one that's audited by an independent CPA or filed with the SEC or certain other government agencies. If you don't have this statement, it's still possible to defer income; you simply need a reasonable method for determining the extent to which advance payments are earned in Year 1.

Suppose, for example, that a company issues gift certificates but doesn't track their use and doesn't have an applicable financial statement. The company may be able to defer income based on a statistical study that indicates the percentage of gift certificates expected to be redeemed in Year 1.

IRS clarifications for gift cards

Gift card sales generally are treated like other advance payments for tax purposes. But what about gift cards that are redeemable by either the seller *or* a related business under common ownership? For example, a restaurant group might issue gift cards that can be used at any of several participating restaurants that operate in various locations using various names.

In a 2011 ruling, the IRS clarified that these cards are treated in the same manner as cards redeemable only by the issuer. And in 2013, the IRS extended this treatment to advance payments for cards redeemable by unrelated businesses whose financial results aren't included in the seller's financial results. Generally, these payments are recognized in Year 1 to the extent they're redeemed in Year 1.

Advance planning

If your business receives advance payments, consult your tax advisor to determine whether you can reduce this year's tax bill by deferring some of this income. And make sure you abide by the IRS's rules on these payments. ◎

How to protect your retirement future in an up-and-down economy

To ensure your retirement nest egg doesn't crack, it's critical to abide by several retirement plan fundamentals — especially in today's uncertain economy. Doing so can mean the difference between a comfortable retirement and a retirement filled with regrets.

Maintain a cash reserve

Economic uncertainty isn't the only danger your retirement nest egg faces. In fact, *you* could present one of the biggest dangers — if you make early withdrawals from your IRA or take a 401(k) plan loan.

For example, in addition to being subject to income tax, traditional IRA withdrawals before age 59½ will likely be subject to a 10% early withdrawal penalty. A 401(k) loan won't create a tax liability, but, if you default on it, your outstanding balance will be treated as a distribution and trigger any attendant tax liabilities and penalties.

Perhaps more important, the amount that can continue to grow tax-deferred — tax-free in the case of a Roth account — will be reduced after a retirement plan withdrawal or loan, which can significantly shrink what you have at retirement.

To avoid having to tap into your retirement plan, maintain a cash reserve. The optimal amount will vary depending on your age, health, available credit and job situation. But generally you should have enough cash on hand to cover three to six months of living expenses.

Keep contributing

While market volatility may make you leery of putting more into your retirement plan, for most people it's advantageous to do so. First, the power of a retirement plan is tax-deferred — or, in the case of Roth accounts, tax-free — growth. The more time funds have to grow, the larger your nest egg can become.

If you're like most Americans, your biggest asset is your ability to earn income. Disability insurance can protect that asset.

Second, when the value of stocks is low, you can buy more shares for the same amount of money. Assuming retirement is still at least several years away (so there's ample time for the market to recover), a down market can be a great time to buy.

Third, if your employer offers a match, at minimum you should contribute enough to get the maximum match. If you don't, it's essentially like turning down additional compensation.

Consider taxable accounts

Because retirement plans are subject to annual contribution limits, many people also need to save for retirement outside these tax-advantaged accounts. Consider the tax consequences of investments that create realized capital gains or dividend distributions, because they'll affect your return on investment. And remember that timing can have a dramatic impact.

A taxpayer's long-term capital gains rate can be as much as 20 percentage points lower than his or her ordinary-income rate. The long-term rate applies to investments held for more than 12 months. So holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain.

Also examine your investments to see whether the allocation percentages are in harmony with your current risk tolerance and financial objectives. Diversification — which offers some protection during market declines and higher potential returns over the long run — continues to be a critical investment strategy.

Factor in disability insurance

If you're like most Americans, your biggest asset is your ability to earn income. Disability insurance can protect that asset.

Although many employers offer short-term disability insurance, you may wish to obtain additional, long-term coverage. In computing the level of coverage to carry, plan so that monthly income (based on disability benefits and your current resources) equals at least 60% of your pretax salary.

Stick with the fundamentals

Of course, your situation will likely differ from your neighbor's. But everyone should carefully plan out a road to a comfortable retirement. Your tax and financial advisors can help ensure you're on the right track.

tax TIPS

Don’t get trapped in the alimony gap

According to the Treasury Inspector General for Tax Administration (an IRS watchdog), there’s a big discrepancy between deductions claimed by ex-spouses paying alimony and the alimony income reported by recipients. Generally, alimony is deductible by the payer and taxable to the recipient. But property settlements and child support payments are neither deductible nor includable in income.

The IRS is looking at strategies for closing the alimony gap. If you’re uncertain whether payments you’re making or receiving constitute alimony — or if you’re not sure how your spouse is treating these payments for tax purposes — consult your tax advisor.

Year end bonus plans: Design with care

A popular year end tax-planning strategy for employers is to deduct bonuses in the year they’re earned but to defer payment to the following year. Many employers assume that they’re eligible for the IRS rule that permits this strategy if bonuses are paid within 2½ months after the end of the tax year in which they’re earned (by March 15 for a calendar-year taxpayer). But that’s not always the case.

First, the strategy is available only to accrual-basis taxpayers. Cash-basis taxpayers must deduct bonuses in the year paid. Second, even businesses using the accrual method of accounting must meet certain requirements to deduct bonuses in the year earned, including the “all events” test.

Under that test, an accrued bonus is deductible when 1) all events have occurred to establish liability for the bonus, and 2) the amount of the bonus can be determined with reasonable accuracy.

Certain bonus plan design features may cause bonuses to not be deductible until paid. For example, if an employee who leaves the company before the payment date forfeits his or her bonus, you won’t pass the all events test until the bonus is paid (unless forfeited bonuses are reallocated to other employees who remain with the company). Also, bonuses that are contingent on board approval or other events that take place after year end generally aren’t deductible until paid. Further, there are restrictions on deducting accrued bonuses to related parties.

How to collect your 2014 refund now

If you usually receive a large federal income tax refund, you’re essentially making an interest-free loan to the IRS. Rather than wait until 2015, why not enjoy your “refund” now by reducing your withholdings or estimated tax payments for the remainder of 2014? It’s particularly important to review your withholdings, and adjust them if necessary, when you experience a major life event, such as marriage, divorce, birth or adoption of a child, or if you or your spouse is laid off.

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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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