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Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

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Taxable Versus Tax-Deferred Accounts

Some people do all of their investing in an employer-sponsored retirement plan where earnings are untaxed until withdrawn, and perhaps in an IRA as well. Withdrawals are generally taxed at ordinary income rates, which now go up to 39.6% as of this writing in late 2017.

Conversely, others have taxable accounts as well; each year, income tax is due on investment interest, dividends, and net capital gains in these taxable accounts. Some dividends and gains qualify for favorable rates, currently no higher than 20%. (Taxpayers who are subject to the 3.8% surtax on net investment income might actually owe 23.8%.)

Therefore, investors with a foot on both sides of the tax-now-or-tax-later line must make some decisions about their savings and investments. Which types of assets go into tax-deferred territory and which assets work better in taxable accounts? Making informed decisions can help you substantially in long-term results from your investments after tax.

Financial advisers and investment managers may have differing preferences in this area. Stocks inside retirement accounts and bonds outside? Bonds inside and stocks outside? There are no universal rules to follow and there are many factors to consider when making decisions about asset location. The "correct" mix may vary from investor to investor. Nevertheless, some basic principles can help you in this decision.

Liquidity

Emergency funds should be held in taxable accounts where you can reach them if the money is needed. That's also the case if you're saving for a major outlay, such as a home purchase or higher education. With the money in a taxable account, you can access the funds without owing ordinary income tax or worrying about a 10% early withdrawal penalty before age 59½.

Historically, liquid dollars were often held in bank accounts and money market funds. Yields on these instruments are so low now that investors may be using short-term bond funds or something similar to get some return on their money. Even so, if you are holding assets for use in emergencies or for an anticipated expense, they probably should be in a taxable account.

Availability

If you're saving for retirement in a 401(k) or similar plan, you'll be limited to the menu options presented to plan participants. Therefore, if your investment plan calls for an allocation to precious metals, you may have to use a taxable account for a fund that holds mining stocks, say, or a gold bullion ETF. The same

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What's Inside

Maximum Maintenance

The costs of homeownership are highest in the New York metro area with a 2.0% property tax rate, $78 average monthly home insurance, and $234 average monthly utility bill.

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could be true if you want to own an emerging markets bond fund or a small company growth fund, if no acceptable option in these categories is on your plan's menu.

Note that you can hold virtually anything in an IRA (except for life insurance and certain collectibles). Thus, your IRA could be used for hard-to-find assets.

Tax magnitude

Assuming that liquidity and availability are not concerns, tax treatment will drive the decision about where to hold specific assets. One aspect to consider is the expected return of an investment. The lower that return, the lower the annual tax bill, and the smaller the advantage of deferring that tax. On the other hand, deferring large amounts of tax each year may be a good reason for using a tax-deferred account for a given asset.

Example 1: Martin Miller's asset allocation includes a high-quality corporate bond fund, now yielding around 2%. The fund seldom distributes capital gains to investors, so Martin expects to owe tax on that 2% payout this year and in succeeding years. In his 25% tax bracket, Martin would save 0.5% of his investment (25% bracket times the 2% yield) per year. That much tax deferral might not be enough to warrant holding the fund in a tax-deferred plan, so a taxable account could be the better choice.

Suppose that Martin's asset allocation also includes a high-yield corporate bond fund, now yielding 5%, which has a history of distributing taxable gains to shareholders. In his 25% tax bracket, Martin can expect to save 1.25% or more in tax each year. This fund could be a better choice for his tax-deferred retirement account.

Tax efficiency

Municipal bonds and muni funds often generate no income tax, so they are very tax efficient, whereas high-yield bond funds might generate steep annual tax bills, making them tax inefficient. As a general rule, you should try to hold assets with the least tax efficiency in your tax-deferred retirement plan.

Example 2: Phil Grant has an asset allocation that includes stock market index funds and funds that hold real estate investment trusts (REITs). Equity index funds tend to be tax efficient because they may have modest dividend payouts and seldom generate taxable gains, so Phil holds these funds in his taxable account. REIT funds may be tax inefficient, with relatively high dividends that might be fully taxable, as ordinary income. Phil puts his REIT funds into his tax-deferred account to avoid the annual tax bite.

Our office can go over the tax efficiency of investments you're considering to help you decide on the best location. As the saying goes, you shouldn't let the tax tail wag the investment dog. If you have a plan regarding which investments will help you attain your goals, you can get an added return when you know where to hold them. ■

Tax Credits Beat Tax Deductions

Many people prize tax deductions. The promise of a deduction can affect decisions in many areas, including charitable contributions, home buying, and investing in rental property.

However, tax deductions offer only partial relief because they reduce income, not the tax bill. The higher your income and tax bracket, the more you'll benefit from a tax deduction.

Example 1: Heidi Jones has recently finished her education and joined the work force. With a modest income, Heidi is in a 15% tax bracket. If Heidi donates $1,000 to charity (and if she itemizes deductions on her tax return), Heidi will reduce her taxable income by $1,000. In a 15% bracket, she will save $150 in tax (15% times $1,000).

Example 2: Ken Larsen, a middle-aged executive, has a high salary, placing him in the 35% tax bracket. If Ken itemizes a $1,000 charitable contribution, he'll save $350 (35% times $1,000), more than twice the amount of tax that Heidi saves for the same charitable gift.

Dollar for dollar

A tax credit, on the other hand, is a direct reduction of the tax you owe. If Heidi and Ken both receive a $1,000 tax credit, they'll both trim their tax obligation by $1,000. Moreover, many tax credits have income limits and phaseouts, which effectively means they're available to low- and middle-income taxpayers but not to people with relatively high incomes.

Here are some widely used tax credits.

Earned income tax credit

This credit is designed to help workers, including those with self-employment earnings, who have modest incomes. The good news is that the earned income tax credit (EITC) is refundable.

Example 3: Jim Carter files his 2017 tax return in early 2018. Without the EITC, Jim would owe $500 in tax. Jim's EITC amount is $1,200. Therefore, his $500 obligation is wiped out, and Jim would receive a check from the IRS for the $700 balance. (Most tax credits are not refundable, meaning that they do no more than offset any tax obligation.)

Besides having earned income, there are several other hurdles to clear to get the EITC. They include age (at least age 25, but under 65), investment income (no more than $3,500 in 2018), and filing status (married, filing separately, not eligible).

In addition, there are income limits for the EITC; those limits vary by filing status and by the number of qualifying children. (The definition of *qualifying children* is very broad for EITC purposes.) This year, for instance, a married couple filing a joint tax return with two *qualifying children* must have both earned income and adjusted gross income (AGI) of less than $51,598 to get this credit.

EITC amounts vary, as well. The 2018 maximum credit is $6,444 for a recipient with three or more qualifying children.

Child tax credit

For the child tax credit, the definition of a *child* is a bit more limited than it is for the EITC. Although the EITC can cover students under age 24, the child tax credit does not go beyond age 16. Other requirements apply.

The maximum tax credit is $1,000 for each qualifying child. This credit phases out after the taxpayer's income exceeds a threshold amount based on his or her income. The threshold amount depends on filing status—to get the maximum credit, for instance, a couple filing a joint return must have modified adjusted gross income (MAGI) of no more than $110,000. Above the threshold, the child tax credit drops by $50 per $1,000 of MAGI. Under a tax code provision known as the *additional child tax credit*, some of the credit may

be refundable, depending on the amount of the taxpayer's earned income.

Child and dependent care tax credit

As the name indicates, this credit has two broad applications. One is for taxpayers who have children under age 13 and the other is for those who have spouses, dependents, or certain other individuals who are physically or mentally incapable of self-care. Either way, the credit is a portion of amounts paid to a caregiver so that the taxpayer can go to work, actively look for work, or go to school.

To calculate this credit, start by finding the amount spent on qualifying care for a given calendar year. Here, the maximum amount that counts is $3,000 for one qualifying person and $6,000 for two or more people needing care.

However, this maximum credit amount may be limited for some individuals. The maximum amount is limited, in the case of a single individual, to the individual's earned income for the year. In the case of a married individual, the maximum amount is limited to the lesser of the individual's earned income or the earned income of the individual's spouse. In addition, if the individual receives dependent care benefits that he or she excludes from income, the maximum credit amount is reduced by the amount of the dependent care benefits excluded.

This resulting amount is multiplied by a percentage that depends on your AGI. The minimum percentage, used by many who claim this credit, is 20%, which applies when AGI is $43,000 or more.

Example 4: Paul and Robin Scott, who have $100,000 in AGI, pay over $6,000 to caregivers for their two children this year. Therefore, the Scotts multiply the maximum amount ($6,000) by the minimum percentage (20%) to get $1,200, the amount of this tax credit they can claim. (Claimants may also be responsible for payroll tax reporting in some situations.)

More credits, more assistance

Many other tax credits are available, including some for higher education. For all of them, the rules go beyond these brief descriptions. Our office can help you plan to make the most of these dollar-for-dollar tax savers. ■

Asset Allocation in 529 Plans

Parents with young children have two broad choices when investing for higher education. One is to invest as you did before you had children, with assets in taxable and tax deferred accounts, under your own names. This will give you maximum flexibility in terms of investment choices and tax planning. When the time comes, you can peel off

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assets to pay college bills. (Financial advisers may advise against tapping retirement accounts to pay for college.)

The other approach is to have a dedicated college fund, or one college fund for each student. One advantage of this method is psychological; you may be reluctant to use higher education money for a cruise or a luxury car lease.

In addition, a dedicated college fund has a compressed time horizon. When the child is in his or her late teens and early twenties, the money will be needed. If the portfolio value has dropped sharply before and during those years, there may not be enough time to recover losses, let alone continue to grow.

Why 529 is the magic number

For parents and grandparents who prefer a dedicated college fund, 529 plans—named after a section of the tax code—are increasingly appealing. Over $275 billion is invested in these plans, mainly in college savings plans that are similar to 401(k) retirement plans in that account holders choose from a menu and enjoy untaxed investment income. (Some 529 plans are prepaid tuition plans, which operate differently.)

Unlike 401(k)s, 529 plans are largely funded with after-tax dollars. As an offset, all 529 withdrawals can be tax-free, whereas 401(k) distributions are taxable. To qualify for tax exclusion, 529 withdrawals must not exceed the amount spent on qualified higher education costs, which generally include tuition, fees, room, and board.

Age-old question

The holders of 529 accounts face a dilemma when it comes to investing. To make the most of the benefit of tax-free distributions, 529 plans should be invested for growth. The tax savings from an account that has gained, say, 2% a year will be much less than the tax savings from a 529 account in which growth has been 7% or 8% a year.

On the other hand, for a 529 account to grow rapidly, investors must put money into volatile assets, such as stock funds. That brings the risk of poor timing; your student might enter college after a bear market has depleted the 529 account, which could leave your student with a smaller college fund.

Investment professionals may suggest a "glide path" strategy to address such concerns. For a young child who is 10, 15, or even 18 years away from high school graduation, 529 money might be invested mostly in equities with a hope for strong growth. As college nears, the asset allocation can shift from stocks to bonds and cash. Some observers assert that a 529 account should be very light (perhaps less than 10%) in equities by the time of college admission, minimizing risk, whereas others suggest a somewhat larger position in stocks for continuing growth potential.

Packaged portfolios

Parents who like the idea of a glide path can choose from a 529 plan's menu. Every year or so, move money from aggressive to more conservative investment options.

If you don't feel up to such maneuvers, or just prefer not to be bothered, don't fret. "Age-based" portfolios usually are offered to 529 investors. Essentially, these portfolios are on autopilot so that your child's 529 account will become more conservative over time.

Nevertheless, an age-based portfolio in one state's 529 plan may be much different from another state's. Before signing up, look at the details carefully. Are you comfortable with the underlying asset allocation and the way that allocation will shift? There may be multiple options to consider within one state's plan, as well as from different states. Make sure you know just how your college fund will be managed. ■

IRS Ruling May Rescue Estate Plans

President Trump's campaign promise to abolish the federal estate tax may or may not be realized. Meanwhile, as of this writing in late 2017, the "death tax" still exists, and it continues to be a major concern for high net-worth taxpayers, including the owners of successful small companies.

If a deceased taxpayer has a surviving spouse, the estate of the deceased spouse may make a portability election. If this election is made, the unused federal estate tax exclusion of the deceased spouse (called the *deceased spouse unused exclusion*, or DSUE) can be carried over to and used by the surviving spouse. The executor of the deceased spouse's estate must make the portability election on a timely filed estate tax return that includes a computation of the DSUE.

IRS Revenue Procedure 2017-34, effective June 9, 2017, provides relief when a deceased spouse's executor fails to make a timely portability election.

The revenue procedure sets out a simplified method for requesting an extension of time to executors of certain estates of decedents who died after 2010 to make the election.

The portability extension offered by this revenue procedure was until the later of January 2, 2018, or 2 years after the decedent's date of death to make the election, so the 2-year extension remains in effect. Normally, the deadline is 9 months after death, or 15 months if the decedent's estate requested an extension of time to file an estate tax return.

The new extension is permanent but applies only to estates of decedents who died after 2010, survived by a spouse, that are otherwise not required to file an estate tax return, except to make the portability election. In cases in which the surviving spouse died before a portability election was made, and the surviving spouse's estate paid federal estate tax, a tax refund may result.

Doubling the exemption

The federal estate tax exemption has gradually increased from $5 million to $5.6 million (announced by the IRS for 2018) in recent years. Thus, many estates have not owed this tax, and many executors have not filed a Form 706 federal estate tax return.

Example 1: Jim Cook died in 2012 when the estate tax exemption was $5.12 million. His estate was worth $4 million, all of which he left to his wife, Marie. Therefore, his executor was not required to file Form 706 and did not do so.

That could have been an error. Jim's estate did not use any of that year's estate tax exemption. By filing a Form 706, his executor could have elected portability of his DSUE. If the election had been made, Jim's widow Marie's estate could have used Jim's DSUE in addition to her own at her death.

Example 2: Assume Marie dies in 2018 with a total of $8 million, including the assets inherited from Jim. Her estate would be over the $5.6 million estate tax exemption this year by $2.4 million. At a 40% estate tax rate, Marie's estate would owe nearly over $1 million to the IRS.

Now suppose that Jim's executor had elected portability on Form 706. Because Jim had left all of his assets to Marie, his entire $5.12 million DSUE would be added to Marie's $5.6 million exemption, for a total of $10.72 million. Marie's $8 million estate would be under that threshold, and no federal estate tax would be due.

Filing the form

To obtain relief under Rev. Proc. 2017-34 from the failure to make a portability election, all the executor must do is file a complete and properly prepared Form 706 estate tax return on or before two years from the decedent's date of death. On this return, the executor should explain that it is being "filed pursuant to Rev. Proc. 2017-34 to elect portability under § 2010(c)(5)(a)." If these requirements are met, the extension of time to elect portability will be granted, and the Form 706 electing portability will be considered to have been timely filed.

As previously noted, the IRS provided this relief retroactively to estates of decedents who died after 2010, which had until January 2, 2018 to obtain relief under Rev. Proc. 2017-34. Estates of decedents who died after January 2, 2016, have two years from the date of death. If the decedent's surviving spouse has died, and the surviving spouse's estate has already filed Form 706 and paid estate tax on which the statute of limitation on refund has not expired, the executor of that estate can file an amended Form 706, including the decedent's DSUE, and get any resulting refund.

Good news for business owners

Rev. Proc. 2017-34 can benefit the estates of all wealthy decedents, but it may be especially valuable for business owners and their heirs. When the owner of a business dies, his or her interest in the company must be valued. A moderately successful firm can have a value well into seven or even eight figures. Counting the decedent's other assets, the total can be in estate tax territory.

Generally, estate tax must be paid within nine months of death. In some cases, estates of the owners of closely-held companies may defer the tax over an extended time period. Still, the tax payments may be considerable, and the heirs of business owners may lack the liquid assets necessary for this obligation.

Such concerns might lead business owners and others into sophisticated tax planning tactics to deal with future estate tax. These tactics may be helpful, for various reasons, but the presence of portability may reduce the need, as a married couple now can easily pass on over $11 million worth of assets to the next generation with portability. ■

ESOPs as Retirement Plans

Among the retirement plans that small businesses can offer to their workers are employee stock ownership plans (ESOPs). As the title indicates, an ESOP is a process for transferring ownership of the company to employees. How does that work as a retirement plan?

In some ways, an ESOP is similar to a profit-sharing plan in which the company makes cash contributions. With a "vanilla" or unleveraged ESOP,

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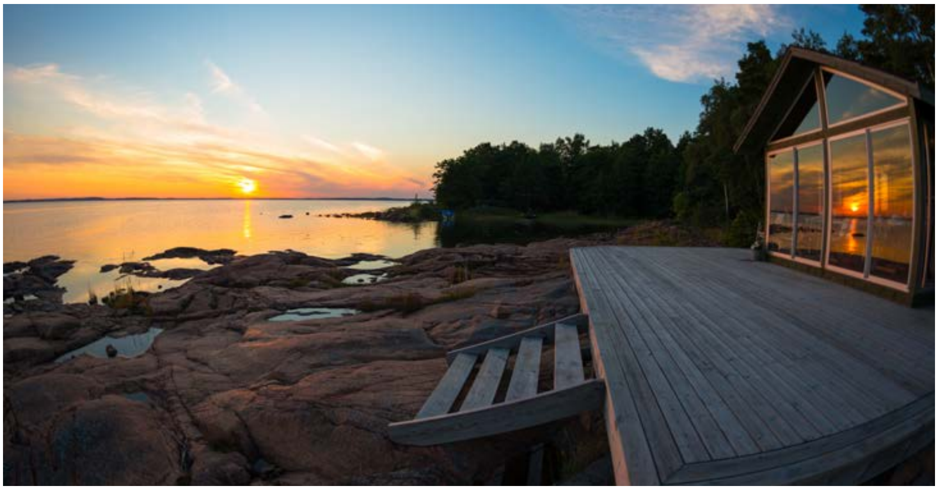
the company funds the plan by contributing shares of its stock, or cash to buy those shares.

Uniquely among retirement plans, ESOPs can be leveraged. In one scenario, the ESOP borrows money from a financial institution or from another party, then uses the borrowed funds to purchase shares of the employer's stock. Once the shares are in the plan, they are allocated to accounts of participating employees, generally all full-time workers over age 21. Assuming the company's shares are not publicly traded, annual independent appraisals track the value of the company's shares, which in turn determine the value of each participant's ESOP holdings.

Current law calls for gradual vesting of all employer contributions over six years, or complete vesting at three years. When employees leave the company, at retirement or sooner, they receive their vested shares. The employer is required to buy back the shares, at the currently appraised price. Therefore, a long-time ESOP participant could retire with a substantial amount from the plan.



Advantages to owners

Why should business owners consider an ESOP? Some studies indicate that employees become motivated to excel when they become employee-owners. They know that good corporate results will boost the annually appraised value of their shares, and ultimately provide a bigger payout. Strong results will benefit major shareholders as well.

What's more, ESOPs offer some exceptional tax benefits to the sponsoring company and its principals.

Example 1: A local bank lends money to an ESOP, which uses those dollars to buy common stock from ABC Corp, the ESOP sponsor. Going forward, ABC makes tax-deductible contributions to the ESOP, which uses that money to repay the bank loan. With such an arrangement, ABC effectively borrows money through the ESOP, then deducts the principal and interest payments made on the ESOP loan, rather than just the interest payments.

In addition to such tax advantages, an ESOP provides a way for business owners to sell their shares at appraised value, if there are no other obvious buyers. In some situations, the owners may be able to defer taxes on a profitable sale of shares to an ESOP, perhaps indefinitely.

Example 2: Alice Baker sells 50% of her Alice Baker Co. stock to her company's ESOP for $2 million. Her basis in those shares is $200,000, giving her a taxable gain of $1.8 million. Alice reinvests the sale proceeds in qualified replacement property, which includes stock in other U.S. corporations. Alice can defer tax on that $1.8 million gain until she sells her qualified replacement property.

If her company is an S corporation, however, Alice won't qualify for the tax deferral on the gain from the sale of her stock to the ESOP. However, ESOPs may offer other tax benefits to S corporations, such as tax exemption for any profits attributable to ESOP ownership.

ESOPs can be expensive

Business owners sponsoring ESOPs may realize advantages, but there are drawbacks as well. Payouts to departing employees, for share buybacks, can be a cash drain. The same is true for regulatory requirements, including annual appraisals. In addition, ESOP participants lack diversification in their retirement plans because the primary holding is the sponsoring company's stock. Therefore, companies that sponsor ESOPs also may offer a retirement plan such as a 401(k), where employees can defer some of their salary (and the tax on that income) in order to acquire other investments.

If the idea of using an ESOP as a retirement plan appeals to you, our office can help you evaluate the costs and the potential benefits. ■