CPA

Client Tax Letter

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

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Juggling Appreciated Assets and Bequests

During your lifetime, donating appreciated assets to charity can make sense. As long as you have held those assets for more than one year, you'll get a deduction for the assets' current value. The paper gain will avoid income tax.

Example 1: Ava Brown wants to donate $10,000 to her favorite charity this year. Instead of writing a check, Ava donates $10,000 of stock that she bought years ago for $4,000. Ava receives a $10,000 tax deduction for the donation and the $6,000 gain is never taxed.

At the same time, Ava leaves her traditional IRA untouched, for ongoing tax deferral.

Reversing course

When Ava prepares her estate plan, she decides to switch tactics. Ava intends to make a much larger bequest to her favorite charity, but she will not use appreciated assets for this donation from her estate. Instead, she will make this large bequest from her traditional IRA.

Why the change? Consider the following scenario, which would have been the case without a switch.

Example 2: At Ava's death, her only assets are a $100,000 traditional IRA and $100,000 in appreciated stocks. She leaves her traditional IRA to her son Brad and her $100,000 of appreciated assets to charity.

After Brad inherits the traditional IRA, he will have to pay income tax on all distributions from that IRA. If his effective income tax rate is 40%, Brad's net inheritance will be only $60,000 (60% of $100,000) after tax.

Instead, Ava could make the switch mentioned previously, leaving her $100,000 traditional IRA to charity and the $100,000 of appreciated assets to Brad. The tax-exempt charity would not be affected because it can withdraw all the money from Ava's IRA and not owe any income tax.

Brad, on the other hand, would be much better off inheriting the appreciated assets. Under current law, those assets would get a basis step-up to fair market value on the date of Ava's death. Brad could sell those assets for $100,000 and owe no tax.

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Return to reality

Of course, it's unlikely that Ava will die with only those two assets, of equal value. Nevertheless, the principle generally applies to estate planning. When your traditional IRA passes to a taxpaying beneficiary, you are leaving an income tax obligation as well as that IRA. It is better to make charitable bequests from the IRA because a charity won't pay the deferred income tax.

Meanwhile, you should consider holding onto appreciated assets (and other low basis assets, such as depreciated property) until your death, if that's practical. Your heirs will get a basis step-up, so capital gains tax can be avoided. ■

How Inherited Assets Differ From Gifts

When someone gives you cash or other valuable assets, do you owe income tax? No. The same is true if you receive an inheritance. The giver may owe gift tax, and the decedent's estate may owe estate tax, but you, as the recipient, won't owe income tax.

The situation will change, however, if you receive a noncash asset as a gift or inheritance and subsequently sell that asset. You'll incur tax consequences, which will depend on your so-called "basis" in the asset. In this context, your basis can be considered your cost for tax purposes.

Carryover basis

When you receive an appreciated asset as a gift, you also receive the giver's basis in that gift. In tax parlance, the former owner's basis "carries over" to you.

Example 1: Mike Owens invested $10,000 in ABC Corp. stock many years ago. Mike always receives the dividends from ABC, rather than reinvesting them. When the shares are worth $19,000, Mike gives those shares to his niece Pam. In this scenario, Pam retains Mike's $10,000 basis in the shares. If she sells the shares for $22,000, Pam will owe tax on a $12,000 gain, because of the carryover basis, rather than owing tax on the $3,000 gain since the gift.

For gifts of appreciated assets, the donor's holding period also carries over. Here, Pam will have a favorably taxed long-term gain because Mike held the shares for many years. In another situation, where Pam's sale takes place one year or less since Mike's purchase, her $12,000 gain would be taxed at ordinary income rates. (The carryover basis rules on gifts of *depreciated* property are more complex.)

Stepped-up basis

Different rules apply to inherited assets. Here, the heir's basis typically is the asset's value on the date of death.

Example 2: Rebecca Smith dies and leaves $200,000 worth of XYZ Corp. shares to her nephew Tom. Even if Rebecca's basis in the shares was only, say, $90,000, Tom's basis in the shares is $200,000, their value when Rebecca died. Tom will have no taxable gain on a subsequent sale for $200,000, a $10,000 gain on a sale for $210,000, and a $5,000 capital loss on a sale for $195,000. Depreciated assets are stepped down: if Rebecca had bought the shares for $200,000, but they were worth $90,000 when she died, Tom's basis would be $90,000.

After an inheritance, sales generally are taxed as a long-term gain or loss, regardless of the heir's or the decedent's holding period.

In some cases, special rules apply to the basis of inherited assets. For property held jointly with right of survivorship (JTWROS), the survivor generally gets a basis step up for half of the asset value.

Example 3: Victor and Wendy Young hold shares of DEF Corp. in a brokerage account. The account is titled as JTWROS, so the surviving co-owner will be the sole owner. Victor dies first, when the couple's basis in the shares is $60,000 and the current value is $88,000.

Going forward, Wendy owns those DEF shares. Her basis is stepped up to $74,000: $30,000 for her half of the previous $60,000 basis plus $44,000 for Victor's half of the current $88,000 value, which is stepped up at his death. If Wendy sells the DEF shares a week later for $89,000, she will have a $15,000 long-term capital gain, considering the basis increase to $74,000 at Victor's death. (Different rules may apply to property held by married couples living in community property states.)

Basis backup

As you can see, documenting your basis in gifted or inherited assets is vital. When you get a gift, find out the giver's basis in that asset; after an inheritance, document the date of death value.

Putting a value on listed securities or other assets held in an investment account may be relatively easy. Such information should be available online or from the financial firm holding the assets. If you receive a gift of stock from Uncle Joe, who dimly recalls buying the shares "in the 1980s," make every effort to find a number that can be justified by hard evidence.

Illiquid assets present more of a challenge. Again, try to get a valuation you can support for the basis of assets you receive as a gift. For inherited assets, hire a reputable professional as soon as possible to appraise assets, such as real estate, collectibles and shares of a closely held company. ■

Mixing Annuities and IRAs

According to the Investment Company Institute, 68% of households with IRAs have mutual funds in those accounts. That's followed by individual stocks (41%), annuities (35%), and bank deposits (25%). Therefore, annuities are among the most common IRA holdings; they are also among the most controversial because many observers assert that annuities don't belong in an IRA.

Defining the terms

To understand this seeming contradiction, you should know some terminology. Generally, the most heated debate does not involve *immediate* annuities, which also may be known as *income* or *payout* annuities. Here, you give a sum of money to an insurance company in return for a specified flow of cash over a specified time period, perhaps the rest of your life.

Deferred annuities are a different story. With these investments, the money you contribute can grow inside the annuity contract. Different types of deferred annuities offer various ways that the amounts invested can grow over the years. Regardless of the method or the amount of accumulation, earnings inside the annuity aren't taxed until money is withdrawn.

Critics of holding deferred annuities inside an IRA say that they are redundant. Any investment inside an IRA is tax deferred or tax-free (with a Roth IRA), so you don't get any tax benefit by investing IRA money in a deferred annuity. Why pay the costs that come with a deferred annuity when you get the same tax deferral with mutual funds or individual securities or bank accounts held inside your IRA?

Because there might be advantages as well as drawbacks. Deferred annuities offer various guarantees, which might include certain death benefits and certain amounts of cash flow during the investor's life, regardless of investment performance. These guarantees may be a valid reason to include a deferred annuity in an IRA, some annuity issuers and sellers contend.

Among different deferred annuities, death benefits and so-called "living benefits" vary widely. Some can be extremely complicated. If you are interested in a deferred annuity, our office can explain the guarantees in the contract, so you can make an informed decision.

Verifying value

Another thing to consider when deciding whether to hold a deferred annuity in your IRA, is that these annuities must be valued for purposes such as Roth IRA conversions and required minimum distributions (RMDs). This also will arise if you already have such an annuity in your IRA. The reported value of the annuity contract may not be the appropriate number.

Example: Sarah Thomson invests $50,000 of her IRA money in a deferred annuity that offers several investment options. After this outlay, Sarah's investments decline, so her annuity account is now reported at $40,000. Sarah decides this reduced value would generate a lower tax cost on a conversion to a Roth IRA.

However, Sarah's deferred annuity also contains a rider guaranteeing to pay her a certain amount per year for the rest of her life. Such a rider has some value, which Sarah must include in valuing the annuity inside the IRA if she does a Roth conversion. The same problem will arise when Sarah must take RMDs. Sarah's best course of action may be to ask the annuity issuer for help with the valuation because insurers typically have actuaries and software designed to perform these intricate calculations. ■

Making Expense Accounts Accountable

Business owners who work for their company typically have expense accounts; the same usually is true for many employees. If your company has what the IRS calls an accountable plan, everyone can benefit from the tax treatment. The company gets a full deduction for its outlays (a 50% deduction for most dining and entertainment expenses), while the employee reports no taxable compensation.

A company expense plan judged to be nonaccountable, on the other hand, won't be as welcome. It's true that the company can deduct 100% of the payments it makes for meals and entertainment, but it also will have to pay the employer's share of payroll taxes (FICA and FUTA) on the expense money paid to employees. The employees, meanwhile, will report those payments as wages, subject to income and payroll taxes.

In that situation, the employee can include employee business expenses (minus 50% of those for

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meals and entertainment) with other miscellaneous itemized deductions, but only miscellaneous deductions that exceed 2% of adjusted gross income can be subtracted on a tax return. Taxpayers who owe the alternative minimum tax can't get any benefit from their miscellaneous deductions.

Key factors

In order for expense accounts to get favorable tax treatment, they should pass the following tests:

- Business purpose. There should be an apparent reason why the company stands to gain from this outlay. An employee might be going out of town to see a customer or a prospect, for example.
- Verification. Employees should submit a record of their expenses, in order to be reimbursed. Lodging expenses require a receipt, as do other items over $75.

In order to reduce the effort of dealing with multiple receipts, employers are allowed to give employees predetermined mileage and per diem travel allowances.

Substantiation of other elements besides amounts spent (time, place, business purpose) is still required. If the amounts of those allowances don't exceed the amounts provided to federal employees, the process can be considered an accountable plan. (Excess allowance amounts are taxable wages.) Per diem rates can be found at www.gsa.gov/portal/category/104711.

Example: XYZ Corp. asks a marketing manager, Jill Matthews, to take a two-day business trip to Atlanta to demonstrate new products. The federal rate for Atlanta (lodging, meals and incidentals) on the federal per diem website is $189 per day. As required by the XYZ accountable plan, Jill accounts for the dates, place, and business purpose of the trip. XYZ reimburses Jill $189 a day ($378 total) for living expenses; her expenses in Atlanta are not more than $189 a day. In this situation, XYZ does not include any of the reimbursement on her Form W-2, and Jill does not deduct the expenses on her tax return.

- **Refunds.** Employees must return any amounts that were advanced or reimbursed if they were not spent on substantiated business activities.
- **Timeliness.** Substantiation and any required refunds should be made within a reasonable amount of time after the expense was incurred. Those times vary, but IRS publications indicate that substantiation should be made within 60 days, and any employee refunds should be made within 120 days.

For a plan to be accountable, reimbursements and allowances should be clearly identified. They can be paid to employees in separate checks. Alternatively, expense payments can be combined with wages if the distinction is noted on the check stub. ■

Don't Waste 529 Tax Benefits

Qualified tuition programs (QTPs), also known as 529 plans, offer substantial tax benefits. Investment earnings inside such plans avoid income tax. In addition, distributions from 529 plans to cover qualified higher education costs are tax-free.

However, you'll lose the full value of 529 tax benefits if you're not careful about managing distributions. One trap is taking out too much money; another involves not pulling enough money from your 529.

Expensive excess

The risk of insufficient 529 withdrawals may be easier to grasp. If you leave money in the account after all the relevant college bills have been paid, further distributions may be highly taxed.

Example 1: Art and Kim Wilson open up a 529 account for their daughter, Eve. After Eve graduates and gets a full time job, there is still $20,000 left in the 529 account. The senior Wilsons have no younger children to whom they might transfer the account.

If the Wilsons want to use that $20,000 for purposes other than education, distributions will be taxable. The taxable amount will depend on the ratio of earnings to the overall account value. The Wilsons also will owe a 10% penalty on the amount included in income.

Qualified (that is, tax-free) distributions from a 529 plan may cover tuition, fees, books, supplies, and equipment, as well as room and board, in many cases. However, money spent by the Wilsons or by Eve to repay student loan debt will not be considered a qualified 529 expense, for this purpose. Ideally, 529 account owners should fully draw down 529 accounts for qualified higher education costs before all the likely beneficiaries are finished attending classes.

Credit check

Another 529 tax trap involves other college tax breaks such as the American Opportunity Tax Credit, the Lifetime Learning Tax Credit, and the tuition and fees tax deduction. Many taxpayers can save taxes by claiming such benefits. For instance, the American Opportunity Tax Credit is fully available to joint filers with modified adjusted gross income (MAGI) of $160,000 or less, and to single filers as well as household heads with MAGI of $80,000 or less. (Partial credits are available with slightly higher income.) Someone who qualifies can trim taxes by as much as $2,500, on $4,000 worth of higher education outlays.

However, you can't claim these education tax benefits and 529 qualified distributions for the same expenses. To claim either credit or the deduction, you may owe tax on your 529 distribution.

Example 2: Eve Wilson's total qualified college costs in 2013 are $25,000. Her parents take a $25,000 distribution from their 529 account to pay those bills. When the senior Wilsons file their 2013 tax return, they discover they are eligible for a full American Opportunity Tax Credit, which they claim.

Because the Wilsons use $4,000 of Eve's qualified expenses to claim the tax credit, only $21,000 of their 529 withdrawal counts as a qualified distribution. Thus, the Wilsons must treat $4,000 as a nonqualified distribution. (Note: Taxpayers won't owe the 10% penalty if they lose the 529 tax break because of a conflict with the American Opportunity Tax Credit.)

If the Wilsons had been aware of this tax treatment, they could have paid $4,000 of Eve's college bills from another source to align with the American Opportunity Tax Credit. Then they could have withdrawn only $21,000 from the 529 plan, all of which would have been tax-free.

Our office can help you determine which accounts to tap for college bills to maintain maximum tax efficiency. ■

Trusted Advice

Family QTP Transfers

- Assets in a Qualified Tuition Program (QTP) can be rolled over or transferred from one QTP to another. In addition, the designated beneficiary can be changed without transferring accounts.
- There are no income tax consequences if the designated QTP beneficiary is changed to a member of the existing beneficiary's family.
- A beneficiary's family includes many relatives, for this purpose. Besides children, the list includes parents, siblings, in-laws, and their spouses.

Business Owners Get More Bang From Flex Plan Bucks

Although all the effects of the Affordable Care Act (ACA) are still unclear, it's likely that health insurance costs will continue to increase in the future. Business owners may require greater health plan contributions from participating employees. In addition, this health care law already has made it more difficult for individuals to deduct medical outlays: For most taxpayers, only expenses over 10% of adjusted gross income (AGI) are tax deductible, versus a 7.5% hurdle under prior law. (The 7.5% rule remains in place through 2016 for individuals 65 and older and their spouses.)

In this environment, business owners stand to benefit substantially by offering a health flexible spending account (health FSA). These plans allow employees to set aside up to $2,500 per year that they can use to pay for health care expenses with pretax dollars.

Example 1: XYZ Corp. offers a health FSA to its employees. Harvey James, who works there, puts $2,400 into the plan at the beginning of the year. Each month, $200 will be withheld from Harvey's paychecks, and he'll owe no income tax on those amounts.

Going forward, Harvey can be reimbursed for his qualified medical expenses that are not covered by his health plan at XYZ. Possible examples include health insurance deductibles, copayments, dental treatments, eyeglasses, eye surgery, and prescription drugs. Such reimbursements are not considered taxable income. Thus, Harvey will pay those medical bills with pretax rather than after-tax dollars.

Health FSAs and the Affordable Care Act

Under the ACA, there are limitations on an employer offering a health FSA to their employees. Standalone health FSAs can only be offered to provide limited scope dental and vision benefits. An employer can only offer a health FSA that provides more

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than limited scope dental and vision benefits to employees if the employer also offers group major medical health coverage to the employees.

Additionally, an employer can make contributions to an employee's health FSA. However, under the ACA, the maximum employer contribution the plan can offer is $500 or up to a dollar-for-dollar match of the employee's salary reduction contribution.

Ultimately, these additional new rules can affect whether an employer can offer a health FSA and the amount of any optional employer match; our office can provide guidance for your specific situation.

Employer benefits

A health FSA's benefits to participating employees are clear. What will the business owner receive in return? Chiefly, the same advantages that come from offering any desirable employee benefit. Recruiting may be strengthened, employee retention might increase, and workers' improved morale can make your company more productive.

There's even a tax benefit for employers, too. When Harvey James reduces his taxable income from, say, $75,000 to $72,600 by contributing $2,400 to a health FSA, he also reduces the amount subject to Social Security and Medicare withholding by $2,400. Similarly, XYZ Corp. won't pay its share of Social Security or Medicare tax on that $2,400 going into the health FSA.

Counting the costs

However, drawbacks to offering an FSA to employees do exist. The plan, including reimbursements for eligible expenses, must be managed. Many companies save headaches by hiring a third-party administrator to handle a health FSA, but there will be a cost for such services.

In addition, companies offering health FSAs to employees should have enough cash to handle a large demand for reimbursement, especially early in the year.

Example 2: Kate Logan also works for XYZ and she chooses to contribute $1,800 to her health FSA at the beginning of the year: $150 a month, or $75 per each semimonthly paycheck. Just after her first contribution of the year, Kate submits paperwork for a $1,000 dental procedure. XYZ might not have trouble coming up with $1,000 for Kate, but there could be a problem if several employees seek large reimbursements after making small health FSA contributions.

Using It, Losing It

Employers also should be sure that employees are well aware of all the implications of health FSA participation. For years, these plans have been "use it or lose it." Any unused amounts would be forfeited at year end.

Example 3: Mark Nash participated in an FSA offered by XYZ several years ago. He contributed $2,000 but spent only $1,600 during the year. The unspent $400 went back to XYZ.

In 2005, the rules changed. Now, if the FSA permits, participants have until mid-March of the following year to use up any excess. If XYZ had adopted this optional grace period, Mark Nash would have had an extra 2½ months to spend that leftover $400 on qualified medical costs.

Yet another change occurred in late 2013—a $500 option. Under this provision, FSA plans can be amended to allow each employee a carryover of up to $500, from one year to the next. Plans with this $500 carryover provision cannot allow a grace period as well. If your company now has an FSA with this optional grace period, it will have to amend the FSA to eliminate the grace period in order to add the $500 carryover provision. Our office can help with the necessary paperwork.

In addition to explaining all the rules on possible forfeitures, employers offering an FSA should be sure their employees know about a possible impact on Social Security benefits. As mentioned, FSA contributions aren't subject to Social Security; those contributions aren't included in official compensation, for Social Security purposes. Employees should know that reduced compensation today might reduce Social Security benefits tomorrow. Companies that spell out all the FSA implications to workers may reduce misunderstandings and future complaints. ■

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