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JULY 2018

CALL IT WHAT YOU LIKE – THE DEDUCTION WILL STILL BE LIMITED

As many taxpayers will recall, the Tax Cuts and Job Act, effective January 1, 2018, limits the itemized deduction of state and local taxes for individual taxpayers to an aggregate amount of \$10,000 state and local taxes paid during the calendar year. Such payments in excess of \$10,000 are no longer deductible. The state legislatures of some high state income tax jurisdictions have responded to this federal law limitation by considering legislative proposals that the sponsors assert will allow their taxpayers to indirectly deduct state and local taxes. The proposals generally allow a taxpayer who makes “contributions” or transfers to charities controlled by state or local governments, or to other transferees specified by the state, to receive credits against the state or local taxes that the taxpayer is required to pay. These proposals purport to allow the taxpayer to characterize for federal income tax purposes such transactions as fully deductible

charitable contributions while the same transfers are allowed under state law to satisfy state and local tax liabilities. In other words, a payment that satisfied state and local taxes would become a charitable contribution deduction.

The Internal Revenue Service (IRS) has issued Internal Revenue Service Notice 2018-54 stating that it intends to propose regulations addressing the federal income tax treatment of such transfers. According to the IRS, the proposed regulations will make clear that the requirements of the Internal Revenue Code govern the federal income tax treatment of such transfers and are based on substance-over-form principles. The regulations are not yet issued, but the notice indicates, at least to us, that the IRS will hold that if a payment directly or indirectly satisfies a tax liability, it is a tax payment and not a charitable contribution.

TO ROTH OR NOT (A TAX PAYMENT OR A PURCHASE?)

Tax law allows all taxpayers (without income limitations) to convert all or part of their traditional IRAs to Roth IRAs. We believe that conventional wisdom is correct in holding that the early payment of taxes is generally a bad idea. However, for some IRA owners, consideration of converting a traditional IRA into a Roth IRA and paying the related income tax now can create a very significant benefit. Our website contains a discussion, “To Roth or Not,” which discusses why conversion might be a

good idea and includes some related questions and answers.

Thinking about conversion to Roth raises a question – are the income taxes paid for a conversion of a traditional IRA to a Roth IRA “income taxes” or might they be considered the “purchase of an investment?”

For some taxpayers, the conversion might appropriately be viewed as the “purchase” at a

(Continued on reverse)

bargain price of an asset which can grow tax-free. For example, assume (to remove the effect of bracket changes) that the taxpayer has a constant total state and federal tax rate of 40 percent. For this constant bracket taxpayer, \$1,000 inside a traditional IRA is in effect “owned” by the taxpayer in the amount of \$600 and by the taxing authorities \$400. While no taxes are being paid currently (it is a tax-deferred account), all distributions will, in the future, benefit the IRA owner 60 percent and 40 percent will be consumed by income taxes. A Roth IRA conversion will cause the taxpayer to pay \$400 (40 percent of \$1,000) in current tax and will result in the entire amount of the IRA working for the owner tax-free for the balance of the life of the Roth IRA, which can exceed the life of its original owner. By converting to Roth, this owner has “purchased” the taxing authorities’ “ownership interest” in the traditional IRA for \$400. Assuming the owner’s tax bracket is constant (to remove the benefit or detriment of

any future change in the applicable tax rate), the taxpayer has not, from one perspective, “paid tax” of \$400 but rather has purchased a \$400 investment, which is likely worth more than \$400 as it compounds tax-free over the balance of the taxpayer’s life and, if the taxpayer predeceases a spouse, over the longer life of the spouse. Additionally, following the death of the second to die of the couple, the Roth IRA can continue to compound tax-free as it is distributed (forced out of the Roth IRA) over the initial life expectancies of the beneficiaries who might be children (or even grandchildren) or a trust for their benefit.

For taxpayers who can pay the conversion tax from sources outside the IRA and who do not anticipate significantly reduced tax rates on IRA withdrawals, conversion allows an expansion of the tax benefits of an IRA by as much as 66⅔ percent by “purchasing” the governments’ interest in the traditional IRA.

THE VERDICT IS IN – DULL WINS (BUFFETT’S BET)

As long-time readers may recall, we, as advocates of passive index investing, have closely followed the charitable contribution bet Warren Buffett made effective January 1, 2008 with Ted Siedes, an asset manager of Protégé Partners. Mr. Buffett’s offer was that no accepting investment professional (Mr. Siedes was the only responder) could out perform an S&P 500 Index Fund over a 10-year period. The 10-year period ended December 31, 2017. Mr. Buffett detailed the final results in the Berkshire Hathaway 2017 Annual Report. After all fees and expenses but before income taxes, the S&P 500 Index Fund returned 8.5 percent annually and the active asset managers (more than 100 hedge funds selected by Mr. Siedes) returned an average of 2.96 percent annually. In other words, the investment return on \$1 million in Mr. Buffett’s suggested index fund (the Vanguard 500 Index Fund) produced a pre-tax gain of \$1,260,983 compared to \$338,706 for the actively managed portfolio of over 100

hedge funds selected by Mr. Siedes.

Active management results in current taxation of dividends and net gains from sales (largely at short-term capital gains rates) while a passive index fund results in current taxation (at favorable rates) of only the dividend portion of the total return. Thus, the major portion (capital appreciation) of the return from passive index investing is tax deferred and, if held to death (or the death of a community property spouse), never subjected to income taxation. If the results were adjusted for current taxation, the over-performance of the S&P Index Fund (3.7 to 1) compared to the managed portfolio would increase dramatically – probably to more than five to one.

In summary, the results validate Buffett’s often repeated advice that “both large and small investors should stick with low-cost index funds.”

Tax & Business Alert

JULY 2018

DON'T LET THE KIDDIE TAX PLAY COSTLY GAMES WITH YOU

It's not uncommon for parents, grandparents and others to make financial gifts to minors and young adults. Perhaps you want to transfer some appreciated stock to a child or grandchild to start them on their journey toward successful wealth management. Or maybe you simply want to remove some assets from your taxable estate or shift income into a lower tax bracket. Whatever the reason, beware of the "kiddie tax." It can play costly games with the unwary.

AN EVOLVING CONCEPT

Years ago, the kiddie tax applied only to those under age 14. But, more recently, the age limits were revised to children under age 19 and to full-time students under age 24 (unless the students' earned income is more than half of their own support).

Another important, and even more recent, change to the kiddie tax occurred under the Tax Cuts and Jobs Act (TCJA). Before passage of this law, the net unearned income of a child was taxed at the parents' tax rates if the parents' tax rates were higher than the tax rates of the child. The remainder of a child's taxable income — in other words, earned income from a child's job, plus unearned income up to \$2,100 (for 2018), less the child's standard deduction — was taxed at the child's rates. The kiddie tax applied to a child if the child:

- Hadn't reached the age of 19 by the close of the tax year, or the child was a full-time student under the age of 24 whose earned income was less than half of their own support, and either of the child's parents was alive at such time,

- Had unearned income exceeding \$2,100 (for 2018), and

- Didn't file a joint return.

Now, under the TCJA, for tax years beginning after December 31, 2017, the taxable income of a child attributable to earned income is taxed under the rates for single individuals, and taxable income of a child attributable to net unearned income is taxed according to the brackets applicable to trusts and estates. This rule applies to the child's ordinary income and his or her income taxed at preferential rates. As under previous law, the kiddie tax can potentially apply until the year a child turns 24.

THE TAX IN ACTION

Let's say you transferred to your 16-year-old some stock you'd held for several years that had appreciated \$10,000. You were thinking she'd be eligible for the 0% long-term gains rate and so could sell the stock with no tax liability for your family. But you'd be in for an unhappy surprise: Assuming your daughter had no other unearned income, in 2018 \$7,900 of the gain would be taxed at the estate and trust capital gains rates, equal to a tax of \$795.



Or let's say you transferred the appreciated stock to your 18-year-old grandson with the plan that he could sell the stock tax-free to pay for his college tuition. He won't end up with the entire \$10,000 gain available for tuition because of the kiddie tax liability.

Fortunately, there may be ways to achieve your goals without triggering the kiddie tax. For example, if you'd like to shift income and you have adult children (older than 24) who're no longer subject to the kiddie tax but in a lower tax bracket, consider transferring income-producing or highly appreciated assets to them.

A RISKY TIME

Many families wait until the end of the year to make substantial, meaningful gifts. But, given what's

4 QUESTIONS TO ASK BEFORE HIRING HOUSEHOLD HELP

When you hire someone to work in your home, you may become an employer. Thus, you may have specific tax obligations, such as withholding and paying Social Security and Medicare (FICA) taxes and possibly federal and state unemployment insurance. Here are four questions to ask before you say, "You're hired."

1. WHO'S CONSIDERED A HOUSEHOLD EMPLOYEE?

A household worker is someone you hire to care for your children or other live-in family members, clean your house, cook meals, do yard work or provide similar domestic services. But not everyone who works in your home is an employee.

For example, some workers are classified as independent contractors. These self-employed individuals typically provide their own tools, set their own hours, offer their services to other customers and are responsible for their own taxes. To avoid the risk of misclassifying employees, however, you may want to assume that a worker is an employee unless your tax advisor tells you otherwise.

2. WHEN DO I PAY EMPLOYMENT TAXES?

You're required to fulfill certain state and federal tax obligations for any person you pay \$2,100 or more annually (in 2018) to do work in or around your house. (The threshold is adjusted annually for inflation.)

In addition, you're required to pay the employer's half of FICA (Social Security and Medicare) taxes (7.65% of cash wages) and to withhold the employee's half. For employees who earn \$1,000 or more in a calendar quarter, you must also pay federal unemployment taxes (FUTA) equal to 6% of the first \$7,000 in cash wages. And, depending on your resident state, you may be required to make state unemployment contributions, but you'll receive a FUTA credit for those contributions, up to 5.4% of wages.

You don't have to withhold federal (and, in most cases, state) income taxes, unless you and your employees

at stake, now is a good time to start a methodical process to determine the best possible way to pass along your wealth. After all, with the many changes made under the TCJA, the kiddie tax might affect you in ways you weren't expecting. The best advice is to simply run the numbers with an expert's help. Please contact our firm for more information and some suggestions on how to achieve your financial goals. ■

agree to a withholding arrangement. But regardless of whether you withhold income taxes, you're required to report employees' wages on Form W-2.

3. ARE THERE EXCEPTIONS?

Yes. You aren't required to pay employment taxes on wages you pay to your spouse, your child under age 21, your parent (unless an exception is met) or an employee who is under age 18 at any time during the year, providing that performing household work isn't the employee's principal occupation. If the employee is a student, providing household work isn't considered his or her principal occupation.

4. HOW DO I MAKE TAX PAYMENTS?

You pay any federal employment and withholding taxes by attaching Schedule H to your Form 1040. You may have to pay state taxes separately and more frequently (usually quarterly). Keep in mind that this may increase your own tax liability at filing, though the Schedule H tax isn't subject to estimated tax penalties.



If you owe FICA or FUTA taxes or if you withhold income tax from your employee's wages, you need an employer identification number (EIN).

There's no statute of limitations on the failure to report and remit federal payroll taxes. You can be audited by the IRS at any time and be required to pay back taxes, penalties and interest charges. Our firm can help ensure you comply with all the requirements. ■

ESOPs OFFER BUSINESSES TAX AND OTHER BENEFITS

Wouldn't it be great if your employees worked as if they owned the company? An employee stock ownership plan (ESOP) could make that a reality.

Under an ESOP, employee participants take part ownership of the business through a retirement savings arrangement. Meanwhile, the business and its existing owner(s) can benefit from some tax breaks, an extra-motivated workforce and potentially a smoother path for succession planning.

HOW ESOPs WORK

To implement an ESOP, you establish a trust fund and either:

- Contribute shares of stock or money to buy the stock (an “unleveraged” ESOP), or
- Borrow funds to initially buy the stock, and then contribute cash to the plan to enable it to repay the loan (a “leveraged” ESOP).

The shares in the trust are allocated to individual employees' accounts, often using a formula based on their respective compensation. The business must formally adopt the plan and submit plan documents to the IRS, along with certain forms.

TAX IMPACT

Among the biggest benefits of an ESOP is that contributions to qualified retirement plans such as ESOPs typically are tax-deductible for employers. However, employer contributions to all defined contribution plans, including ESOPs, are generally limited to 25% of covered payroll. But C corporations with leveraged ESOPs can deduct contributions used to pay interest on the loans. That is, the interest isn't counted toward the 25% limit.



Dividends paid on ESOP stock passed through to employees or used to repay an ESOP loan may be tax-deductible for C corporations, so long as they're reasonable.

Dividends voluntarily reinvested by employees in company stock in the ESOP also are usually deductible by the business. (Employees, however, should review the tax implications of dividends.)

In another potential benefit, shareholders in some closely held C corporations can sell stock to the ESOP and defer federal income taxes on any gains from the sale, with several stipulations. One is that the ESOP must own at least 30% of the company's stock immediately after the sale. In addition, the sellers must reinvest the proceeds (or an equivalent amount) in qualified replacement property securities of domestic operation corporations within a set period.

Finally, when a business owner is ready to retire or otherwise depart the company, the business can make tax-deductible contributions to the ESOP to buy out the departing owner's shares or have the ESOP borrow money to buy the shares.

RISKS TO CONSIDER

An ESOP's tax impact for entity types other than C corporations varies somewhat from what we've discussed here. And while an ESOP offers many potential benefits, it also presents risks such as complexity of setup and administration and a strain on cash flow in some situations. For help determining whether one may make sense for your business, contact us. ■

TAX CALENDAR

July 16

If the monthly deposit rule applies, employers must deposit the tax for payments in June for Social Security, Medicare, withheld income tax, and nonpayroll withholding.

July 31

If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds \$500.

- The second quarter Form 941 (“Employer’s Quarterly Federal Tax Return”) is also due today. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

August 15

If the monthly deposit rule applies, employers must deposit the tax for payments in July for Social Security, Medicare, withheld income tax, and nonpayroll withholding.

September 15

Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.

- If a six-month extension was obtained, partnerships should file their 2017 Form 1065 by this date.
- If a six-month extension was obtained, calendar-year S corporations should file their 2017 Form 1120S by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in August for Social Security, Medicare, withheld income tax, and nonpayroll withholding.

RETIREMENT PLAN OPTIONS FOR BUSINESS OWNERS

As a business owner, you may have most of your money tied up in your company — making saving for retirement especially challenging. If you haven't already set up a tax-advantaged retirement plan, think about setting one up this year.



Keep in mind that, if you have employees, they generally must be allowed to participate in the plan, provided they work enough hours and meet other qualification requirements. Here are a few options to consider:

Profit-sharing plans. This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2018 contributions as late as the due date of your 2018 income tax return, including extensions — provided your plan existed on December 31, 2018.

Simplified Employee Pensions (SEPs). A SEP is a defined contribution plan that provides benefits like those

of a profit-sharing plan. But you can establish a SEP in one year and still make deductible contributions as late as the due date of your income tax return for the previous year, including extensions. Another benefit is that a SEP is easier to administer than a profit-sharing plan.

Defined benefit plans. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum annual benefit generally is \$220,000 for 2018 (up from \$215,000 for 2017) — or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the contribution needed to attain the projected future annual benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit.

You can make deductible 2018 contributions until the due date of your 2018 income tax return, including extensions — provided your plan existed on December 31, 2018. Warning: Employer contributions are generally required and must be paid quarterly if there was a shortfall in funding for the prior year. ■