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NOVEMBER 2021

DISABILITY INCOME TAXATION

The first article in the accompanying *Tax & Business Alert* discusses the difference in income tax treatment of employee disability benefits, depending on who paid the disability insurance premium. It is not always clear to the insurance company who paid the premium. In more complex arrangements the premiums could have been paid partially by the employer as a pre-tax employee benefit (e.g., through a cafeteria plan) and paid partially by the employee with after-tax dollars. In that case, the taxable and nontaxable portions of the paid disability benefit are based on the relative amount of premiums paid by the employer and employee.

YES, BUT PLEASE REMEMBER…

The accompanying *Tax & Business Alert* contains on page 2 an article styled "4 Ways to Withdraw Cash from a Corporation." The article fails to mention that the discussion is limited to closely held C corporations and does not apply to corporations electing to be taxed under subchapter S.

We also want you to remember to generally avoid C corporation status in small closely held companies. Although there are a very few situations where closely held C corporations are the most appropriate entity form, the usual best entity for closely held business and investment activity is a limited liability company. Limited liability companies generally offer more tax flexibility with less complexity and without the threat of a double-tax on earnings and appreciation. Long studies, articles, and memos can be created about the differences between, and advantages and disadvantages of, the various legal entities. But, the limited liability company will almost inevitably emerge as the best choice for small, closely held business entities or family investment entities.

"The difference between death and taxes is death doesn't get worse every time Congress meets."

Will Rodgers

DEATH TAXES AND (UN)CERTAINTY

An estate tax is a tax imposed on a decedent's estate on the transfer of property to the decedent's heirs and beneficiaries. An inheritance tax is imposed on the individuals who receive an inheritance or bequest from a decedent. Although technically different, they each can be considered a "death tax," the principles and fairness of which have been

(*Continued on reverse*)

debated for centuries within many countries. We have a federal estate tax. Seventeen states and DC have one or the other (Maryland has both). Louisiana currently has neither.

To its proponents, a death tax (beyond raising government revenue) supports the idea that society should be protected against inherited control of the country's wealth and, thereby, control of the country itself. It encourages merit over unearned advantage. To death tax opponents, it represents a confiscation by a wasteful government of an individual's already-taxed accumulation that one hopes to pass down as a legacy to surviving family members without additional government interference.

According to the Congressional Budget Office, federal estate and gift tax (gift tax can be considered just a prepaid estate tax) collected in 2020 totaled $17.6 billion, which represented 0.1 percent of the gross domestic product. Because this collected tax is relatively small, one might assume that a primary reason for our federal estate tax (and the recent proposals for expanding it) is based on the goal of reducing "wealth inequality."

One current federal estate tax proposal would terminate early the temporary increase of the estate tax exemption (currently $11,700,000). Scheduled to revert back to half the amount after 2025, the exemption would revert instead effective for decedents dying after December 31, 2021.

Other current proposals are intended to curtail the use of discounts for lack of marketability and control in the valuation of interests in family investment entities and the use of intentionally defective trusts. Two earlier proposals that do not appear in the current draft bills are the income taxation of asset appreciation on death of the individual and elimination of the stepped-up basis of assets at death. Of course, nobody knows what changes might actually become law. However, two certainties of taxation are, at least to us, that tax law incentives almost inevitably will become "loopholes" and that tax law changes occur all too frequently.

IS LONG-TERM INFLATION RETURNING?

The U.S. Bureau of Labor Statistics CPI reports inflation for the 12-months ended September 30, 2021 as 5.39 percent. For the 12-months ended September 30, 2020, inflation was reported at an annual rate of 1.37 percent – a very sharp increase between the two annual periods. The CPI reports inflation for the 30-year period ended September 30, 2021 at 2.34 percent – less than half the rate of the recent 12 months. Some forecasters are estimating inflation for all of 2021 at 5.5 percent, which would be the highest annual level in more than 30 years. The Social Security Administration has stated that the cost-of-living adjustment for 2022 benefits will be 5.9 percent as the inflation adjustment formula for Social Security is more generous than the Consumer Price Index.

Understanding that inflation is currently elevated and that the opinions of those speaking out about inflation vary widely, is there a broad consensus available to investors about inflation over the next few years? One source of such information is the difference in yield fixed by the bond market on U.S. Treasury obligations, which are protected from inflation (TIPS – Treasury Inflation Protected Securities) and non-inflation protected Treasury securities of the same maturities, terms, etc. Both the interest payments and the principal payments on TIPS are adjusted for inflation.

On October 25, 2021, the five-year interest rate on Treasury bonds not protected from inflation per the Daily Treasury Yield Curve Rates

(*Continued on page 3*)

was at 1.19 percent per year. The five-year interest rate on TIPS per the Daily Treasury Real Yield Curve Rates was a negative 1.76 percent. Accordingly, inflation can be forecast by the difference between these two rates (a negative 1.76 percent and a positive 1.19 percent or 2.95 percent) suggesting that buyers of non-inflation protected five-year U.S. government bonds are willing to accept a nominal annual return of 1.76 percent while buyers of inflation protected bonds (TIPS) will buy inflation protection by accepting a nominal return of 2.95 percent less. Accordingly, while inflation is currently at a level of over five percent, the bond market is predicting inflation over the next five years to average 2.95 percent.

Looking at longer terms and using the same methodology, the Treasury bond market predicts inflation over the next 10 years to average 2.66 percent and for the next 30 years to average 2.41 percent.

Given the frequency and significance of the price increases currently occurring, the shortage of labor and inventory, and the delays in shipping, it is difficult for many of us to grant credibility to the bond market predictions. Nevertheless, buyers of 5, 10 and 30-year non-inflation protected U.S. Treasury Securities (who could remove their inflation risk for less than 3.00 percent per year) are betting that long-term inflation above 3.00 percent is not returning.

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Tax & Business Alert

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IS DISABILITY INCOME TAXABLE?

Many Americans receive disability income. If you're one of them or know someone who is, you may wonder whether it's taxable. As is often the case with tax questions, the answer is "it depends."

KEY FACTOR

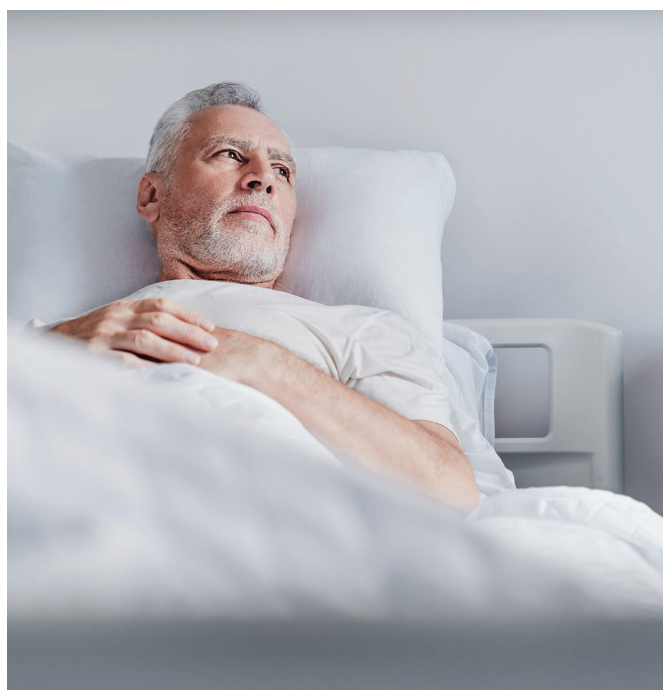
The key factor is who paid it. If the income is paid directly to you by your employer, it's taxable to you as ordinary salary would be. Taxable benefits are also subject to federal income tax withholding — though, depending on the disability plan, they sometimes aren't subject to Social Security tax.

Frequently, the payments aren't made by the employer but by an insurer under a policy providing disability coverage or under an arrangement having the effect of accident or health insurance. In such cases, the tax treatment depends on who paid for the coverage. If your employer paid for it, then the income is taxed to you just as if paid directly to you by the employer. On the other hand, if it's a policy you paid for, the payments you receive under it aren't taxable.

Even if your employer arranges for the coverage (in other words, it's a policy made available to you at work), the benefits aren't taxed to you if you pay the premiums. For these purposes, if the premiums are paid by the employer but the amount paid is included as part of your taxable income from work, the premiums are treated as paid by you.

TWO EXAMPLES

Let's say your salary is $1,000 a week ($52,000 a year). Under a disability insurance arrangement made available to you by your employer, $10 a week ($520 for the year) is paid on your behalf by your employer to an insurance company. You include $52,520 in income as your wages for the year: the $52,000 paid to you plus the $520 in disability insurance premiums. In this case, the insurance is treated as paid for by you. If you become disabled and receive benefits, they aren't taxable income to you.



Now, let's look at an example with the same facts as above. Except in this case, you include only $52,000 in income as your wages for the year because the amount

HOW MUCH COVERAGE IS NEEDED?

In deciding how much disability coverage you need to protect yourself and your family, take tax treatment into consideration. If you're buying the policy, you need to replace your after-tax, "take-home" income because your benefits won't be taxed. On the other hand, if your employer pays for the benefit, you'll lose a percentage to taxes. If your current coverage is insufficient, you may wish to supplement an employer benefit with a policy you take out.

paid for the insurance coverage qualifies as excludable under the rules for employer-provided health and accident plans. In this case, the insurance is treated as paid for by your employer. If you become disabled and receive benefits, they are taxable income to you.

Note: There are special rules in the case of a permanent loss (or loss of the use) of a part or function of the body, or a permanent disfigurement.

ANY QUESTIONS?

This discussion doesn't cover the tax treatment of *Social Security* disability benefits, which may be taxed under different rules. Contact us if you'd like to discuss this further or have questions about regular disability income. ■

4 WAYS TO WITHDRAW CASH FROM A CORPORATION

Owners of closely held corporations often want or need to withdraw cash from the business. The simplest way, of course, is to distribute the money as a dividend. However, a dividend distribution isn't tax-efficient because it's taxable to the owner to the extent of the corporation's earnings and profits. It also isn't deductible by the corporation. Here are four alternative strategies to consider:

1. Capital repayments. To the extent that you've capitalized the corporation with debt, including amounts that you've advanced to the business, the corporation can repay the debt without the repayment being treated as a dividend. Additionally, interest paid on the debt can be deducted by the corporation.

This assumes that the debt has been properly documented with terms that characterize debt and that the corporation doesn't have an excessively high debt-to-equity ratio. If not, the "debt" repayment may be taxed as a dividend. If you make future cash contributions to the corporation, consider structuring them as debt to facilitate later withdrawals on a tax-advantaged basis.

2. Compensation. Reasonable compensation that you, or family members, receive for services rendered to the corporation is deductible by the business. However, it's also taxable to the recipient(s). This same rule applies to any compensation (in the form of rent) that you receive from the corporation for the use of property. In both cases, the compensation amount must be reasonable in terms of the services rendered or the value of the property provided. If it's considered excessive, the excess will be a nondeductible corporate distribution (and taxable to the recipient as a dividend).

3. Property sales. You can withdraw cash from the corporation by selling property to it. However, certain sales should be avoided. For example, you shouldn't sell property to a more than 50%-owned corporation at a loss, since the loss will be disallowed. And you shouldn't sell depreciable property to a more than 50%-owned corporation at a gain, since the gain will be treated as ordinary income, rather than capital gain. A sale should be on terms that are comparable to those in which an unrelated third party would purchase the property. You may need to obtain an independent appraisal to establish the property's value.

4. Loans. You can withdraw cash tax-free from the corporation by borrowing money from it. However, to prevent having the loan characterized as a corporate distribution, it should be properly documented in a loan agreement or note. It should also be made on terms that are comparable to those in which an unrelated third party would lend money to you, including a provision for interest (at least equal to the applicable federal rate) and principal. Also, consider what the corporation's receipt of interest income will mean.

These are just a few ideas. If you're interested in discussing these or other possible ways to withdraw cash from a closely held corporation, contact us. We can help you identify the optimal approach at the lowest tax cost. ■

ONE-TIME THING: IRA TO HSA TRANSFERS

Did you know that you can transfer funds directly from your IRA to a Health Savings Account (HSA) without taxes or penalties? According to the IRS, you're permitted to make one such "qualified HSA funding distribution" during your lifetime.

Ordinarily, if you have an IRA and an HSA, it's typically a good idea to contribute as much as possible to both to make the most of their tax benefits. But if you're hit with high medical expenses and have an insufficient balance in your HSA, transferring funds from your IRA may be a solution.

CALLING IN THE CAVALRY

An HSA is a savings account that can be used to pay qualified medical expenses with pre-tax dollars. It's generally available to individuals with eligible high-deductible health plans. Currently, the annual limit on tax-deductible contributions to an HSA is $3,600 for individuals with self-only coverage and $7,200 for individuals with family coverage. If you're 55 or older, the limits are $4,600 and $8,200, respectively. Those same limits apply to an IRA-to-HSA transfer, reduced by any contributions already made to the HSA during the year.

Here's an example illustrating the potential benefits of a qualified HSA funding distribution from an IRA: Joe is 58 years old, with a self-only, high-deductible health plan. In 2021, he needs surgery for which he incurs $5,000 in out-of-pocket costs. Joe is strapped for cash and only has $500 left in his HSA, but he does have a $50,000 balance in his traditional IRA. Joe may move up to $4,600 from his IRA to his HSA tax- and penalty-free.

CONSIDERING OTHER FACTORS

If you decide to transfer funds from your IRA to your HSA, keep in mind that the distribution must be made directly by the IRA trustee to the HSA trustee, and the transfer counts toward your maximum annual HSA contribution.

Also, funds transferred to the HSA in this case aren't tax deductible but, because the IRA distribution is excluded from your income, the effect is the same (at least for federal tax purposes).

EXPLORING THE OPPORTUNITY

IRA-to-HSA transfers are literally a once-in-a-lifetime opportunity, but that doesn't mean they're the right move for everyone. If you're interested, our firm can help you explore the concept in the context of your distinctive tax and financial circumstances. ■

GIVING BAD DEBTS THE BUSINESS

When one of your company's customers can't pay up, you may be able to give that debt "the business." That is, you may be able to claim a tax deduction under Internal Revenue Code Section 166. To successfully do so, however, you'll need to know how the tax code defines a partially or wholly worthless "bad debt."

A deductible bad debt can generally be defined as a loss arising from the worthlessness of a debt that was created or acquired in your trade or business, or that was closely related to your trade or business when it became partly or totally worthless. The most common bad debts involve credit sales to customers for goods or services.

Other examples include loans to customers or suppliers that are made for business reasons and have become uncollectible, and business-related guarantees of debts that have become worthless. Debts attributable to an insolvent partner may also qualify.

The IRS will scrutinize loans to be sure they're legitimate. For example, it might deny a bad debt deduction if it determines that a loan to a corporation was actually a contribution to capital.

There's no standard test or formula for determining whether a debt is a bad debt; it depends on the facts and circumstances of each case. To qualify for the deduction, you simply must show that you've taken reasonable steps to collect the debt and there's little likelihood it will be paid. Our firm can look at your potentially bad debts and tell you for sure whether they're deductible. ■