

# Client Tax Letter

Tax Saving and Planning Strategies *from your Trusted Business Advisor*<sup>sm</sup>

## Cons and Pros of Roth IRAs

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contributions. A complete Roth IRA conversion would add \$400,000 to her income for the year. That would put her in the top 39.6% tax bracket and expose her to other tax obligations, such as the 3.8% Medicare surtax. Counting state income tax, Jill might owe close to \$200,000 in tax on this conversion, for 2016. If she didn't convert her traditional IRA, Jill could avoid taking any taxable distributions for more than 10 years; going forward,

she would be required to withdraw relatively modest amounts each year.

### Roth rewards

The biggest drawback of a Roth IRA conversion is the upfront tax obligation. In addition, Roth IRAs are subject to recordkeeping requirements and federal rules, which can change. Several years ago, for example, Roth IRA conversions were prohibited if you reported adjusted gross income of \$100,000 or more, on a single or joint tax return.

Despite these drawbacks, Roth IRAs are increasingly popular. The big attraction is the lure of tax-free cash flow. Once your Roth IRA has been in place for five years and you reach age 59½, all

Annual contributions to IRAs, including Roth IRAs, are now capped at \$5,500 (\$6,500 if you're 50 or older). Roth IRA contributions aren't tax deductible, they're available only to workers and their spouses, and they're off-limits to high-income taxpayers.

Nevertheless, there is a way to get large amounts into a Roth IRA, regardless of your income or your work status. You can convert a tax deferred account such as a traditional IRA or a 401(k) to a Roth IRA. Such a conversion, though, probably will trigger income tax much earlier than necessary.

**Example 1:** Jill Kent, age 60, has \$400,000 in her traditional IRA, all of which came from deductible

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## Down to Zero

*The 0% cost-of-living adjustment (COLA) for Social Security benefits in 2016 follows COLAs of only 1.7% in 2013, 1.5% in 2014, and 1.7% in 2015, far below the 4.1% historical average.*

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distributions are tax-free. (The first hurdle is really 4+ years because any 2015 Roth IRA conversion, even in late December, reaches the official five-year mark on January 1, 2020.)

Qualified Roth IRA distributions will be untaxed, no matter how much income you report or how high tax rates might be in the future. Thus, having some money in a Roth IRA offers a hedge against rising income tax rates, which many observers predict.

### Staying power

Another advantage of Roth IRAs is that owners have no required minimum distributions (RMDs). With traditional IRAs, 401(k)s, and so on, you generally must take out certain amounts each year after age 70½, or face a 50% penalty on any shortfall.

**Example 2:** With a \$400,000 traditional IRA at age 60, Jill Kent could have a much larger account by age 70½. She might have to take taxable withdrawals of at least \$15,000, \$20,000, or more each year, regardless of whether she needs all the money.

If she converts her entire traditional IRA to a Roth IRA before that age, Jill will have no RMDs. She eventually can withdraw as much or as little as she wants, tax-free, and leave the balance to her beneficiaries. Those beneficiaries—who might be in their own high tax brackets when they inherit the account—can take untaxed distributions, although they will be on an RMD schedule.

By converting her traditional IRA to a Roth IRA in 2016, Jill will be reducing or eliminating her RMD obligation while creating a long-term, tax-free investment account.

### Perfect hindsight

Two other features of Roth IRAs make them especially attractive. One, partial conversions are allowed. Jill might convert, say, \$40,000 of her Roth IRA in 2016. Assuming an effective tax rate (federal and state) of 32%, her \$40,000 conversion would trigger a tax bill of \$12,800, which Jill can manage. If she does this every year, Jill could move most or all of her traditional IRA to a tax-free, RMD-free Roth IRA in 10 years.

The second appealing feature of a Roth IRA conversion is the ability to recharacterize (reverse) the conversion back to a traditional IRA by October 15 of the following year. This can be done in full or in part, so you effectively have the ability to specify the amount of tax you'll have to pay.

**Example 3:** Jill converts her entire \$400,000 IRA to a Roth IRA in 2016. In 2017, when Jill prepares her 2016 tax return, her CPA calculates her tax bill at various conversion amounts. Jill discovers that the total tax rate on an \$80,000 (20% of \$400,000) Roth IRA conversion would be 35% in this hypothetical scenario. She decides to make the conversion, resulting in a tax bill of \$28,000. She recharacterizes the other 80% of her Roth IRA back to a traditional IRA, planning to repeat the process later in 2017.

Our office can help you determine the amount to recharacterize, if you wish to execute a Roth IRA conversion in 2016 and perhaps a recharacterization in 2017, to hold down the tax you'll owe. ■

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## Facing College Costs

How much does it cost to send a child to college now? For the 2015-2016 academic year, the College Board puts the average cost of tuition, fees and room and board at private nonprofit four-year schools at nearly \$44,000. The College Board estimates other expenses (including books, supplies and transportation) at about \$4,000. Thus, sending your child away to a private institution costs an average of around \$48,000 this year; at universities considered "elite," the total tab is generally well over \$60,000. Those numbers likely will be even higher in the 2016-2017

school year, and they will certainly be higher for youngsters entering college in the future.

Parents of collegians can reduce their concerns a bit by considering the College Board's report on "net prices." These prices are determined by subtracting grant aid (reductions in direct college costs) and education tax benefits (savings from tax deductions and credits related to higher education). As reported by the College Board, such reductions bring down the cost at private institutions from the published price of almost \$44,000 to a net price of less than

\$27,000. Including the other expenses mentioned previously, sending your child to a private university might cost "only" \$30,000 or so a year, rather than \$48,000.

Be aware, though, that the net price offsets will vary enormously from family to family. The higher your net worth and your income, the less need-based grant aid your student is likely to receive. The higher your income, the smaller your tax savings from education tax breaks, many of which have income-based phaseouts. Our office can help you determine how much relief

you can expect from grants and tax benefits.

### Higher and lower

The numbers mentioned previously in this article are national averages. Therefore, at some schools the total cost will be much higher while others will have much lower costs. Regional differences can be huge. According to the College Board, total costs for private institutions in New England are well over \$50,000 a year, yet costs average about \$40,000 in the South, Southwest, and West.

Moreover, all of those figures are for private colleges and universities. Costs come down dramatically when you send your children to public institutions. The College Board puts the average total cost for in-state students at four-year public colleges and universities at less than \$24,000: about half the cost of private schools. After grants and tax benefits, the net price at these public institutions is around \$14,000 a year. At two-year public colleges, including community colleges, costs are even lower.

### Charting a course

Even relatively modest costs for higher education can be daunting for many families. Therefore, parents should consider starting college funds for their children as early as possible. Creating a designated account for higher education may help you avoid “dipping in” for other purposes.

Under the federal formula, a family is more likely to qualify for need-based financial aid if savings and investment accounts are held by the parent, rather than in the student’s name. For example, a parent might be the owner of a 529 college savings plan, with the child as the beneficiary. Such plans, offered by nearly all states and some private firms, can generate tax-free investment earnings to pay college bills.

Once children are finishing their high school careers, it may make sense to apply to multiple colleges—some more expensive than others. Private and public institutions could be in the mix. If students are interested, applications to virtually no-cost military academies and Reserve Officers’ Training Corps (ROTC) program scholarships also might be included, along with other specialty schools.

Accomplished youngsters may receive more than one college acceptance, allowing the family to decide among the various opportunities. Published costs, net of any aid and tax benefits, might not be the main reason for making a decision, but they also should not be ignored. Everyone—students and parents—should have a reasonable idea of how the costs will be covered.

Keep in mind that your child’s first college might not be his or her last place for higher education. Your youngster might start at a less expensive institution and wind up graduating from or getting a

## Trusted Advice

### Taking Credit

- The American opportunity tax credit (AOTC) is among the most valuable higher education tax benefits.
- This tax credit (a direct reduction in your tax bill) equals 100% of the first \$2,000 of qualified education expenses you paid for each eligible student and 25% of the next \$2,000 of such expenses you paid for that student.
- Thus, the maximum annual credit is \$2,500 per student.
- If the credit reduces your tax to zero, 40% of the remaining credit amount (up to \$1,000) can be refunded.
- To claim the full credit, your modified adjusted gross income (MAGI) must be \$80,000 or less (\$160,000 for married couples filing jointly). Partial credits are available with MAGI up to \$90,000 (\$180,000 on a joint return).

postgraduate degree from a more prestigious college or university.

Regardless of a student’s path through higher education, it’s possible that family cash flow plus grant aid won’t be able to cover all the expenses that arise. Consequently, as is the case for many, your family may need to explore loans as an option to pay for the desired schooling. ■

## Deducting Taxes Paid

When you file your 2016 federal income tax return next year, you can take a standard deduction. For 2016, that’s \$6,300 for

single taxpayers and for married individuals filing separately; \$12,600 for couples filing jointly and for certain widow(er)s; and

\$9,300 for those filing as heads of household. (If you haven’t yet filed your 2015 return, the numbers are the same, except \$9,250 for

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heads of household.) The beauty of taking the standard deduction is that it's simple: There's no need to



gather information and scant risk of triggering an audit.

However, taking the time to itemize deductions can be a tax saver. If your itemized deductions exceed the standard amounts, you'll generally come out ahead by listing them on Schedule A of Form 1040. Indeed, the amount you can claim under "Taxes You Paid" may be enough to justify itemizing.

### Property tax

You can itemize the property tax you pay for your home. If you have a second home, the tax on that property also can be deducted. In fact, you can deduct any amount of tax you pay on any number of homes that were not used for business, even if they're in different states or out of the United States.

The key here is to deduct the payment for the year in which it was paid. If you have a property tax payment due in January or February 2017, for instance, and you send in the payment in December 2016, that amount can be an itemized deduction in 2016.

If you make monthly mortgage payments on a home, a portion of each payment might go into an escrow account for eventual forwarding to the property tax collector. In this scenario, the property tax payments are deductible for the year in which the money is actually paid out of the escrow account to the taxing authority.

So-called "local benefits taxes" paid by property owners may or may not be deductible, depending on how the money is used. Our office can determine whether you can deduct such taxes. You also may be able to deduct personal property tax, assessed on the value of

items, such as boats or cars.

### Permanent Possibility

State and local income tax you pay also can be deducted on Schedule A. That includes amounts withheld from paychecks as well as any estimated state or local estimated income tax you pay during the calendar year.

For many years, taxpayers have had the option of deducting state and local sales tax instead of state or local income tax, if that provided a greater deduction. This provision expired several times, only to be renewed. Late in 2015, Congress passed a tax act that makes this choice of deductions permanent, retroactive to 2015.

A sales tax deduction obviously appeals to residents of states or localities with no income tax. If you live in an area with an income tax—and if you are itemizing deductions—you should see which choice provides the greater tax savings.

**Example 1:** Marge Collins pays enough property tax to make

itemizing worthwhile. When getting her records together for tax preparation, Marge discovers that she paid a total of \$3,000 in state income tax. Marge also should see how much sales tax she paid. If the total exceeds \$3,000, she probably should deduct sales tax instead of state income tax.

How can Marge determine the amount of sales tax she paid? One way is to go through all of her receipts for the year, and calculate the sales tax she paid on purchases.

Many people don't keep all their receipts, though. If you're in that category, you can use the optional sales tax table provided by the IRS, in the instructions to Form 1040.

That table shows the amount of the sales tax you're estimated to have paid in the relevant year, depending on your income, where you live, and the exemptions you claim. Note that "income," for this purpose, includes not only your adjusted gross income but also inflows such as tax-exempt interest and nontaxable Social Security benefits. The greater your income, the more sales tax you're presumed to have paid.

What's more, the IRS tables don't assume you have made any large purchases. Thus, the resulting amount from the tables can be increased by any sales tax you paid for a car (bought or leased), motorcycle, boat, airplane, motor home, or similar items.

For 2015 tax returns, a Sales Tax Deduction Calculator was offered at [irs.gov](http://irs.gov). The IRS asked for a few simple entries in order to illustrate the amount of state and local sales tax you could claim. Assuming the same calculator is available for 2016 tax returns, this calculator may help you get your records ready for tax preparation next year as well. ■

# QTIP Trusts Still Offer Advantages

For many people, trusts can play a role in estate planning. Indeed, a qualified terminable interest property (QTIP) trust may offer benefits to married couples. That's especially true for people who are in a second (or even a third) marriage, because a QTIP trust can prevent a second spouse from disinheriting children from a first marriage.

## Extending control

A QTIP trust allows the creator (grantor) to provide funds for a surviving spouse and also name the final beneficiaries.

**Example 1:** Dwight Emerson's will calls for the establishment of a QTIP trust, to be funded with most of his assets. His second wife, Flo, will be entitled to all of the income from the QTIP trust, for as long as she lives. At Flo's death, the assets remaining in the trust will go to Gregg Emerson and Helen Jenkins, Dwight's children from a prior marriage.

Thus, Flo will be assured of cash flow for the rest of her life. However, she won't be able to direct the QTIP trust assets to her own children, also from a prior marriage. Dwight can be sure that his children will receive whatever is left in the trust after Flo's death.

This process can go both ways. Flo's will also can create a QTIP trust for her assets, so that Dwight would receive lifetime income if he is the surviving spouse, yet Flo's children would ultimately get the trust assets.

## Asset protection

What's more, a QTIP trust can provide asset protection.

**Example 2:** Kirk and Laurie Miller are married with grown children. Both Millers have wills calling for all of their assets to go into QTIP trusts. The surviving spouse will get all the trust income; in addition, the local bank named as trustee will be instructed to provide the survivor with additional funds from the trust, if necessary for ordinary living expenses, such as health care. Then, the remainder ultimately will go to their children.

With this arrangement, a remarriage after the death of the first spouse won't lead to their children being disinherited. Control of the assets by a trustee will reduce the chance of depletion through squandering or unwise investments by the surviving spouse.

## Tax benefits

Historically, QTIP trusts were used to defer estate tax to the death of the second spouse. With the federal estate tax exemption now at \$5.45 million per person, scheduled to rise with inflation, federal estate tax is not a concern for many people.

Nevertheless, many states have their own estate tax or inheritance tax, with lower exemption levels. A couple with combined net worth of \$3 million or \$4 million might wind up owing substantial amounts of state tax at death, so tax deferral through a QTIP trust could be valuable. State rules regarding QTIP trusts vary greatly, however, so the applicable state's rules must be reviewed carefully when determining whether to use a QTIP trust. In addition, couples with combined

net worth well in excess of \$10 million may have federal estate tax exposure, so a QTIP trust could be worthwhile for them.

## Addressing concerns

Just as any well-drafted trust may offer advantages, trusts also require time and expense to create and maintain. Moreover, a QTIP trust poses specific issues in addition to the usual cautions about using a knowledgeable attorney to set it up.

With a QTIP trust, the executor will have to make a required election after the grantor's death. A separate state election also may be required to get QTIP tax treatment. Thus, if you create a QTIP trust, the trustee you name should be prepared to make a well-considered election.

You also should prepare your heirs for QTIP consequences. Your spouse, for example, should know that income will flow life-long, but access to the trust principal will be limited. If your children will be the ultimate beneficiaries, they should understand they'll have to wait for their inheritance, perhaps for many years. You might want to provide a more immediate source of funds to your children through insurance on your life or through a bequest outside of the trust.

In addition, you should discuss ongoing investment of trust assets with your chosen trustee. A QTIP trust must be invested to generate income to the surviving spouse, yet the trustee should attempt to provide a substantial amount to the ultimate beneficiaries as well. ■

# Succession Planning for a Family Business

If you intend to name a family member to succeed you in running your company, you have some advantages. The person you'll name (probably your son or daughter, son- or daughter-in-law) is someone you can identify easily, without an extensive search. You know that person's capabilities and shortcomings; he or she likely works for the company now, so you have a good idea of how well the future owner will do.

That said, passing on your company to a family member can pose problems. Intra-family dynamics should be considered, which may not be the case if your successor is an outsider. Moreover, there are several methods of relinquishing ownership, all of which may be closely scrutinized by the IRS.

## Seeing things clearly

Designating a family member as your successor can raise emotional issues. Does your son really want to run your business, working the long hours you've always put in? Is your daughter truly eager to jump off the partner track at her law firm to take charge of your company? Be honest with yourself, even if it leads to painful conclusions.

**Example:** Donna Allen realized that her two sons did not get along with each other, but she thought that would change as they grew older. Instead, their mutual animosity continues, and they're competing with each other to replace their mother as CEO of Allen Enterprises. Facing reality, Donna concluded that a 50-50 ownership solution would ruin her successful company. Thus, she is dividing the company into two firms, along product lines, so each son can be the sole owner of his own business in the future.

## Playing fair

If you have more than one child, it's often the case that one will be the obvious successor, while the others will have different careers. Passing on ownership to all the children and leaving one to run the company can lead to strife: the operator may feel like he or she is working to enrich siblings and the outside owners might second-guess business decisions.



Naming the child who will manage the company as the sole owner may make sense, from a business perspective, but it also can deprive the others of a valuable asset. In such cases, it may be desirable to equalize the inheritances. (If you're married, your estate plan also should provide for a surviving spouse.)

Our firm can help you devise an estate plan that's fair to all of your loved ones, yet transfers control of the company to the most competent heir or heirs. Situations differ, but life insurance might offer a way to compensate family members who won't wind up with your valuable business.

## Transfer tactics

Your estate plan also should focus on the method you'll use to keep your company in the family. Broadly, here are your options:

- **Sell it.** This mode has the obvious benefit of providing you with income in retirement,

enabling you to enjoy the fruits of building the business. Coming up with enough cash for the buyout may be difficult for your younger successor, so it might be necessary to arrange financing or an installment sale so payments will come from future company earnings, in some manner.

- **Give it.** Another option is to transfer some shares to your successor during his or her lifetime. Gift tax may be avoided or minimized by using discounts for fractional interests in the company while ownership might be motivational. On the downside, such gifts can reduce the income you'll get from the business and you should have a strategy for dealing with other children.
- **Leave it.** You can simply hold onto the company until you die and bequeath it to your successor. This approach allows you to remain in control and perhaps receive income from dividends once you stop working. A lack of ownership, though, might discourage your chosen successor and lead to that person's leaving for another opportunity.

No matter which of these methods you choose, the IRS may challenge the valuation involved. A below-market sale, for example, could be recast as part sale and part taxable gift. Thus, having a reliable valuation of the company should be part of your all-in-the-family succession plan.

A sophisticated approach might involve a mix of selling, giving, and leaving your business to a younger relative. Tactics such as retaining income-producing shares while transferring operational control may be appropriate. Our office can help you put together a tax-effective strategy. ■