

A photograph of a woman with dark hair, wearing a red top, smiling warmly and hugging a young child from behind. The child is wearing a blue long-sleeved shirt and a white apron with a red tie. They are in a kitchen, with a wooden rolling pin and cookie cutters visible on a table in the foreground. The background is softly blurred, showing a bookshelf and a window.

2014 - 2015  
Individual Tax Planning Guide

CBIZ



®

## To Our Valued Clients and Friends:

Having the right ingredients, equipment and environment all factor into the successful execution of a recipe. In many respects, tax planning is similar – you need to understand the tax landscape and have the right tools and vehicles at your disposal in order to effectively plan for and execute your short- and long-term recipe for life. In 2013, higher marginal and capital gain tax rates, new Medicare taxes on investment and earned income and hidden taxes such as the restored limitations on itemized deductions and personal exemptions significantly inflated the tax bills of many taxpayers. This Guide provides information and several planning techniques to help you manage your tax burden for 2014 and the years to come.

Managing your income tax liability is always an important goal – but it's not the only one. Effective retirement planning is also key. Qualified retirement plans provide not only tax-deferred (or tax-free) growth, but the distributions are also not subject to net investment income tax. The current Federal tax structure only enhances the benefits on your retirement plan and this Guide provides some ideas on how to maximize it.

The third pillar of an effective and integrated tax management strategy is proper estate planning. The record-high lifetime gift and estate exemption continues to provide an excellent opportunity to move assets and future appreciation out of your estate. With some taxpayers still benefiting from lower marginal and capital gain tax rates, you can also reduce your family's overall tax burden by gifting assets to family members in lower tax brackets.

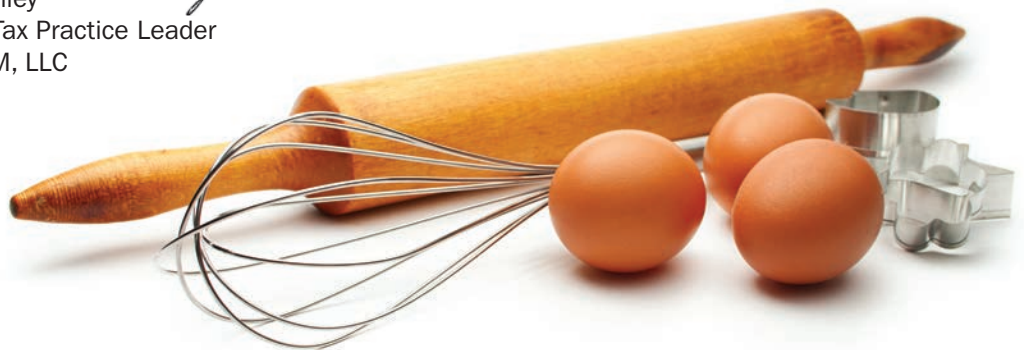
Taxes are not only increasing in dollars, but also in complexity. Recent guidance on the applications of the new net investment income tax and the new tangible property regulations increases the compliance burden on many investors, especially those with a financial stake in real estate or operating businesses. Our Guide will discuss ways to maximize the tax benefits of property ownership.

Please do not hesitate to contact your CBIZ MHM professional for assistance or help creating and/or executing your recipe. Best wishes for a fulfilling and prosperous 2015!



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## Tax planning challenging but crucial for higher-income taxpayers

*At the beginning of 2013, many tax rates and breaks were made permanent. The increased certainty brought by these tax law changes has in some ways made tax planning in 2014 a little easier.*

*But the changes also brought tax hikes to higher-income taxpayers — including the return of the 39.6% income tax rate and 20% long-term capital gains rate. In addition, some new and expanded taxes under the Affordable Care Act (ACA) now affect higher-income taxpayers: the 3.8% net investment income tax and the 0.9% additional Medicare tax.*

*It's also important to remember that, even though many tax law provisions are now "permanent," this simply means that they don't have expiration dates. With tax reform still on its agenda, Congress may make some major changes in the future. So in your 2014 planning, don't count on the tax regime remaining the same indefinitely.*

*What does this all mean? Tax planning in 2014 will be challenging but crucial for higher-income taxpayers. This guide provides an overview of some key tax provisions that you need to be aware of and offers a wide variety of strategies for minimizing your taxes. But there isn't space to touch on all of the available tax-savings opportunities. So please contact your tax advisor to learn exactly which strategies can benefit you the most.*

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## Smart timing still critical for higher-income taxpayers



*Last year, higher-income taxpayers faced both tax increases on “ordinary income” and reductions to certain tax breaks. Unfortunately, there’s no relief in sight for 2014. So monitor your year-to-date ordinary income, which generally includes salary, income from self-employment or business activities, interest, and distributions from tax-deferred retirement accounts. Also consider how it will be taxed. Finally, keep an eye on your deductible expenses. Smart timing of income and deductions, along with other strategies, may help keep tax increases in check.*

### AMT triggers

The top alternative minimum tax (AMT) rate is 28%, compared to the top regular ordinary-income tax rate of 39.6%. (See Chart 7 on page 24.) But the AMT rate typically applies to a higher taxable income base.

So before taking action to time income and expenses, you should determine whether you’re already likely to be subject to the AMT — or whether the actions you’re considering might trigger it. Many deductions used to calculate regular tax aren’t allowed under the AMT (see Chart 1) and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability:

- ▶ Long-term capital gains and dividend income, even though they’re taxed at the same rate for both regular tax and AMT purposes,
- ▶ Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- ▶ Tax-exempt interest on certain private-activity municipal bonds. (For an exception, see the AMT Alert on page 11.)

Finally, in certain situations exercising incentive stock options (ISOs) can trigger significant AMT liability. (See the AMT Alert on page 7.)

### Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, reduce its impact or even take advantage of its lower maximum rate. Planning is a little easier now that the AMT brackets and exemptions are annually adjusted for inflation. Before 2013, Congress had to legislate any adjustments, which they often were slow to do. This left uncertainty about what the AMT situation would be the next year, inhibiting the ability to effectively implement timing strategies.

To determine the right timing strategies for your situation, work with your tax advisor to assess whether:

**You could be subject to the AMT *this* year.** Consider accelerating income into this year, which may allow you to benefit from the lower maximum AMT rate. And deferring expenses you can’t deduct for AMT purposes may allow you to preserve those deductions. If you also defer expenses you *can* deduct for AMT purposes, the deductions may become more valuable because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

**You could be subject to the AMT *next* year.** Consider taking the opposite approach. For instance, defer income to next year, because you’ll likely pay a relatively lower AMT rate. And prepay expenses that will be

deductible this year but that won’t help you next year because they’re not deductible for AMT purposes. Also, before year end consider selling any private-activity municipal bonds whose interest could be subject to the AMT.

If you pay AMT in one year on deferral items, such as depreciation adjustments, passive activity adjustments or the tax preference on ISO exercises, you may be entitled to a credit in a subsequent year. In effect, this takes into account timing differences that reverse in later years.

### Timing income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. When you don’t expect to be subject to the AMT in the current year or the next year, deferring income to the next year and accelerating deductible expenses into the current year typically is a good idea. Why? Because it will defer tax, which usually is beneficial.

But when you expect to be in a *higher* tax bracket next year — or you expect tax rates to go up — the opposite approach may be beneficial: Accelerating income will allow more income to be taxed at your current year’s lower rate. And deferring expenses will make the deductions more valuable, because deductions save more tax when you’re subject to a higher tax rate.

Don't forget that the income-based itemized deduction reduction returned last year. (See Case Study I on page 4.) Its impact should be taken into account when considering timing strategies.

Whatever the reason behind your desire to time income and expenses, here are some income items whose timing you may be able to control:

- ▶ Bonuses,
- ▶ Consulting or other self-employment income,
- ▶ U.S. Treasury bill income, and
- ▶ Retirement plan distributions, to the extent they won't be subject to early-withdrawal penalties and aren't required. (See page 21.)

And here are some potentially controllable expenses:

- ▶ State and local income taxes,
- ▶ Property taxes,
- ▶ Mortgage interest,

- ▶ Margin interest, and
- ▶ Charitable contributions.

**Warning:** Prepaid expenses can generally be deducted only in the year to which they apply. For example, you can prepay (by Dec. 31) property taxes that relate to this year but that are due next year, and deduct the payment on your return for this year. But you generally can't prepay property taxes that relate to next year and deduct the payment on this year's return.

### Miscellaneous itemized deductions

Many expenses that may qualify as miscellaneous itemized deductions are deductible for regular tax purposes only to the extent they exceed, in aggregate, 2% of your adjusted gross income (AGI). Bunching these expenses into a single year may allow you to exceed this "floor."

As the year progresses, record your potential deductions to date. If they're close to — or they already exceed — the 2% floor, consider paying accrued expenses and incurring and paying additional expenses by Dec. 31, such as:

- ▶ Deductible investment expenses, including advisory fees, custodial fees and publications,
- ▶ Professional fees, such as tax planning and preparation, accounting, and certain legal fees, and
- ▶ Unreimbursed employee business expenses, including travel, meals, entertainment and vehicle costs.

**AMT ALERT! Miscellaneous itemized deductions subject to the 2% floor aren't deductible for AMT purposes. So don't bunch them into a year when you may be subject to the AMT.**

### Health-care-related breaks

If your medical expenses exceed 10% of your AGI, you can deduct the excess amount. Eligible expenses may include:

- ▶ Health insurance premiums,
- ▶ Long-term care insurance premiums (limits apply),
- ▶ Medical and dental services,
- ▶ Prescription drugs, and
- ▶ Mileage (23.5 cents per mile driven for health care purposes).

Consider bunching nonurgent medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into one year to exceed the 10% floor. Taxpayers age 65 and older enjoy a 7.5% floor through 2016 for regular tax purposes but are subject to the 10% floor now for AMT purposes.

Expenses that are reimbursable by insurance or paid through a tax-advantaged account such as the following aren't deductible:

**HSA.** If you're covered by qualified high-deductible health insurance, you can contribute pretax income to an

**CHART 1** Regular tax vs. AMT: What's deductible?

Expense	Regular tax	AMT	For more information
State and local income tax	●		See "Timing income and expenses" at left.
Property tax	●		See "Home-related deductions" on page 12.
Mortgage interest	●	●	See "Home-related deductions" on page 12.
Interest on home equity debt not used to improve your principal residence	●		See "Home-related deductions" on page 12.
Investment interest	●	●	See "Investment interest expense" on page 11.
Investment expenses	●		See "Miscellaneous itemized deductions" above.
Professional fees	●		See "Miscellaneous itemized deductions" above.
Unreimbursed employee business expenses	●		See "Miscellaneous itemized deductions" above.
Medical expenses	●	●	See "Health-care-related breaks" at right.
Charitable contributions	●	●	See page 16.

employer-sponsored Health Savings Account — or make deductible after-tax contributions to an HSA you set up yourself — up to \$3,300 for self-only coverage and \$6,550 for family coverage (for 2014), plus an additional \$1,000 if you're age 55 or older. HSAs can bear interest or be invested, growing tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

**FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed \$2,500 for plan years beginning in 2014. The plan pays or reimburses you for qualified medical expenses. What you don't use by the plan year's end, you generally lose — though your plan might allow you to roll over up to \$500 to the next year. Or it might give you a 2½-month grace period to incur expenses to use up the previous year's contribution.

If you have an HSA, your FSA is limited to funding certain "permitted" expenses.

### Sales tax deduction

The break allowing you to take an itemized deduction for state and local sales taxes in lieu of state and local income taxes was available for 2013 but, as of this writing, hasn't been extended for 2014. (Check with your tax advisor for the latest information.)

### Employment taxes

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. The 12.4% Social Security tax applies only up to the Social Security wage base of \$117,000 (up from \$113,700 for 2013). *All* earned income is subject to the 2.9% Medicare tax. Both taxes are split equally between the employee and the employer.

### Self-employment taxes

If you're self-employed, you pay both the employee and employer portions of employment taxes on your self-employment income. The employer portion (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line.

As a self-employed taxpayer, you may benefit from other above-the-line deductions as well. You can deduct 100% of health insurance costs for yourself, your spouse and your dependents, up to your net self-employment income. You also can deduct contributions to a retirement plan and, if you're eligible, an HSA for yourself. Above-the-line deductions are particularly valuable because they reduce your AGI and modified AGI (MAGI), which are the triggers for certain additional taxes and the phase-outs of many tax breaks.

## CASE STUDY I

### Exemption phaseout and deduction reduction can be costly

When they filed their 2013 joint income tax return, Stan and Margaret were surprised to learn that they wouldn't fully benefit from the personal exemptions and itemized deductions they thought they were entitled to. This is because the income-based phaseout of personal exemptions and reduction on certain itemized deductions that had been eliminated for 2010 through 2012 returned in 2013. The 2014 adjusted gross income (AGI) thresholds for both are \$254,200 (singles), \$279,650 (heads of households), \$305,050 (married filing jointly) and \$152,525 (married filing separately), up a little from 2013.

The personal exemption phaseout reduces exemptions by 2% for each \$2,500 (or portion thereof) by which a taxpayer's AGI exceeds the applicable threshold (2% for each \$1,250 for married taxpayers filing separately).

The itemized deduction limitation reduces otherwise allowable deductions by 3% of the amount by which a taxpayer's AGI exceeds the applicable threshold (not to exceed 80% of otherwise allowable deductions). It doesn't apply, however, to deductions for medical expenses, investment interest, or casualty, theft or wagering losses.

Stan and Margaret consulted their tax advisor to find out if there were any steps they could take to reduce the impact of the reduction and phaseout on their 2014 tax return. The couple has four dependent children, expects to have an AGI of \$1 million, and will be in the top tax bracket (39.6%). Without the AGI-based exemption phaseout, their \$23,700 of personal exemptions ( $\$3,950 \times 6$ ) would save them \$9,385 in taxes ( $\$23,700 \times 39.6\%$ ). But because their personal exemptions are completely phased out, they'll lose that tax benefit.

The AGI-based itemized deduction reduction could also be expensive. Stan and Margaret could lose the benefit of as much as \$20,849 [ $3\% \times (\$1 \text{ million} - \$305,050)$ ] of their itemized deductions that are subject to the reduction — at a tax cost as high as \$8,256 ( $\$20,849 \times 39.6\%$ ).

These two AGI-based provisions combined could increase the couple's tax by \$17,641.

Their advisor explained that, if their AGI were close to the \$305,050 threshold for joint filers, AGI-reduction strategies (such as making retirement plan and HSA contributions) might allow them to stay under it. But Stan and Margaret's AGI will likely be far above the threshold. So they can't avoid the reduced tax benefit of the exemptions or affected deductions. But they should keep it in mind before implementing strategies to accelerate or defer deductible expenses.

## Additional 0.9% Medicare tax

Another employment tax that higher-income taxpayers must be aware of is the additional 0.9% Medicare tax. Under the ACA, since 2013, taxpayers have had to pay this tax on FICA wages and self-employment income exceeding \$200,000 per year (\$250,000 for married filing jointly and \$125,000 for married filing separately).

If your wages or self-employment income varies significantly from year to year or you're close to the threshold for triggering the additional Medicare tax, income timing strategies may help you avoid or minimize it. For example, if you're an employee, perhaps you can time when you receive a bonus, or you can defer or accelerate the exercise of stock options. If you're self-employed, you may have flexibility on when you purchase new equipment or invoice customers. If you're a shareholder-employee of an S corporation, you might save tax by adjusting how much you receive as salary vs. distributions. (See "Owner-employees" at right.)

Also consider the withholding rules. Employers are obligated to withhold the additional tax beginning in the pay period when wages exceed \$200,000 for the calendar year — without regard to an employee's filing status or income from other sources. So your employer might withhold the tax even if you aren't liable for it — or it might *not* withhold the tax even though you are liable for it.

If you *don't* owe the tax but your employer is withholding it, you can claim a credit on your 2014 income tax return. If you *do* owe the tax but your employer isn't withholding it, consider filing a W-4 form to request additional *income* tax withholding, which can be used to cover the shortfall and avoid interest and penalties. Or you can make estimated tax payments.



## Owner-employees

There are special considerations if you're a business owner who also works in the business, depending on its structure:

**Partnerships and limited liability companies.** Generally, all trade or business income that flows through to you for income tax purposes is subject to self-employment taxes — even if the income isn't distributed to you. But such income may not be subject to self-employment taxes if you're a limited partner or the LLC member equivalent. Check with your tax advisor on whether the additional 0.9% Medicare tax on earned income or the new 3.8% NIIT (see page 8) will apply.

**S corporations.** Only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. To reduce these taxes, you may want to keep your salary relatively — but not unreasonably — low and increase your distributions of company income (which generally isn't taxed at the corporate level or subject to the 0.9% Medicare tax or 3.8% NIIT).

**C corporations.** Only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. Nevertheless, you may prefer to take more income as salary (which is deductible at the corporate

level) as opposed to dividends (which aren't deductible at the corporate level yet are still taxed at the shareholder level and could be subject to the 3.8% NIIT) if the overall tax paid by both the corporation and you would be less.

**Warning:** The IRS is cracking down on misclassification of corporate payments to shareholder-employees, so tread carefully.

## Estimated payments and withholding

You can be subject to penalties if you don't pay enough tax during the year through estimated tax payments and withholding. Here are some strategies to help avoid underpayment penalties:

### Know the minimum payment rules.

For you to avoid penalties, your estimated payments and withholding must equal at least 90% of your tax liability for 2014 or 110% of your 2013 tax (100% if your 2013 AGI was \$150,000 or less or, if married filing separately, \$75,000 or less).

**Use the annualized income installment method.** This method often benefits taxpayers who have large variability in income from month to month due to bonuses, investment gains and losses, or seasonal income (especially if it's skewed toward the end of the year). Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

**Estimate your tax liability and increase withholding.** If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters.

**Warning:** You can incur interest and penalties if you're subject to the additional 0.9% Medicare tax and it isn't withheld from your pay and you don't make sufficient estimated tax payments. ▮

## Complex tax consequences demand careful planning



*Executives and other key employees often are compensated with more than just salary, fringe benefits and bonuses: You might also be awarded stock-based compensation, such as restricted stock, restricted stock units (RSUs) or stock options (either incentive or nonqualified). Or you might be offered nonqualified deferred compensation (NQDC). Although these rewards can be valuable, the tax consequences are complex. They involve not only a variety of special rules but also several types of taxes — including ordinary income taxes, capital gains taxes, employment taxes and the expanded taxes under the ACA. That's why careful planning is critical.*

### Restricted stock

Restricted stock is stock that's granted subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that risk or you sell it. When the restriction lapses, you pay taxes on the stock's fair market value (FMV) at your ordinary-income rate. (The FMV will be considered FICA income, so it also could trigger or increase your exposure to the additional 0.9% Medicare tax. See page 5.)

But you can instead make a Section 83(b) election to recognize ordinary income when you *receive* the stock. This election, which you must make within 30 days after receiving the stock, can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. Why? Because the election allows you to convert future appreciation from ordinary income to long-term capital gains income and defer it until the stock is sold.

There are some potential disadvantages of a Sec. 83(b) election, however. First, you must prepay tax in the current year — which also could trigger or increase your exposure to the 39.6% ordinary-income tax rate or the additional 0.9% Medicare tax. But if your company is in the earlier stages of development, the income recognized may be relatively small.

Second, any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or you sell it at a decreased value. However, you'd have a capital loss when you forfeited or sold the stock.

Third, when you sell the shares, any gain will be included in net investment income and could trigger or increase your liability for the 3.8% NIIT. (See page 8.)

Work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for you in each particular situation.

### RSUs

RSUs are contractual rights to receive stock (or its cash value) after the award has vested. Unlike restricted stock, RSUs aren't eligible for the Sec. 83(b) election. So there's no opportunity to convert ordinary income into capital gains.

But they do offer a limited ability to defer income taxes: Unlike restricted stock, which becomes taxable immediately upon vesting, RSUs aren't taxable until the employee actually receives the stock. So rather than having the stock delivered immediately upon vesting, you may be able to arrange with your employer to delay delivery. This will defer income tax and may allow you to reduce or avoid exposure to the additional 0.9% Medicare tax (because the RSUs are treated as FICA income).

However, any income deferral must satisfy the strict requirements of Internal Revenue Code (IRC) Section 409A.

### Incentive stock options

ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's FMV at the date of the grant. Therefore, ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price *below* what they're then trading for, as long as you've satisfied the applicable ISO holding periods.

ISOs receive tax-favored treatment but must comply with many rules. Here are the key tax consequences:

- ▶ You owe no tax when ISOs are granted.
- ▶ You owe no regular income tax when you exercise the ISOs.
- ▶ If you sell the stock *after* holding the shares at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate. You also may owe the NIIT. (See page 8.)
- ▶ If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates. (Disqualified dispositions aren't, however, subject to the additional 0.9% Medicare tax.)



**AMT ALERT!** In the year of exercise, a tax “preference” item is created for the difference between the stock’s FMV and the exercise price (the “bargain element”) that can trigger the AMT. A future AMT credit, however, should mitigate this AMT hit. Consult your tax advisor because the rules are complex.

If you’ve received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or to hold them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there’s also market risk to consider. Plus, acting earlier can be advantageous in several situations:

- ▶ Exercise early to start the holding period so you can sell and receive long-term capital gains treatment sooner.
- ▶ Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- ▶ Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.



- ▶ Sell in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares’ value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT liability.

The timing of ISO exercises could also positively or negatively affect your liability for the 39.6% ordinary-income tax rate, the 20% long-term capital gains rate or the NIIT. With your tax advisor, evaluate the risks and crunch the numbers to determine the best strategy for you.

### Nonqualified stock options

The tax treatment of NQSOs is different from the tax treatment of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don’t create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Keep in mind that an exercise could trigger or increase exposure to top tax rates, the additional 0.9% Medicare tax and the NIIT.

### NQDC plans

These plans pay executives in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s, in several ways. For example, unlike 401(k) plans, NQDC plans can favor highly compensated employees, but plan funding isn’t protected from the employer’s creditors. (For more on 401(k)s, see page 20.)

One important NQDC tax issue is that employment taxes (see page 4) are generally due once services have been performed and there’s no longer a substantial risk of forfeiture — even though compensation may not be paid or recognized for income tax purposes until much later. So your employer may withhold your portion of the employment taxes from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you’ll have additional taxable income. **Warning:** The additional 0.9% Medicare tax could also apply. ▶

#### CASE STUDY II

#### Watch out for falling stock prices after exercising ISOs

Marco was granted incentive stock options (ISOs) to buy 50,000 shares of his company stock at \$15 a share.

When eligible one year later, Marco exercised 10,000 shares at the trading price of \$25. He might be subject to an AMT liability as high as \$28,000. That’s because the exercise results in a \$100,000 tax preference item on the bargain element (the difference between the \$250,000 trading price and the \$150,000 exercise price), which could be taxed at the top AMT rate of 28%. This might be a problem, because exercising the option doesn’t generate any cash with which to pay the tax.

The problem is magnified if the stock price drops after the exercise. For example, if Marco pays the AMT but the trading price per share later falls back to \$15, he’ll have paid the tax even though the selling price of his shares is equal to the price he paid for them. Fortunately, he’ll be able to claim a credit in future years for the AMT paid.

## Navigating the tax obstacles of investing in 2014



*It's never been easy to navigate the various tax consequences of buying and selling securities. Among the many obstacles higher-income investors need to consider in 2014 is the relatively new net investment income tax (NIIT). This 3.8% tax may apply to your net investment income if your income exceeds certain levels. (See Case Study III.) And the NIIT can show up when you least expect it — for example, passive-activity and qualified-dividend income are subject to the tax. That's just one reason why it's important to plan ahead and consider taking advantage of the strategies available to you.*

### Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your long-term capital gains rate might be as much as 20 percentage points lower than your ordinary-income rate. The long-term gains rate applies to investments held for more than 12 months. The applicable rate depends on your income level and the type of asset you've sold. (See Chart 2 on page 11.) Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain.

Remember: Appreciating investments that don't generate current income aren't taxed until sold, deferring tax and perhaps allowing you to time the sale to your tax advantage — such as in a year when you have capital losses to absorb the capital gain. Or, if you've cashed in some big gains during the year and want to reduce your 2014 tax liability, before year end look for unrealized losses in your portfolio and consider selling them to offset your gains. (See Case Study IV.)

**AMT ALERT!** Substantial net long-term capital gains can trigger the AMT.

### The wash sale rule

If you want to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or an option to buy such a security) within 30 days before or after you sell the security that created the loss. You can recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid the wash sale rule and still achieve your goals. For example, you can:

- ▶ Immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold,
- ▶ Wait 31 days to repurchase the same security, or
- ▶ Before selling the security, purchase additional shares of that security equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

Alternatively, you can do a bond swap, where you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus, you can achieve a tax loss with virtually no change in economic position.

### CASE STUDY III

#### Avoiding or reducing a 3.8% NIIT hit

When Edgar and Julia filed their 2013 joint tax return, they were surprised to be hit with a new tax on their investments: the NIIT. Under the ACA, starting in 2013, taxpayers with modified adjusted gross income (MAGI) over \$200,000 per year (\$250,000 for married filing jointly and \$125,000 for married filing separately) are subject to this extra 3.8% tax on the lesser of their net investment income or the amount by which their MAGI exceeds the applicable threshold.

To learn how they might reduce their NIIT hit in 2014 (or perhaps even avoid the tax), Edgar and Julia consulted a tax advisor. The advisor explained that many of the strategies that can help save or defer income tax on investments can also help avoid or defer NIIT liability. For example, the couple could use unrealized losses to absorb gains or transfer highly appreciated or income-producing assets to a family member who isn't subject to the NIIT. And because the threshold for the NIIT is based on MAGI, strategies that reduce MAGI — such as making retirement plan contributions (see page 20) — could also help avoid or reduce NIIT liability.

### Loss carryovers

If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married filing separately) of the net losses per year against ordinary income.

You can carry forward excess losses indefinitely. Loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains.

Be aware, however, that loss carryovers die with the taxpayer. So older or seriously ill taxpayers may want to sell investments at a gain now to absorb these losses. They can immediately reinvest the proceeds in the same stocks if they wish to maintain their position. The wash sale rule isn't an issue because it applies only to losses, not gains.

Alternatively, they can use the proceeds to purchase different stocks and diversify their portfolio at no tax cost.

Finally, remember that capital gains distributions from mutual funds can also absorb capital losses.

### The 0% rate

The 0% rate applies to long-term gain that would be taxed at 10% or 15% based on the taxpayer's ordinary-income rate. If you have adult children in one of these tax brackets, consider transferring appreciated assets to them so they can enjoy the 0% rate. This strategy can be even more powerful if you'd be subject to the 3.8% NIIT or the 20% long-term capital gains rate if you sold the assets.

**Warning:** If the child will be under age 24 on Dec. 31, first make sure he or she won't be subject to the "kiddie tax." (See page 19.) Also consider any gift tax consequences. (See page 22.)

### Paying attention to details

If you don't pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

### CASE STUDY IV

### Taking advantage of capital losses

Maia's investments overall are down significantly in 2014 and, to date, her net realized losses are \$100,000. Her portfolio includes \$200,000 of a technology company stock that was worth \$300,000 a year ago but that she paid only \$105,000 for. She's been thinking about selling it to lock in her gains before they potentially shrink further and to diversify her portfolio. But she's been concerned about the capital gains tax.

Now might be a good time to sell the stock because Maia's \$95,000 gain would essentially be tax-free: It would absorb almost all of the \$100,000 of losses, leaving her with a \$5,000 net loss, \$3,000 of which she could use to offset ordinary income and \$2,000 of which she could carry forward to offset gains — or even ordinary income — next year.

And if you bought the same security at different times and prices and want to sell high-tax-basis shares to reduce gain or increase a loss to offset other gains, be sure to specifically identify which block of shares is being sold.

### Mutual funds

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls. First, mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Second, earnings on mutual funds are typically reinvested, and unless you (or

your investment advisor) keep track of these additions and increase your basis accordingly, you may report more gain than required when you sell the fund. Since 2012, brokerage firms have been required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Third, buying equity mutual fund shares later in the year can be costly tax-wise. Such funds often declare a large capital gains distribution at year end. If you own the shares on the distribution's record date, you'll be taxed on the full distribution amount even if it includes significant gains realized by the fund *before* you owned the shares. And you'll pay tax on those gains in the current year — even if you reinvest the distribution.



### Small business stock

By purchasing stock in certain small businesses, you can diversify your portfolio. You also may enjoy preferential tax treatment:

**Conversion of capital loss to ordinary loss.** If you sell qualifying Section 1244 small business stock at a loss, you can treat up to \$50,000 (\$100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 39.6% of this portion of the loss. Sec. 1244 applies only if total capital invested isn't more than \$1 million.

**Tax-free gain rollovers.** If within 60 days of selling qualified small business (QSB) stock you buy other QSB stock with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled-over gain reduces your basis in the new stock. For determining long-term capital gains treatment, the new stock's holding period includes the holding period of the stock you sold. To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed \$50 million.

**Exclusion of gain.** Generally, taxpayers selling QSB stock are allowed to exclude up to 50% of their gain if they've held the stock for more than five years. But, depending on the acquisition date, the exclusion may be greater: The exclusion is 75% for stock acquired after Feb. 17, 2009, and before Sept. 28, 2010, and 100% for stock acquired after Sept. 27, 2010, and before Jan. 1, 2014. (Congress could extend the 100% exclusion — or some other exclusion that's higher than 50% — to QSB stock acquired in 2014. Contact your tax advisor for the latest information.)

The taxable portion of any QSB gain will be subject to the lesser of your ordinary-income rate or 28%, rather than the normal long-term gains rate. (See Chart 2.) Thus, if the 28% rate and the 50% exclusion apply, the effective rate on the QSB gain will be 14% ( $28\% \times 50\%$ ).

Keep in mind that all three of these tax benefits are subject to additional requirements and limits. Consult your tax and financial advisors to be sure an investment in small business stock is right for you.

### Passive activities

If you've invested in a trade or business in which you don't materially participate, remember the passive activity rules. Why? Passive activity *income* may be subject to the 3.8% NIIT, and passive activity *losses* generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, typically you must participate in a trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. (Special rules apply to real estate; see page 13.) If you don't pass this test, consider:

**Increasing your involvement.** If you can exceed 500 hours, the activity no longer will be subject to passive activity rules. If the business is structured as a limited liability company (LLC), proposed IRS regulations may make it easier for you to meet the material participation requirement. Check with your tax advisor for the latest information.

**Grouping activities.** You may be able to group certain activities together to be treated as one activity for tax purposes and exceed the 500-hour threshold. But the rules are complex, and there are potential downsides to consider.

**Disposing of the activity.** This generally allows you to deduct all passive losses — including any loss on disposition (subject to basis and capital loss limitations). But, again, the rules are complex.

**Looking at other activities.** One option is to limit your participation in another activity that's generating income, so that you don't meet the 500-hour test. Another is to invest in another income-producing trade or business that will be passive to you. Under both strategies, you'll have passive income that can absorb your passive losses.

### Income investments

Qualified dividends are taxed at the favorable long-term capital gains tax



rate rather than your higher, ordinary-income tax rate. (Qualified dividends are, however, included in investment income under the 3.8% NIIT.)

Interest income generally is taxed at ordinary-income rates, which are now as high as 39.6%. So stocks that pay qualified dividends may be more attractive tax-wise than other income investments, such as CDs, money market accounts and bonds. But there are exceptions.

Some dividends, for example, are subject to ordinary-income rates. These may include certain dividends from:

- Real estate investment trusts (REITs),
- Regulated investment companies (RICs),
- Money market mutual funds, and
- Certain foreign investments.

The tax treatment of bond income varies. For example:

- Interest on U.S. government bonds is taxable on federal returns but generally exempt on state and local returns.
- Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return, depending on the state.
- Corporate bond interest is fully taxable for federal and state purposes.
- Bonds (except U.S. savings bonds) with original issue discount (OID) build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay this interest annually — and you must pay tax on it.

Keep in mind that state and municipal bonds usually pay a lower interest rate, but their rate of return may be higher than the after-tax rate of return for a taxable investment, depending on your tax rate. To compare apples to apples, calculate the tax-equivalent yield, which incorporates tax savings into the municipal bond’s yield. The formula is simple:

$$\text{Tax-equivalent yield} = \text{actual yield} / (1 - \text{your marginal tax rate}).$$

**CHART 2 What’s the maximum capital gains tax rate?**

Assets held	2014 <sup>1</sup>
12 months or less ( <i>short term</i> )	Taxpayer’s ordinary-income tax rate
More than 12 months ( <i>long term</i> )	
• 39.6% ordinary-income tax bracket	20%
• 25%, 28%, 33% or 35% ordinary-income tax bracket	15%
• 10% or 15% ordinary-income tax bracket	0%
<b>Some key exceptions</b>	
Long-term gain on collectibles, such as artwork and antiques	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%
Gain on qualified small business (QSB) stock held more than 5 years	
• Acquired on or before Feb. 17, 2009	14% <sup>2</sup>
• Acquired after Feb. 17, 2009	7% <sup>3</sup>

<sup>1</sup> In addition, the 3.8% NIIT applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households), \$250,000 (married filing jointly) or \$125,000 (married filing separately).

<sup>2</sup> Effective rate based on 50% exclusion from a 28% rate.

<sup>3</sup> Effective rate based on 75% exclusion from a 28% rate.

**AMT ALERT! Tax-exempt interest from private-activity municipal bonds can trigger or increase AMT liability. However, any income from tax-exempt bonds issued in 2009 and 2010 (along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009) is excluded from the AMT.**

**Investment interest expense**

Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — generally is deductible for both regular tax and AMT purposes. But special rules apply.

Your investment interest deduction is limited to your net investment income, which, for the purposes of this deduction, generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other

investment expenses. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

You may elect to treat net long-term capital gains or qualified dividends as investment income in order to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.

Payments a short seller makes to the stock lender in lieu of dividends may be deductible as an investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn’t deductible.

Also keep in mind that passive interest expense — interest on debt incurred to fund passive activity expenditures — becomes part of your overall passive activity income or loss, subject to limitations. •

## How real estate can reduce your tax obligation



*To maximize the tax benefits of property ownership, homeowners, investors and real estate professionals alike need to be aware of the breaks available to them as well as the rules and limits that apply. Whether you're selling your principal residence, renting out a vacation property or maintaining a home office, tax savings are available if you plan carefully.*

### Home-related deductions

There are many tax benefits to home ownership — among them, various deductions. But the return of the itemized deduction reduction (see Case Study I on page 4) could reduce your benefit from these deductions:

**Property tax deduction.** If you're looking to accelerate or defer deductions, property tax is one expense you may be able to time. (See "Timing income and expenses" on page 2.)

**AMT ALERT! Property tax isn't deductible for AMT purposes. If you're subject to the AMT this year, a prepayment may hurt you because you'll lose the benefit of the deduction.**

**Mortgage interest deduction.** You generally can deduct (for both regular tax and AMT purposes) interest on up to a combined total of \$1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your *principal* residence also may be deductible.

**Home equity debt interest deduction.** Interest on home equity debt used for any purpose (debt limit of \$100,000) may be deductible. So consider using a home equity loan or line of credit to pay off credit cards or auto loans, for which interest isn't deductible and rates may be higher.

**AMT ALERT! If home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes and could trigger or increase AMT liability.**

### Home office deduction

If your use of a home office is for your employer's benefit and it's the only use of the space, you generally can deduct a portion of your mortgage interest, property taxes, insurance, utilities and certain other expenses, and the depreciation allocable to the space. Or you may be able to take the simpler "safe harbor" deduction. (Contact your tax advisor for details.)

For employees, home office expenses are a miscellaneous itemized deduction. This means you'll enjoy a tax benefit only if these expenses plus your other miscellaneous itemized expenses exceed 2% of your AGI. (See page 3.)

If you're self-employed, however, you can deduct qualified home office expenses from your self-employment income. The 2% floor doesn't apply.

### Home rental rules

If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

If you rent out your principal residence or second home for 15 days or more, you'll have to report the income. But you also may be entitled to deduct some or all of your rental expenses — such as utilities, repairs, insurance and depreciation. Exactly what you can deduct depends on whether the home is classified as a rental property for tax purposes (based on the amount of personal vs. rental use):

**Rental property.** You can deduct rental expenses, including losses, subject to the real estate activity rules. (See page 13.) You can't deduct any interest that's attributable to your personal use of the home, but you can take the personal portion of property tax as an itemized deduction.

**Nonrental property.** You can deduct rental expenses only to the extent of your rental income. Any excess can be carried forward to offset rental income in future years. You also can take an itemized deduction for the personal portion of both mortgage interest and property taxes. In some situations, it may be beneficial to reduce personal use of a residence so it will be classified as a rental property. (See Case Study V.)

### Home sales

When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for married filing jointly) of gain if you meet certain tests. Gain

that qualifies for exclusion will also be excluded from the 3.8% NIIT. (See page 8.) To support an accurate tax basis, maintain thorough records, including information on your original cost and subsequent improvements, reduced by any casualty losses and depreciation claimed based on business use. **Warning:** Gain that's allocable to a period of "nonqualified" use generally isn't excludable.

Losses on the sale of a principal residence aren't deductible. But if part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

Because a second home is ineligible for the gain exclusion, consider converting it to rental use before selling. It can be considered a business asset, and you may be able to defer tax on any gains through an installment sale or a Section 1031 exchange. (See below.) Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

### Real estate activity rules

Income and losses from investment real estate or rental property are passive by definition — unless you're a real estate professional. Why is this important? Passive income may be subject to the 3.8% NIIT, and passive losses are deductible only against passive income, with the excess being carried forward.

To qualify as a real estate professional, you must annually perform:

- ▶ More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- ▶ More than 750 hours of service in these businesses during the year.

Each year stands on its own, and there are other nuances to be aware of. If you're concerned you'll fail either test and be subject to the 3.8% NIIT or stuck with passive losses, consider increasing your hours so you'll meet the test. Keep in mind that special rules for spouses may help you meet the 750-hour test. **Warning:** The IRS has successfully challenged claims of

real estate professional status in instances where the taxpayer didn't keep adequate records of time spent.

### Depreciation-related breaks

Three valuable depreciation-related breaks for real estate investors expired Dec. 31, 2013, and haven't, as of this writing, been extended to 2014:

- 1. 50% bonus depreciation.** This additional first-year depreciation allowance was for qualifying leasehold improvements.
- 2. Section 179 expensing.** This was an election to deduct under Sec. 179 (rather than depreciate over a number of years) up to \$250,000 of qualified leasehold-improvement, restaurant and retail-improvement property.

**3. Accelerated depreciation.** This break allowed a shortened recovery period of 15 — rather than 39 — years for qualified leasehold-improvement, restaurant and retail-improvement property.

One or more of these breaks could be revived for 2014, perhaps retroactively to Jan. 1. Check with your tax advisor for the latest information.

### Tax-deferral strategies for investment property

It's possible to divest yourself of appreciated investment real estate but defer the tax liability. Such strategies may even help you keep your income low enough to avoid triggering the 3.8% NIIT and the 20% long-term capital gains rate. Here are a couple of deferral strategies to consider:

**Installment sale.** An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds. **Warning:** Ordinary gain from certain depreciation recapture is recognized in the year of sale, even if no cash is received.

**Sec. 1031 exchange.** Also known as a "like-kind" exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. Discuss the limits and risks with your tax advisor. ▶

#### CASE STUDY V

#### Converting a personal residence to a rental property may save taxes

Martha owns a vacation home that in 2014 she uses a few times and rents out several weeks, collecting a total of \$20,000 in rent. Her mortgage interest is \$10,000, her property taxes are \$8,000, and her other expenses related to the home are \$12,000, for a total of \$30,000 of expenses. Martha rents out another property that she doesn't use personally. It generates net income of \$10,000.

Assuming Martha's personal use of the vacation home is enough that it's considered a residence for tax purposes, her rental expense deduction would be limited to the \$20,000 in rental income. If, based on her use of the home, her expenses are 20% personal and 80% rental, she can deduct 20% of her interest and taxes, or \$3,600, as itemized deductions. Her rental expenses are \$24,000 (80% of \$30,000). She can use \$20,000 of those expenses to offset her rental income, but she can't deduct the rental loss of \$4,000 — she can only carry it forward. So, her 2014 total deductions related to the home are \$23,600.

But if Martha's personal use is low enough that the home is considered a rental property, she'll save some tax. Let's say her expenses are 10% personal and 90% rental. The rental portion of interest, taxes and other expenses is \$27,000 (90% of \$30,000), resulting in a \$7,000 loss, which, because her rental income from her other rental property is sufficient to absorb it, is fully deductible. Although she can't deduct her personal portion of interest, she *can* take her 10% personal portion of property taxes, or \$800, as an itemized deduction. Martha's total current deductions related to the home increase to \$27,800.

## Using this investment to help ensure your long-term financial security



*For many business owners, their company is the biggest investment in their portfolio. If your business makes up the bulk of your net worth, it's critical to not just run it profitably but also to use it to help ensure your long-term financial security. This includes making the most of tax-advantaged retirement plans available to business owners and planning for a tax-efficient exit that will fulfill your income needs.*

### Retirement saving

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider doing so this year. If you might be subject to the 3.8% NIIT (see page 8), this may be particularly beneficial because retirement plan contributions can reduce your MAGI and thus help you reduce or avoid the NIIT.

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 that may enable you to make substantial contributions:

**Profit-sharing plan.** This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2014 contributions (see Chart 3 for limits) as late as the due date of your 2014 income tax return, including extensions — provided your plan exists on Dec. 31, 2014.

**SEP.** A Simplified Employee Pension is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish a SEP in 2015 and still make deductible 2014 contributions (see Chart 3) as late as the due date of your 2014 income tax return, including extensions. Another benefit is that a SEP is easier to administer than a profit-sharing plan.

**Defined benefit plan.** This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum annual benefit for 2014 is generally \$210,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the 2014 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. For this reason, a business owner age 50 or older with a younger staff should consider a defined benefit plan.

You can make deductible 2014 defined benefit plan contributions until the due date of your return, provided your plan

exists on Dec. 31, 2014. **Warning:** Employer contributions generally are required and must be paid quarterly if there was a shortfall in funding for the prior year.

### Exit planning

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money from the business. This requires planning well in advance of the transition. Here are the most common exit options:

**Buy-sell agreement.** When a business has more than one owner, a buy-sell agreement can be a powerful tool. The agreement controls what happens to the business when a specified event occurs, such as an owner's retirement,

CHART 3

### Profit-sharing plan vs. SEP: How much can you contribute?

Profit-sharing plan	SEP
<b>2014 maximum contribution:</b> \$52,000 or \$57,500.	<b>2014 maximum contribution:</b> \$52,000.
<b>Eligibility:</b> You can't contribute more than 25% of your compensation generally, but you can contribute 100% up to the 401(k) limits (see Chart 5 on page 20) if the plan includes a 401(k) arrangement. To qualify for the \$57,500 limit, your plan must include a 401(k) arrangement and you must be eligible to make catch-up contributions (that is, be age 50 or older).	<b>Eligibility:</b> You can't contribute more than 25% of your eligible compensation (net of the deduction for the contribution if you're self-employed). So, to make the maximum contribution, your eligible compensation must be at least \$208,000 (\$260,000 if you're self-employed).
<b>Note:</b> Other factors may further limit your maximum contribution.	



disability or death. Among other benefits, a well-drafted agreement:

- ▮ Provides a ready market for the departing owner's shares,
- ▮ Prescribes a method for setting a price for the shares, and
- ▮ Allows business continuity by preventing disagreements caused by new, unwanted owners.

A key issue with any buy-sell agreement is providing the buyer(s) with a means of funding the purchase. Life or disability insurance often helps fulfill this need and can give rise to several tax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary's taxable income. There are exceptions, however, so be sure to consult your tax advisor.

**Succession within the family.** You can pass your business on to family members by giving them interests, selling them interests or doing some of each. Be sure to consider your income needs, the tax consequences, and how family members will feel about your choice.

Now may be a particularly good time to transfer ownership interests through gifting. If your business is worth less than it was several years ago or if you're anticipating meaningful growth, you'll be able to transfer a greater number of shares now without exceeding your \$14,000 gift tax annual exclusion amount. Valuation discounts may further reduce the taxable value. And, with the lifetime gift tax exemption at a record-high \$5.34 million for 2014, this may be a great year to give away more than just your annual exclusion amounts. (See page 22 for more on gift and estate planning.)

**Management buyout.** If family members aren't interested in or capable of taking over your business, one option is a management buyout. This can provide for a smooth transition because there may be little learning curve for the new owners. Plus, you avoid the time and expense of finding an outside buyer.



**ESOP.** If you want rank and file employees to become owners as well, an employee stock ownership plan (ESOP) may be the ticket. An ESOP is a qualified retirement plan created primarily to purchase your company's stock. Whether you're planning for liquidity, looking for a tax-favored loan or wanting to supplement an employee benefit program, an ESOP can offer many advantages.

**Sale to an outsider.** If you can find the right buyer, you may be able to sell the business at a premium. Putting your business into a sale-ready state can help you get the best price. This generally means transparent operations, assets in good working condition and a healthy balance sheet.

### Sale or acquisition

Whether you're selling your business as part of an exit strategy or acquiring another company to help grow your business, the tax consequences can have a major impact on the transaction's success or failure. Here are a few key tax considerations:

**Asset vs. stock sale.** With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. (For more on capital gains tax, see page 8.) Buyers generally want an asset sale to maximize future depreciation write-offs and avoid potential liabilities.

**Tax-deferred transfer vs. taxable sale.** A transfer of corporation ownership can be tax-deferred if made solely in exchange for stock or securities of

the recipient corporation in a qualifying reorganization. But the transaction must comply with strict rules.

Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- ▮ The parties don't have to meet the technical requirements of a tax-deferred transfer.
- ▮ The seller doesn't have to worry about the quality of buyer stock or other business risks of a tax-deferred transfer.
- ▮ The buyer enjoys a stepped-up basis in its acquisition's assets and doesn't have to deal with the seller as a continuing equity owner.

**Installment sale.** A taxable sale might be structured as an installment sale if the buyer lacks sufficient cash or pays a contingent amount based on the business's performance. An installment sale also may make sense if the seller wishes to spread the gain over a number of years — which could be especially beneficial if it would allow the seller to stay under the thresholds for triggering the 3.8% NIIT or the 20% long-term capital gains rate. But an installment sale can backfire on the seller. For example:

- ▮ Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- ▮ If tax rates increase, the overall tax could wind up being more.

Of course, tax consequences are only one of many important considerations when planning a sale or acquisition. ▮

## Take advantage of one of the most flexible tax planning tools



*Giving to charity can provide not only large tax deductions, but also the satisfaction of doing good. On top of that, it's one of the most flexible tax planning tools because you can control the timing to best meet your needs. Well-planned gifts also can save estate tax while allowing you to take care of your heirs in the manner you choose. But you must keep in mind various limits that could reduce the tax benefits of your donations.*

### Cash donations

Outright gifts of cash (which include donations made via check, credit card and payroll deduction) are the easiest. The substantiation requirements depend on the gift's value:

- ▶ Gifts under \$250 can be supported by a canceled check, credit card receipt or written communication from the charity.
- ▶ Gifts of \$250 or more must be substantiated by the charity.

Deductions for cash gifts to public charities can't exceed 50% of your adjusted gross income (AGI). The AGI limit is 30% for cash donations to nonoperating private foundations. Contributions exceeding the applicable AGI limit can be carried forward for up to five years.

**AMT ALERT!** Charitable contribution deductions are allowed for AMT purposes, but your tax savings may be less if you're subject to the AMT. For example, if you're in the 39.6% tax bracket for regular income tax purposes but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 39.6%.

### Stock donations

Publicly traded stock and other securities you've held more than one year are long-term capital gains property, which can make one of the best charitable gifts. Why? Because you can deduct the

current fair market value and avoid the capital gains tax you'd pay if you sold the property. This will be especially beneficial to taxpayers facing the 3.8% NIIT (see page 8) or the top 20% long-term capital gains rate this year.

Donations of long-term capital gains property are subject to tighter deduction limits, however — 30% of AGI for gifts to public charities, 20% for gifts to nonoperating private foundations.

Don't donate stock that's worth less than your basis. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

### Making gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private foundation. It offers you significant control over how your donations ultimately will be used. You must comply with complex rules, however, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower.

If you'd like to influence how your donations are spent but avoid a foundation's downsides, consider a donor-advised



fund (DAF). Many larger public charities and investment firms offer them.

**Warning:** To deduct your DAF contribution, you must obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

### Charitable remainder trusts

To benefit a charity while helping ensure your own financial future, consider a CRT. Here's how it works:

- ▶ For a given term, the CRT pays an amount to you annually (some of which generally is taxable).
- ▶ At the term's end, the CRT's remaining assets pass to one or more charities.
- ▶ When you fund the CRT, you receive an income tax deduction for the present value of the amount that will go to charity.
- ▶ The property is removed from your estate.

A CRT can also help diversify your portfolio if you own non-income-producing assets that would generate a large capital gain if sold. Because a CRT is tax-exempt, it can sell the property without paying tax on the gain and then invest the proceeds in a variety of stocks and bonds.

You'll owe capital gains tax when you receive CRT payments, but, because the payments are spread over time, much of the liability will be deferred. Plus, only a portion of each payment will be attributable to capital gains; some will be considered tax-free return of principal. This may help you reduce or avoid exposure to the 3.8% NIIT and the 20% top long-term capital gains rate.

You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

### Charitable lead trusts

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a CLT. It works as follows:

- ▶ For a given term, the CLT pays an amount to one or more charities.

## CHART 4 What's your donation deduction?

**Cash.** This includes not just actual cash but gifts made by check, credit card or payroll deduction. You may deduct 100%.

**Ordinary-income property.** Examples include stocks and bonds held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.

**Long-term capital gains property.** This might be stocks or bonds held more than one year. You may deduct the current fair market value.

**Tangible personal property.** Your deduction depends on the situation:

- If the property *isn't* related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis.
- If the property *is* related to the charity's tax-exempt function (such as an antique donated to a museum for its collection), you can deduct the fair market value.

**Vehicle.** Unless it's being used by the charity, you generally may deduct only the amount the charity receives when it sells the vehicle.

**Use of property.** Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.

**Services.** You may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.

**IRA funds.** If you were age 70½ or older, in 2013 you could have distributed up to \$100,000 from your IRA directly to charity. No charitable deduction was allowed for any amount that would otherwise have been taxable, but you'd save the tax you would otherwise have owed on the distribution. Such a donation could help satisfy your required minimum distribution. (See page 21.) However, this break expired Dec. 31, 2013, and, as of this writing, it hasn't been extended. Contact your tax advisor for the latest information.

**Note:** *Your annual charitable donation deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. If you receive some benefit from the charity in connection with your donation, such as services or products, your deduction must be reduced by the value of the benefit you receive. Various substantiation requirements also apply. Consult your tax advisor for additional details.*

- ▶ At the term's end, the CLT's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- ▶ When you fund the CLT, you make a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- ▶ The property is removed from your estate.

For gift tax purposes, the remainder interest is determined assuming that the trust assets will grow at the Section 7520 rate. The lower the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax — or the less of your lifetime gift tax exemption you'll have to

use up. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries gift- and estate-tax-free.

Because the Sec. 7520 rate currently is low, now may be a good time to take the chance that your actual return will outperform it. Plus, with the currently high gift tax exemption, you may be able to make a larger transfer to the trust this year without incurring gift tax liability. (For more on the gift tax, see page 22.)

You can name yourself as the remainder beneficiary or fund the CLT at your death, but the tax consequences will be different. ▶

## Investing in a child's financial future



*No matter the age of your children or grandchildren, it's never too early to teach them the benefits — including the tax benefits — of investing in their future. Children can contribute to their own retirement and college savings plans. But you likely want to take advantage of estate planning benefits associated with making gifts to them. Several strategies can enable you to do so without fully giving up control, and some may provide income tax savings for your family as well.*

### IRAs for teens

One of the best ways to get children on the right financial track is to set up IRAs for them. Their retirement may seem too far off to warrant saving now, but IRAs can be perfect for teenagers precisely because they likely will have many years to let their accounts grow tax-deferred or tax-free.

The 2014 contribution limit is the lesser of \$5,500 or 100% of earned income. A teen's traditional IRA contributions generally are deductible, but distributions will be taxed. On the other hand, Roth IRA contributions aren't deductible, but qualified distributions will be tax-free.

Choosing a Roth IRA is typically a no-brainer if a teen doesn't earn income that exceeds the standard deduction (\$6,200 for 2014 for single taxpayers), because he or she will likely gain no benefit from the ability to deduct a traditional IRA contribution. (See Case Study VI for an illustration of just how powerful Roth IRAs for teens can be. For more information on Roth IRAs, see page 20.)

If your children or grandchildren don't want to invest their hard-earned money, consider *giving* them the amount they're eligible to contribute — but keep the gift tax in mind. (See page 22.)

If they don't have earned income and you own a business, consider hiring them. As the business owner, you can

deduct their pay, and other tax benefits may apply. **Warning:** The children must be paid in line with what you'd pay non-family employees for the same work.

### 529 plans

Section 529 plans provide another valuable tax-advantaged savings opportunity. You can choose a prepaid tuition plan to secure current tuition rates or a tax-advantaged savings plan to fund college expenses. Here are some of the possible benefits of such plans:

- ▶ Although contributions aren't deductible for federal purposes, plan assets can grow tax-deferred. (Some states do offer tax incentives, in the form of either deductions or credits.)
- ▶ The plans usually offer high contribution limits, and there are no income limits for contributing.
- ▶ There's generally no beneficiary age limit for contributions or distributions.
- ▶ You remain in control of the account, even after the child is of legal age.
- ▶ You can make tax-free rollovers to another qualifying family member.

Whether a prepaid tuition plan or a savings plan is better depends on your situation and goals.

### Prepaid tuition vs. savings plan

With a 529 *prepaid tuition plan*, if your contract is for four years of tuition,

tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. One downside is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school. Another is that the plan doesn't cover costs other than tuition, such as room and board.

A 529 *college savings plan*, on the other hand, can be used to pay a student's expenses at most postsecondary educational institutions. Distributions used to pay qualified expenses (such as tuition, mandatory fees, books, equipment, supplies and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes as well.

The biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. Additionally, for funds already in the plan, you can make changes to your investment options only once during the year or when you change beneficiaries. For these reasons, some taxpayers prefer Coverdell ESAs. (See "ESAs," opposite.)

But each time you make a *new* contribution to a 529 savings plan, you can select a different option for that contribution, regardless of how many times you contribute throughout the year. And you can make a tax-free rollover to a different 529 plan for the same child every 12 months.

## Jumpstarting a 529 plan

To avoid gift taxes on 529 plan contributions, you must either limit them to \$14,000 annual exclusion gifts or use part of your lifetime gift tax exemption. A special break for 529 plans allows you to front-load five years' worth of annual exclusions and make a \$70,000 contribution (or \$140,000 if you split the gift with your spouse). That's *per beneficiary*.

If you're a grandparent, this can be a powerful estate planning strategy.

## ESAs

Coverdell Education Savings Accounts (ESAs) are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free.

One of the biggest ESA advantages is that tax-free distributions aren't limited to college expenses; they also can fund elementary and secondary school costs. Another advantage is that you have more investment options. ESAs are worth considering if you want to fund elementary or secondary education expenses or would like to have direct control over how and where your contributions are invested. But

the \$2,000 contribution limit is low, and contributions are further limited based on income. The limit begins to phase out at a modified adjusted gross income (MAGI) of \$190,000 for married filing jointly and \$95,000 for other filers. No contribution can be made when MAGI hits \$220,000 and \$110,000, respectively.

Also, amounts left in an ESA when the beneficiary turns age 30 generally must be distributed within 30 days, and any earnings may be subject to tax and a 10% penalty.

## Gifts and the "kiddie tax"

If you'd like to help your grandchildren (or other minors) fund their college education but you don't want to be subject to the limitations of a 529 plan or an ESA, you can transfer cash, stocks and bonds to a Uniform Gifts (or Transfers) to Minors Act (UGMA/UTMA) account:

- ▶ Although the transfer is irrevocable, you maintain control over the assets, but only until the age at which the UGMA/UTMA account terminates (age 18 or 21 in most states).
- ▶ The transfer qualifies for the annual gift tax exclusion. (See page 22.)

But keep in mind that UGMA/UTMA accounts are less attractive from an

income tax perspective than they used to be: The income shifting that once — when the "kiddie tax" applied only to those under age 14 — provided families with significant tax savings now offers much more limited benefits. Today, the kiddie tax applies to children under age 19 as well as to full-time students under age 24 (unless the students provide more than half of their own support from earned income).

For children subject to the kiddie tax, any unearned income beyond \$2,000 (for 2014) is taxed at their parents' marginal rate rather than their own, likely lower, rate. Keep this in mind before transferring income-generating assets to them, whether directly or via an UGMA/UTMA account.

## American Opportunity credit

When your child enters college, you may not qualify for the American Opportunity credit because your income is too high (phaseout range of \$80,000 – \$90,000; \$160,000 – \$180,000 for joint filers) but your child might. The maximum credit, per student, is \$2,500 per year for the first four years of postsecondary education. And both the credit and a tax-free ESA or 529 plan distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit.

If your dependent child claims the credit, you must forgo your dependency exemption for him or her (and the child can't take the exemption). But because of the exemption phaseout (see Case Study I on page 4), you might lose the benefit of your exemption anyway:

- ▶ If your exemption *is* fully phased out, there likely is no downside to your child taking the credit.
- ▶ If your exemption *isn't* fully phased out, compare the tax savings your child would receive from the credit with the savings you'd receive from the exemption to determine which break will provide the greater overall savings for your family.

Your tax advisor can help you run the numbers. ▶

### CASE STUDY VI

### Roth IRAs: A powerful savings tool for teens

Roth IRAs can be perfect for teenagers — just look at how much difference starting contributions early can make: Both Ethan and Hannah contribute \$5,500 per year to their Roth IRAs through age 66. But Ethan starts contributing when he gets his first job at age 16, while Hannah waits until age 23, after she's graduated from college and started her career. Ethan's additional \$38,500 of early contributions results in a nest egg at full retirement age of 67 that's nearly \$600,000 larger!

#### Total contributions made

Ethan:  \$280,500  
Hannah:  \$242,000

#### Balance at age 67

Ethan:  \$1,698,158  
Hannah:  \$1,098,669

**Note:** This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume \$5,500 is contributed at the end of each year over the ages shown and a 6% rate of return. See page 20 for more information on Roth IRAs.

## Retirement plans can minimize taxes and help maximize investment returns



*With time and tax deferral on your side, investing early and generously in a retirement account can reap rewards unavailable with other investment vehicles. Maximizing your contributions to tax-deferred retirement plans is particularly important if you're in the top (39.6%) tax bracket. But be careful not to neglect other available planning opportunities. For example, if you convert a traditional IRA to a Roth IRA, you may ultimately be able to transfer the entire IRA balance to your heirs. Also, it's important to avoid taking lump-sum distributions when leaving a job and to carefully follow rules regarding required minimum distributions.*

### Retirement plan contributions

Contributing the maximum you're allowed (see Chart 5) to an employer-sponsored defined contribution plan, such as a 401(k), is likely a smart move because:

- ▶ Contributions are typically pretax, reducing your modified adjusted gross income (MAGI), which also can help you reduce or avoid exposure to the 3.8% NIIT (see page 8),
- ▶ Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions, and
- ▶ Your employer may match some or all of your contributions pretax.

If you participate in a 401(k), 403(b) or 457 plan, it may allow you to designate some or all of your contributions as Roth contributions. While Roth contributions

don't reduce your current MAGI, qualified distributions will be tax-free. Roth contributions may be especially beneficial for higher-income earners, who are ineligible to contribute to a Roth IRA.

### Roth IRA conversions

If you have a traditional IRA, consider whether you might benefit from converting some or all of it to a Roth IRA. A conversion can allow you to turn tax-deferred future growth into tax-free growth. It also can provide estate planning advantages: Roth IRAs don't require you to take distributions during your life, so you can let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

There's no income-based limit on who can convert to a Roth IRA. But the converted amount is taxable in the year of the

conversion. Whether a conversion makes sense for you depends on factors such as:

- ▶ Your age,
- ▶ Whether the conversion would push you into a higher income tax bracket or trigger the 3.8% NIIT,
- ▶ Whether you can afford to pay the tax on the conversion,
- ▶ Your tax bracket now and expected tax bracket in retirement, and
- ▶ Whether you'll need the IRA funds in retirement.

Your tax advisor can run the numbers and help you decide if a conversion is right for you this year.

If you *don't* have a traditional IRA, consider a "back door" Roth IRA: You set up a traditional account and make a nondeductible contribution to it. You then wait until the transaction clears and convert the traditional account to a Roth account. The only tax due will be on any growth in the account between the time you made the contribution and the date of conversion.

### Early withdrawals

With a few exceptions, retirement plan distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due. This means that, if you're in the top tax bracket of 39.6%, you can lose almost half of your withdrawal to taxes and penalties — and more than half if

CHART 5

Retirement plan contribution limits for 2014

	Regular contribution	Catch-up contribution <sup>1</sup>
Traditional and Roth IRAs	\$ 5,500	\$ 1,000
401(k)s, 403(b)s, 457s and SARSEPs <sup>2</sup>	\$ 17,500	\$ 5,500
SIMPLEs	\$ 12,000	\$ 2,500

<sup>1</sup> For taxpayers age 50 or older by the end of the tax year.

<sup>2</sup> Includes Roth versions where applicable.

**Note:** Other factors may further limit your maximum contribution. But if you're a business owner or self-employed, you may be able to set up a plan that allows you to make much larger contributions. See Chart 3 on page 14.

## CASE STUDY VII

## Waiting until age 70½ to take distributions can pay off

Bill has a \$1 million traditional IRA and will be subject to required minimum distributions (RMDs) when he turns 70½ in five years. He's trying to decide whether to wait to take distributions until he's subject to RMDs or to start taking distributions now. His tax advisor runs some numbers and provides the following example:

Age at year end	Distributions begin at age 70½			Distributions begin at age 65½		
	Total distributions	Year end IRA balance	Combined total	Total distributions	Year end IRA balance	Combined total
70½	\$ 66,911	\$1,275,314	\$1,342,225	\$ 305,299	\$ 983,719	\$1,289,018
80½	\$ 692,415	\$1,498,007	\$2,190,422	\$ 789,302	\$1,159,129	\$1,948,431
90½	\$1,628,333	\$1,431,055	\$3,059,388	\$1,513,498	\$1,107,323	\$2,620,821

By waiting until age 70½, Bill would not only maintain a much larger balance, but, if he lived long enough, he'd also receive more total distributions. Even if he lived only long enough to take his first RMD, he'd still have about \$53,000 more in combined distributions received and IRA balance than if he'd started taking distributions at age 65½.

So if he can afford to leave the funds in the plan until age 70½, he may want to do so — even if it means depleting other investment accounts.

*This example is for illustrative purposes only and isn't a guarantee of future results. It assumes a 6% return on the IRA funds and annual distributions equal to the greater of Bill's RMD or 5% of the IRA balance.*

you're also subject to state income taxes and/or penalties. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you have a Roth account, you can withdraw up to your contribution amount without incurring taxes or penalties. But you'll be losing the potential tax-free growth on the withdrawn amount.

So if you're in need of cash, consider tapping your taxable investment accounts rather than dipping into your retirement plan. (See page 8 for information on the tax treatment of investments.)

### Leaving a job

When you change jobs or retire, avoid taking a lump-sum distribution from your employer's retirement plan because it generally will be taxable — and potentially subject to the 10% early-withdrawal penalty. Here are options that will help you avoid current income tax and penalties:

**Staying put.** You may be able to leave your money in your old plan. But if you'll be participating in a new employer's plan or you already have an IRA, this may not be the best option. Why? Because keeping track of multiple plans can make managing your retirement assets more difficult. Also consider how well the old plan's investment options meet your needs.

**A rollover to your new employer's plan.** This may be a good solution if you're changing jobs, because it may leave you with only one retirement plan to keep track of. But also evaluate the new plan's investment options.

**A rollover to an IRA.** If you participate in a new employer's plan, this will require keeping track of two plans. But it may be the best alternative because IRAs offer nearly unlimited investment choices.

If you choose a rollover, request a direct rollover from your old plan to your new plan or IRA. Otherwise, you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties.

**Warning:** The check you receive from your old plan may be net of 20% federal income tax withholding. If you don't roll over the gross amount (making up for the withheld amount with other funds), you'll be subject to income tax — and potentially the 10% penalty — on the difference.

### Required minimum distributions

After you reach age 70½, you must take annual required minimum distributions (RMDs) from your IRAs (except Roth IRAs) and, generally, from your defined contribution plans. If you don't comply, you can owe a penalty equal to 50% of

the amount you should have withdrawn but didn't. You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

So, should you take distributions between ages 59½ and 70½, or take more than the RMD after age 70½? Waiting to take distributions until age 70½ generally is advantageous. (See Case Study VII.) But a distribution (or larger distribution) in a year your tax bracket is low may save tax. Before making such a distribution, consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause your Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect other tax breaks with income-based limits.

**Warning:** While retirement plan distributions aren't subject to the additional 0.9% Medicare tax (see page 5) or 3.8% NIIT (see page 8), they are included in your MAGI. That means they could trigger or increase the NIIT, because the thresholds for that tax are based on MAGI.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you. ▸

## Seize opportunities while they're available



*Now that estate, gift and generation-skipping transfer (GST) tax exemptions and rates no longer are scheduled to expire, estate planning may be a little easier. Plus, because the exemptions are at record-high levels, far fewer taxpayers need to worry about being subject to these taxes. But Congress could still pass legislation at any time making estate tax law changes — and not necessarily for the better. So whether or not you'd be subject to estate taxes under the current exemptions, it's a good idea to consider whether you can seize opportunities to potentially lock in tax savings today. Those same opportunities might not be available in the future.*

### Estate tax

The estate tax rate is currently 40%, and it's scheduled to remain at that level. The estate tax exemption increased to \$5.34 million for 2014 (see Chart 6), and it will continue to be adjusted annually for inflation.

To avoid unintended consequences, review your estate plan in light of the changing exemption. A review will allow you to make the most of available exemptions and ensure your assets will be distributed according to your wishes.

### Gift tax

The gift tax continues to follow the estate tax exemption and rates. (See Chart 6.) Any gift tax exemption used during life reduces the estate tax exemption available at death.

You can exclude certain gifts of up to \$14,000 per recipient each year (\$28,000 per recipient if your spouse elects to split the gift with you or you're giving community property) without depleting any of your gift tax exemption. This is the same as the 2013 amount. (The exclusion is adjusted for inflation annually, but it increases only in \$1,000 increments, so it typically goes up only every few years.)

**Warning:** You need to use your 2014 exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For

example, if you don't make an annual exclusion gift to your granddaughter this year, you can't add \$14,000 to your 2015 exclusion to make a \$28,000 tax-free gift to her next year. (Case Study VIII shows just how powerful the annual exclusion can be.)

### GST tax

The GST tax generally applies to transfers (both during life and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax exemption and rate. (See Chart 6.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also may have — or may eventually have — large

estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

### State taxes

A federal estate tax deduction is available for state estate taxes paid. Keep in mind that some states impose estate tax at a lower threshold than the federal government does.

To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor with expertise on your particular state.

### Exemption portability

If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect

#### CASE STUDY VIII

#### Why annual exclusion gifts can be a powerful tax-saver

In 2014, Steve and Carol combine their \$14,000 annual exclusions so that their three children and their children's spouses, along with their six grandchildren, each receive \$28,000. The result is that \$336,000 is removed from the couple's estates free of taxes.

If the same amounts were transferred to the recipients upon Steve's or Carol's death instead — and no estate or GST tax exemption was available — the tax hit, at the current 40% rate, would be \$134,400 in federal estate taxes and \$67,200 in GST taxes. So the annual exclusion gifts could potentially save the family \$201,600 in taxes. If they maximize their annual exclusion gifts each year, just think about how much tax they could save!



to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. **Warning:** Portability is available only for the most recently deceased spouse. It doesn't apply to the GST tax exemption and isn't recognized by some states. And it must be elected on an estate tax return for the deceased spouse — even if no tax is due.

The portability election will provide flexibility if proper planning hasn't been done before the first spouse's death. But portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter trust does. Trusts offer other benefits as well, such as creditor protection, remarriage protection, GST tax planning and state estate tax benefits.

So married couples should still consider marital and credit shelter trusts — and transferring assets to each other to the extent necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) are tax-free under the marital deduction, assuming he or she is a U.S. citizen.

### Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

**Choose gifts wisely.** Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- ▶ To minimize *estate tax*, gift property with the greatest future appreciation potential.
- ▶ To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.
- ▶ To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

### Plan gifts to grandchildren carefully.

Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax

**CHART 6** Transfer tax exemptions and rates

Year	Estate tax exemption <sup>1</sup>	Gift tax exemption	GST tax exemption	Estate, gift and GST tax rate
2013	\$5.25 million	\$5.25 million	\$5.25 million	40%
2014	\$5.34 million	\$5.34 million	\$5.34 million	40%
Future years	Indexed for inflation	Indexed for inflation	Indexed for inflation	40%

<sup>1</sup> Less any gift tax exemption already used during life.

exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

**Gift interests in your business.** If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, in 2014 you can gift an ownership interest equal to as much as \$20,000 tax-free because the discounted value doesn't exceed the \$14,000 annual exclusion. **Warning:** The IRS may challenge the calculation; a professional, independent valuation is recommended.

**Gift FLP interests.** Another way to potentially benefit from valuation discounts is to set up a family limited partnership. You fund the FLP and then gift limited partnership interests. **Warning:** The IRS scrutinizes FLPs, so be sure to properly set up and operate yours.

**Pay tuition and medical expenses.** You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

**Make gifts to charity.** Donations to qualified charities aren't subject to gift tax and may provide an income tax deduction. (See page 16.)

### Trusts

Trusts can provide significant tax savings while preserving some control over

what happens to the transferred assets. You may want to consider these:

- ▶ A *credit shelter (or bypass) trust* helps married couples minimize estate tax and provides additional benefits.
- ▶ A *qualified terminable interest property (QTIP) trust* can benefit first a surviving spouse and then children from a prior marriage.
- ▶ A *qualified personal residence trust (QPRT)* allows you to give your home to your children today — removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.
- ▶ A *grantor-retained annuity trust (GRAT)* works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.

Finally, a GST — or “dynasty” — trust can help you leverage both your gift and GST tax exemptions, and it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate.

### Insurance

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income-tax-free to the beneficiary. And with proper planning, you can ensure proceeds are excluded from your taxable estate. ▶


**CHART 7** 2014 individual income tax rate schedules

Regular tax brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 9,075	\$ 0 – \$ 12,950	\$ 0 – \$ 18,150	\$ 0 – \$ 9,075
15%	\$ 9,076 – \$ 36,900	\$ 12,951 – \$ 49,400	\$ 18,151 – \$ 73,800	\$ 9,076 – \$ 36,900
25%	\$ 36,901 – \$ 89,350	\$ 49,401 – \$ 127,550	\$ 73,801 – \$ 148,850	\$ 36,901 – \$ 74,425
28%	\$ 89,351 – \$ 186,350	\$ 127,551 – \$ 206,600	\$ 148,851 – \$ 226,850	\$ 74,426 – \$ 113,425
33%	\$ 186,351 – \$ 405,100	\$ 206,601 – \$ 405,100	\$ 226,851 – \$ 405,100	\$ 113,426 – \$ 202,550
35%	\$ 405,101 – \$ 406,750	\$ 405,101 – \$ 432,200	\$ 405,101 – \$ 457,600	\$ 202,551 – \$ 228,800
39.6%	Over \$ 406,750	Over \$ 432,200	Over \$ 457,600	Over \$ 228,800

AMT brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	\$ 0 – \$ 182,500	\$ 0 – \$ 182,500	\$ 0 – \$ 182,500	\$ 0 – \$ 91,250
28%	Over \$ 182,500	Over \$ 182,500	Over \$ 182,500	Over \$ 91,250

AMT exemptions				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Amount	\$ 52,800	\$ 52,800	\$ 82,100	\$ 41,050
Phaseout <sup>1</sup>	\$ 117,300 – \$ 328,500	\$ 117,300 – \$ 328,500	\$ 156,500 – \$ 484,900	\$ 78,250 – \$ 242,450

<sup>1</sup> The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

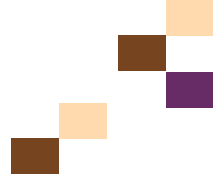
**Note:** Consult your tax advisor for AMT rates and exemptions for children subject to the “kiddie tax.”

**CHART 8** 2014 corporate income tax rate schedule

Tax rate	Tax brackets
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$ 10,000,000
35%	\$ 10,000,001 – \$ 15,000,000
38%	\$ 15,000,001 – \$ 18,333,333
35%	Over \$ 18,333,333

**Note:** Personal service corporations are taxed at a flat 35% rate.

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301.951.3636

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1675 N. Military Trl.  
Boca Raton, FL 33486  
561.994.5050

**Boston**

500 Boylston St.  
Boston, MA 02116  
617.761.0600

**Chicago**

225 W. Wacker Dr.  
Chicago, IL 60606  
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**Clearwater**

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Clearwater, FL 33756  
727.446.3058

**Cleveland**

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216.447.9000

**Columbia**

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Columbia, MD 21046  
443.656.3109

**Cumberland**

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Cumberland, MD 21502  
301.777.3490

**Denton**

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Denton, MD 21629  
410.820.5517

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Denver, CO 80237  
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**Easton**

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Easton, MD 21601  
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Fairborn, OH 45324  
937.320.1717

**Kansas City**

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913.234.1000

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Los Angeles, CA 90025  
310.268.2000

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Memphis, TN 38137  
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Miami, FL 33131  
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Minneapolis, MN 55402  
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New York, NY 10018  
212.790.5700

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Irvine, CA 92612  
949.474.2020

**Oxnard**

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Oxnard, CA 93036  
805.988.3222

**Philadelphia**

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Plymouth Meeting, PA 19462  
610.862.2249

**Phoenix**

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Phoenix, AZ 85012  
602.264.6835

**Providence**

56 Exchange Terr.  
Providence, RI 02903  
401.626.3200

**Salt Lake**

175 S. West Temple  
Salt Lake City, UT 84101  
801.364.9300

**San Diego**

10616 Scripps Summit Ct.  
San Diego, CA 92131  
858.795.2000

**St. Louis**

625 Maryville Centre Dr.  
St. Louis, MO 63141  
314.692.2249

**Tampa Bay**

1530 W. Cleveland St.  
Tampa, FL 33606  
813.594.1400

**Tampa Bay**

13577 Feather Sound Dr.  
Clearwater, FL 33762  
727.572.1400

**Topeka**

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Topeka, KS 66606  
785.272.3176

**Wichita**

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