Safe Harbor LLP
CPAs and Tax Consultants

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

March 2014

Juggling Appreciated Assets and Bequests

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

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

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

Reversing course

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

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

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

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

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

Brad, on the other hand, would be much better off inheriting the appreciated assets. Under current law, those assets would get a basis step-up to

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What's Inside

Feverish Pace

The cost of medical care increased by an average of 5.42% per year from 1948 to 2012, which was about 50% higher than the 3.63% annual increase in general inflation during that period.

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fair market value on the date of Ava's death. Brad could sell those assets for $100,000 and owe no tax.

Return to reality

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

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

Did You Know?

Baby Boomers are starting to receive an estimated $8.4 trillion in inheritances from older generations. Roughly two-thirds of Boomer households (including individuals born from 1946 to 1964) are expected to receive an inheritance. The average value of those inheritances is projected at just under $300,000 per household while the median is almost $64,000.

Source: Center for Retirement Research at Boston College

Learning About Mutual Fund Share Classes

Although some mutual funds are "no load," meaning that there is no sales charge, others are load funds, with some type of sales charge. Many load funds have multiple share classes, with various compensation arrangements. If you're buying a fund that has more than one share class, you should know which is best for your style of investing.

Upfront fee

In general, mutual fund "A" shares have a front-end load that's deducted from your initial investment.

Example 1: Wayne Vaughn invests $20,000 in Mutual Fund XYZ, which offers several share classes. This fund's A shares have a 5% sales commission, which Wayne pays immediately. Therefore, the initial charge is $1,000 (5% of $20,000), and Wayne has $19,000 of XYZ shares in his account.

Obviously, starting with a lower account value will hinder your returns. On the other hand, A shares usually have no charge when they're sold, so shareholders have more flexibility in their investment strategy. In addition, 12b-1 fees, which are ongoing charges for distribution and other services, tend to be relatively low for A shares.

In our example, Wayne intends to hold onto XYZ for many years. He is willing to pay an initial charge in order to have no further sales charges and reasonable recurring costs.

Pay later, not sooner

Investors who prefer to invest $20,000 to buy $20,000 worth of mutual funds might select B shares. These shares impose other charges, though.

- **Redemption fee.** B shares usually have a contingent deferred sales charge (CDSC), which investors pay if they sell within a certain period of time.

  Example 2: Terri Smith does not want to pay upfront fees, so she buys B shares of fund XYZ. The fund will impose a 5% CDSC if Terri sells within 1 year. Over time, the CDSC will decline gradually to 4%, 3%, etc. After 6 years, the CDSC will disappear.
- **Higher 12b-1 fees.** B shares may charge the maximum 12b-1 fee of 1% per year. In our example, Terri will pay that fee for 6 years. At that point, when the CDSC no longer applies, Terri's B shares will become A shares, with an annual 12b-1 fee of only 0.25% a year.

Short-term solution

Yet another option is to buy C shares. Not only will you have all your money working for you at the start,

Trusted Advice

Loading Up

- To figure the gain or loss on a sale of mutual fund shares held in a taxable account, you must know the cost basis of those shares.
- If there were no sales charges, the cost basis is your purchase price.
- If you paid fees or commissions at the time of purchase, they are included in your basis.
- Say you purchased 100 shares of a fund at $9.50 per share and paid an upfront sales charge of 5%, or $50 on a $1,000 outlay. The total cost would be $1,000, and the cost basis for each share would be $10.

you'll soon be free of redemption fees.

Example 3: Stan Roberts puts his money into the C shares of fund XYZ. He accepts a 1% CDSC that will disappear after one year. Stan realizes that C shares charge a maximum 1% 12b-1 fee, year after year, but he doesn't expect to hold fund XYZ for very long. Stan believes that if he sells the fund after holding for a year or two, he will have paid less in fees than he would have paid with A or B shares.

Our office can help you determine which share class of a chosen mutual fund will be best suited for your investment goals.

Estimated Taxes for Business Owners

April 1 may be April Fool's Day, but April 15 might be considered April's cruel day. Not only do you have to pay any income tax due for the previous year, you also may have to make an estimated tax payment for the current year. A poor estimate might result in either an underpayment that triggers a penalty or an overpayment that deprives you of valuable cash flow.

Paying as an individual

Many business owners will pay estimated tax on the same IRS Form 1040-ES that individuals use for estimated tax. That's the case if you run your business as an S corporation, a partnership, an LLC electing partnership taxation, or a sole proprietorship.

Business owners filing estimated taxes on Form 1040-ES must pay in four installments. The first payment is due on April 15 each year; the next payment is due only two months later, on June 15, so there may be a cash crunch. Subsequent deadlines give you more time; payments are due on September 15 and January 15 of the following year. Use IRS Form 1040-ES for these payments.

You generally have to file estimated tax on Form 1040-ES if you owe $1,000 or more in tax when you file your return for the year. Thus, estimated tax won't be a concern for businesses that will show a loss on their annual tax return.

Preventing penalties

You can avoid an underpayment penalty if all of your tax payments for the year—including withholding and tax credits—cover your ultimate tax bill, or at least go far enough that you come up short by less than $1,000. However, few business owners can accurately predict their 2014 tax obligation on April 15 or even June 15.

Thus, there are two safe harbors for those required to pay estimated tax. If you pay either (a) 90% of your current year's tax obligation, or (b) 100% of the prior year's tax, you won't owe any penalty.

Example: Pam Owens has an interior design practice, set up as a sole proprietorship. When Pam prepares her tax return for 2013, it shows a $60,000 tax obligation for the year. Pam has no overpayment to put towards her 2014 tax obligation and she does not plan to have tax withheld during the year.

If Pam were confident of owing another $60,000 in tax this year, she could pay $54,000 (90% of $60,000) in estimated tax this year: $13,500 in each of four scheduled installments. That would avoid any risk of owing a penalty.

However, Pam does not know how much business income she'll earn in 2014. If Pam's income is much greater than in 2013, and she follows that $54,000 schedule, she could underpay her estimated tax and owe a penalty.

As an alternative, Pam could make four $15,000 estimated tax payments for 2014. That would total $60,000 in estimated tax—100% of her 2013 tax bill—and exempt Pam from a penalty.

However, if Pam's adjusted gross income (AGI) in 2013 exceeded $150,000, she must pay more estimated tax under the safe harbor. Above that threshold, the safe harbor requires paying 110% of the prior year's taxable income, rather than 100%. Thus, Pam decides to pay estimated tax this year in four $16,500 installments. This will bring Pam's estimated tax total to $66,000—110% of the $60,000 in tax that she owed for 2013—so she won't owe a penalty.

Note that this example assumes that Pam expects an increase in business this year, and a larger tax obligation. If there is some reason to expect a smaller tax obligation, Pam can reduce her obligation accordingly to meet the 90% safe harbor requirement.

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Corporate calculation

The estimated tax rules for regular C corporations are similar but slightly different than those for individuals. Corporations must make installment payments on IRS Form 1120-W if the expected estimated tax for the year is $500 or more. Equal payments are due on the 15th day of the company's 4th, 6th, 9th, and 12th months of the corporation's tax year. A corporation with a tax year ending June 30, for example, would make payments by October 15, December 15, March 15, and June 15. (As is the case with individual estimated tax payments, the deadline is postponed to the next business day if the 15th is on a weekend or a legal holiday.)

The safe harbors for corporate estimated tax are both 100%. Thus, each installment should be at least 25% of the company's current year income tax or 25% of the prior year's income tax, whichever is smaller, in order to avoid an underpayment penalty.

Some businesses are seasonal, and estimated installment payments may be revised in keeping with two alternate methods. Our office can help you with seasonal estimated payments, if that's an issue with your company.

A matter of interest

Some IRS penalties are fixed, such as the 10% penalty for early withdrawals from retirement accounts. That's not the case with underpayments of estimated tax. For estimated tax infractions, the penalty is based on current interest rates, which are relatively low now. Still, the penalties can mount up, for large underpayments, and those penalties can be easily avoided by mooring in safe harbors. ■

TAX CALENDAR

MARCH 2014

March 17

Corporations. File a 2013 calendar year income tax return (Form1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2013 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), "Shareholder's Share of Income, Deductions, Credits, etc.," or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, "Election by a Small Business Corporation," to choose to be treated as an S corporation beginning with calendar year 2014. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2015.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), "Partner's Share of Income (Loss) From an Electing Large Partnership," or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

APRIL 2014

April 15

Individuals. File a 2013 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, "Application for Automatic Extension of Time To File U.S. Individual Income Tax Return." Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2014 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2014 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of $1,800 or more in 2013 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2012 or 2013 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2013 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065). "Partner's Share of Income, Deductions, Credits, etc.," or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2013 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2014.

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