Tax Impact

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Tax Tips

Required minimum distributions: Tips and strategies

If you're nearing age 70½, it's time to start planning for required minimum distributions (RMDs) from your traditional IRA or employer-sponsored retirement plan. Pay attention because, even if you don't need the funds, taking RMDs will increase your taxable income and decrease the amount of savings that continue to grow tax-free. Here are some tips and strategies for minimizing the impact of RMDs.

What are the rules?

Traditional IRAs and most non–Roth-qualified retirement plans are subject to RMD rules. Generally, you must take your first RMD in the year you reach age 70½, although you may delay the first distribution until April 1 of the following year. After that, RMDs are due by December 31 of each calendar year.

There's one exception for employer-sponsored retirement plans: If you continue to work for that employer past age 70½, you may delay RMDs until April 1 of the year following your retirement, provided:

- You continue to participate in the plan,
- The plan documents permit this option, and
- You don't own more than 5% of the company.

To calculate your RMD for a particular year, take your account balance as of December 31 of the *preceding* year and divide it by your remaining life expectancy (according to IRS tables) or, if your spouse is more than 10 years younger than you, by the longer joint and survivor life expectancy.

What if you miss the deadline?

The penalty for noncompliance is harsh: 50% of the amount by which the RMD exceeds any distributions you took during the year. For example, say you're required to take a $30,000 RMD from your traditional IRA by December 31, 2017. You withdraw $10,000 in June 2017, but make no further withdrawals the rest of the year. Your penalty is 50% of $20,000, or $10,000. However, you can generally avoid the penalty fairly easily by taking the amount that had been missed and request a penalty waiver from the IRS.

Should you delay your first RMD?

When you reach age 70½, you can delay your first RMD until

April 1 of the following year. But should you? Let's say you turn 70½ in March 2017. Your first RMD won't be due until April 1, 2018 (based on your December 31, *2016*, account balance).

Your second RMD, however, will be due by December 31, 2018, so you'll have two distributions in 2018. This will increase your taxable income in 2018 and, depending on your circumstances, could push you into a higher tax bracket or reduce the benefits of certain exemptions or deductions. If that's the case, you may be better off taking your first RMD in 2017. On the other hand, if you expect your income to decline substantially in 2018, delaying the RMD may make sense.

To determine the right strategy, weigh the tax-deferral benefits of delaying your first RMD against the potential tax costs of a double distribution.

Should you convert?

One strategy for avoiding RMDs is to convert a traditional IRA or employer-sponsored plan to a Roth IRA or plan. Roth accounts that you create aren't subject to the RMD rules (inherited accounts, however, are subject to RMD), so you can allow them to continue growing and compounding tax-free throughout your lifetime.

In addition, withdrawals are generally tax-free. The converted amount is taxable in the year of conversion. So you'll need to carefully weigh the potential future benefits of conversion against the initial tax cost. Also, keep in mind that to the extent you have basis in your traditional IRA — say, for instance, because of nondeductible contributions previously made — you'll be able to reduce the amount of the conversion that is taxable.

Are you charitably inclined?

If you plan to make substantial charitable gifts, consider using a qualified charitable distribution (QCD). This tax break, made permanent in 2015, allows taxpayers age 70½ or older to transfer up to $100,000 per year tax-free *directly* from an IRA to a qualified public charity. In addition, you can apply the transferred amount toward your RMD for the year.

A QCD may provide a tax advantage if donating other assets wouldn't be fully deductible — for example, because you don't itemize or the gift would exceed adjusted gross income limits. It may also be desirable if including an RMD in income would trigger unwanted tax consequences, such as reducing deductions or increasing taxes on Social Security benefits.

QCDs aren't available for employer-sponsored plans, but you may be able to do a rollover into an

What about inherited benefits?

The required minimum distribution (RMD) rules are a little different if you inherit an IRA or qualified plan account from someone else:

- If you inherit benefits from your spouse, you may roll them into your own IRA and delay RMDs until you reach age 70½.
- If you inherit an IRA (including a Roth IRA) from someone other than your spouse, and roll the funds into an "inherited IRA," you must begin taking RMDs by December 31 of the year following the year of the account owner's death, but you may stretch RMDs over *your* life expectancy.
- If you inherit a qualified plan account from a nonspouse, *and the plan permits rollovers into inherited IRAs*, you can stretch RMDs over your life expectancy. Otherwise, you must withdraw the funds within five years.

IRA and then make the QCD from there. Keep in mind that, to benefit from a QCD, you must make the transfer *after* you reach age 70½. It's not sufficient to make the transfer during the *year* in which you turn 70½.

Have a plan

If you're nearing retirement age, it's critical to begin planning for RMDs. Work with your tax advisor to develop a plan for dealing with, and minimizing, RMDs. ■

What estate planning strategies are available for non-U.S. citizens?

Are you, or is your spouse, a non-U.S. citizen? If so, several traditional estate planning techniques won't be available to you. However, if you're a U.S. resident, but not a citizen, the IRS treats you similarly to a U.S. citizen.

If you're considered a resident, you're subject to federal gift and estate taxes on your worldwide assets, but you also enjoy the benefits of the $5.49 million exemption and the $14,000 annual exclusion. And you can double the annual exclusion to $28,000 through gift-splitting with your spouse, so long as your spouse is a U.S. citizen or resident. Special rules apply to the marital deduction, however.

Understanding residency

Residency is a complicated subject. IRS regulations define a U.S. resident for federal estate tax purposes as someone who had his or her *domicile* in the United States at the time of death. One acquires a domicile in a place by living there, even briefly, with a present intention of making that place a permanent home.

Whether you have your domicile in the United States depends on an analysis of several factors, including the relative time you spend in the United States and abroad, the locations and

relative values of your residences and business interests, visa status, community ties, and the location of family members.

Estate tax law for nonresident aliens

If you're a nonresident alien — that is, if you're neither a U.S. citizen nor a U.S. resident — there's good news and bad news in regard to estate tax law. The good news is that you're subject to U.S. gift and estate taxes only on property that's "situated" in the United States. Also, you can take advantage of the $14,000 annual exclusion (although you can't split gifts with your spouse).

The bad news is that your estate tax exemption drops from $5.49 million to a miniscule $60,000,

so substantial U.S. property holdings can result in a big estate tax bill. Taxable property includes U.S. real estate as well as tangible personal property (such as cars, boats and artwork) located in the United States.

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Determining the location of intangible property — such as stocks, bonds, partnership interests or other equity or debt interests — is more complicated. For example, if a nonresident alien makes a gift of stock in a U.S. corporation, the gift is exempt from U.S. gift tax. But a bequest of that same stock at death is subject to estate tax. On the other hand, a gift of cash on deposit in a U.S. bank is subject to gift tax, while a bequest of the same cash would be exempt from estate tax.

Your estate planning advisor can help you determine which property is situated in the United States and explore strategies for minimizing your tax exposure. For instance, it may be possible to avoid U.S. estate taxes by setting up a foreign corporation to hold U.S. property.

Create a solid plan

Your status as either a U.S. resident or a nonresident alien will affect the estate planning strategies available to you. Your top goal should be to create an estate plan that will minimize estate tax and allow you to pass more on to your loved ones. ■

Don't overlook the domestic production activities deduction

The domestic production activities deduction (DPAD), also commonly referred to as the manufacturers' deduction or Section 199 deduction, provides a generous tax break for certain "domestic production activities." Unfortunately, many businesses overlook this valuable tax break because they believe it's only for manufacturers.

In fact, the deduction is available to a wide range of businesses, including construction companies, architects, engineers, software developers, oil and mining companies, agricultural processors, and producers of recordings and films. Now is a good time for businesses to revisit DPAD in light of temporary and proposed regulations that may affect their eligibility.

Significant benefits

Calculating the DPAD is complex, but generally it's equal to the lesser of 1) 9% (6% for "oil-related" activities) of a company's income from qualified production activities, or 2) its taxable income. In addition, the deduction can't exceed 50% of the company's W-2 wages for the year that are attributable to domestic production.

To determine a company's qualified income, start with its gross receipts from qualified domestic

production activities and subtract the cost of goods sold and certain other costs allocable to those activities.

IRS offers guidance

The temporary and proposed regulations clarify a number of issues related to the application of DPAD. Here are some of the highlights:

Contract manufacturing. Which party to a contract manufacturing arrangement is entitled to claim the DPAD? Under current rules, the answer depends on which party enjoys the benefits and bears the burdens of ownership. That, in turn, depends on several factors, including which party retains legal title to manufactured property during production, which party controls the property and the process, which party bears the risk of loss or damage, which party receives profits from the property's sale, and which party pays property taxes.

To eliminate the uncertainty associated with this analysis, the proposed regulations would establish a bright-line test under which the party that actually performs the activity would be entitled to claim the deduction.

Construction. Qualified production activities include those associated with the construction or substantial renovation of U.S. real property, including those "typically performed by a general contractor," such as management and oversight of the construction process. The proposed regulations would clarify that a contractor whose activities are limited to approving and authorizing invoices and payments is ineligible for the DPAD.

Testing and packaging. Under current rules, qualified production activities may include testing of component parts, packaging, repackaging, labeling and "minor assembly." The proposed regulations would exclude these activities if the taxpayer isn't otherwise involved in manufacturing, producing, growing or extracting the property in question.

W-2 wages. The temporary regulations provide guidance on application of the W-2 wage limitation to taxpayers with a short taxable year. Wages are calculated on a calendar-year basis and there had been some uncertainty over the treatment of wages paid during a short tax year that didn't include a calendar year end. The temporary regulations provide that wages paid to employees during such a short tax year are included for the purposes of the W-2 wage limitation.

The temporary regulations also clarify the treatment of wages when a business is acquired or disposed of during the year. If employees receive wages from two different taxpayers, those wages are allocated between the taxpayers based on the employees' respective periods of employment with each taxpayer.

DPAD revisited

If your business has claimed the DPAD in the past, or if you think it may qualify in the future, talk to your tax advisor about how the temporary and proposed regulations will affect your eligibility and the size of your deductions. ■

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Take advantage of partial asset dispositions

Often, when a business invests in improvements to a building or other property, the project also involves demolition or removal of a portion of the property. Under those circumstances, the tangible property regulations — popularly known as the "repair regulations" — allow you to make a "partial disposition election," which entitles you to take a loss on the disposed portion of the property and to deduct, rather than capitalize, the removal costs.

To enjoy these tax benefits, however, you must act quickly. To make a partial disposition election, you must claim the loss on the business's tax return *for the year in which the disposition takes place*, even if the project isn't completed until a later year. In certain limited circumstances, late elections are allowed. ■

Late rollover relief just got easier

It's possible to withdraw funds from an IRA or qualified retirement plan free of taxes and penalties, so long as you roll the funds over into another IRA or plan within 60 days. But what if you need more time? In the past, the IRS has granted extensions on a case-by-case basis to taxpayers who missed the deadline with good reason.

Now, under a new Revenue Procedure, you may obtain an extension by self-certifying (via letter to the IRA custodian or plan administrator) that you're eligible for a waiver of the deadline. To qualify, you must have missed the deadline because of one or more of the reasons listed in the Rev. Proc. They include financial institution errors, misplaced checks, deposits into an account mistakenly believed to be an eligible retirement plan, and severe damage to your principal residence. A death or serious illness in your family and postal errors are among the other reasons.

In addition, you must complete the rollover as soon as practicable after the reason for the delay is no longer an impediment. (Within 30 days is deemed to be sufficient.) ■

Watch out for charity scams

Be alert for fake charities attempting to take advantage of your generosity, particularly after a major natural disaster or mass shooting. To protect yourself, the IRS recommends that you:

- Donate to recognized charities only,
- Be wary of charities with names that are similar to those of well-known organizations (when in doubt, use the IRS's *Exempt Organizations Select Check*),
- Not give out personal financial information or Social Security numbers, and
- Donate by check or credit card; never send cash.

Also, look out for bogus websites or emails that mimic legitimate sites, use similar names, or claim to be affiliated with legitimate charities. ■

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