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Tax Tips

5 retirement account tax traps to avoid

If you're like most people, a large portion of your wealth is set aside in individual retirement accounts (IRAs) or qualified retirement plans, such as 401(k) or profit-sharing plans. These accounts offer substantial tax advantages, but they're also fraught with traps for the unwary. Here are five common mistakes to avoid:

1. Missing required minimum distributions

The penalty for failure to take a required minimum distribution (RMD) from an IRA or qualified plan is among the harshest in the tax code: a 50% "excess accumulation" tax on the amount you should have withdrawn. (See "RMDs: When and how much?" on page 3.)

Suppose you're over age 70½ and you're required to take a $50,000 RMD by December 31, 2016. If you miss the deadline, you're liable for a $25,000 penalty tax.

2. Naming your estate as beneficiary

If you designate your estate as beneficiary of an IRA or qualified plan, the RMD rules depend on when you die. If you die *before* the required beginning date for your RMDs, the entire account balance is required to be distributed no later than December 31 of the fifth year following the year that you die. In other words, for a death in 2016, the balance must be distributed no later than December 31, 2021. If you die on or after your required beginning date for taking RMDs, however, the rules are more complicated. Without going into all of the details, the RMDs for the estate (or the beneficiary/beneficiaries of the estate) will be determined by referring to IRS tables based on how old you would have been as of the end of the year in which you died.

Typically, you're permitted to stretch RMDs over your life expectancy, maximizing the benefits of tax deferral.

It's often preferable to name an individual beneficiary, such as a younger spouse or child, to avoid the confusion and to allow the beneficiary (or beneficiaries) to stretch the distributions over longer periods, maximizing tax deferral.

3. Failing to take RMDs from an inherited IRA or qualified plan

If you inherit an IRA or qualified plan account from someone other than your spouse, and you roll the funds into an "inherited IRA," you're generally required to begin taking RMDs by December 31 of the year following the year of the account owner's death. This rule applies regardless of whether you inherit a traditional or a Roth account. Failure to comply is subject to the same 50% penalty tax described above.

Typically, you're permitted to stretch RMDs over your life expectancy, maximizing the benefits of tax deferral. Qualified plans are required to allow rollovers to a nonspouse's inherited IRA, except in certain limited circumstances.

A common, but costly, mistake is to overlook the *account owner's* final distribution. If the account owner was required to take an RMD in the year of death, but died before withdrawing the full amount, you as beneficiary must withdraw any remaining amounts by the end of the year.

4. Titling an inherited IRA incorrectly

To take advantage of the tax-deferral benefits of an inherited IRA or qualified plan, it's critical that the account be retitled properly upon the account owner's death (unless you inherit from your spouse and execute a spousal rollover). Suppose, for example, that John Doe names his daughter, Jane, as beneficiary of his IRA. When John dies, the IRA must continue to be titled in John's name, using language such as "John Doe (deceased) IRA for the benefit of Jane Doe."

If you retitle an inherited account improperly — "Jane Doe IRA," for example — it's possible that the IRS may treat the transaction as a taxable distribution of the entire account balance.

5. Falling into the spousal rollover trap

If you inherit an IRA or qualified plan account from your spouse, you have an opportunity to roll over the benefits into your own IRA. The advantage of a spousal rollover rather than an inherited account is that you need not begin taking RMDs until you reach age 70½.

But watch out for a potential tax trap: If you're under age 59½, and you wish to access your spouse's retirement funds now, you'll be subject to a 10% early withdrawal penalty (unless you qualify for an exception, such as financial hardship). Under these circumstances, you're better off keeping some or all of the funds in an inherited account, from which you can withdraw penalty-free.

Look before you leap

As you approach age 70½, or if you inherit an IRA or qualified account, consult your tax advisors before taking any action. They can help you understand your options and avoid unpleasant tax surprises. ■

RMDs: When and how much?

If you own a traditional IRA or a non-Roth qualified plan account, the tax code requires you to begin taking required minimum distributions (RMDs) once you reach age 70½.

Generally, you determine the amount of your RMD by taking your account's fair market value as of the end of the preceding year and dividing it by your life expectancy (pursuant to IRS tables). For the year in which you turn 70½, you have until April 1 of the following year to take your first RMD. After that, RMDs are required by December 31 of each year.

There's an exception for 401(k) and other defined contribution plans: If you continue to work after you turn 70½, and you own less than 5% of the employer's company that sponsors the plan, you need not begin taking RMDs until April 1 of the year following the year in which you stop working.

Last, you're not required to take lifetime distributions from Roth accounts, although your nonspouse beneficiaries are required to take RMDs after your death.

Property dividends: Handle with care

Corporate shareholders sometimes receive distributions in the form of property rather than cash. And while there's nothing wrong with this practice, it's important to understand the tax implications.

Tax treatment of distributions

The tax rules surrounding corporate distributions are complicated, and a full discussion of them is beyond the scope of this article. In general, a distribution by a C corporation is treated as a dividend (and is taxable to the shareholder) to the extent of the corporation's accumulated earnings and profits (AEP), also referred to as "E&P." If a distribution is greater than the corporation's E&P, the excess is treated as a nontaxable return of capital to the extent of the shareholder's basis, and then as capital gain.

An S corporation is treated like a C corporation to the extent it has E&P — for example, if it was previously organized as a C corporation or if it acquired a C corporation's assets. Otherwise, a distribution to an S corporation shareholder is treated as a nontaxable return of capital up to his or her basis.

If a corporation distributes property other than cash to a shareholder, the amount of the distribution is the property's fair market value (FMV), less any related liabilities the shareholder assumes.

Gain property

Owners often give little thought to taking distributions of corporate property — a company car or truck, for example. But these distributions may trigger unwelcome tax consequences. Consider this example:

ABC Inc. is an S corporation with no E&P, owned equally by two shareholders, Sam and Dave. ABC gives Sam a van with an FMV of $15,000 that it purchased for $35,000. The company has depreciated the van over several years, so its adjusted basis is $5,000. Assuming Sam's basis in the company is more than $15,000, he's not subject to tax on the distribution. But ABC recognizes a $10,000 gain (the van's FMV less ABC's basis), all of which is ordinary income. Even though only Sam benefited from the distribution, the income is passed through to both shareholders ($5,000 each) and reported on their individual tax returns.

If ABC was a C corporation, the income would be reported at the corporate level (subject to potential double taxation when distributed to its shareholders). Sam would be subject to tax on the value he receives — a $15,000 dividend, to the extent of ABC's E&P. Keep in mind that, even if

the company has little or no E&P, distributing the van will *generate* E&P in the amount of the gain ABC recognizes.

Loss property

Suppose that, in addition to the van, ABC distributes a car worth $15,000 to Dave. The company paid $35,000 for the car, but its adjusted basis is $20,000. The company still recognizes a $10,000 gain on the van, but its $5,000 loss on the car is nondeductible. ABC would be better off selling the van and the car for $15,000 each and distributing the cash to Sam and Dave. The shareholders would receive the same value, but the company would be able to deduct the loss on the car, reducing its net gain to $5,000.

Do your homework

If you're considering a corporate distribution of property rather than cash, be sure to analyze the tax consequences first. There may be alternatives that can reduce your tax bill. ■

The Section 1031 exchange

Why it's such a great estate planning tool

Like many business owners, you might own highly appreciated business or investment real estate. Fortunately, there's an effective tax and estate planning strategy at your disposal: the Section 1031 "like kind" exchange. It can help you defer capital gains taxes on appreciated property indefinitely, and even eliminate them permanently.

The exchange game

Sec. 1031 allows you to exchange one or more pieces of business or investment real estate for other business or investment real estate without recognizing capital gain. Despite the term "like-kind," you can exchange an apartment complex for an office building, for example, or a farm for a strip mall. The only limitation is that the value of the new properties should be equal to or greater than the value of the existing properties. If you receive any cash or other non-real-estate property, it'll be currently taxable.

Few Sec. 1031 exchanges involve a direct exchange of one property for another. Most are structured as "deferred exchanges." In other words, you sell your property (the "relinquished" property) and then use the proceeds to acquire new property (the "replacement" property).

Safe harbors to be aware of

The key to avoiding capital gains tax in an exchange is to ensure that you never possess or control the

sale proceeds. And the best way to do that is to use one of several IRS safe harbors. With a deferred exchange, you sell the relinquished property (or properties) and engage a qualified intermediary (QI) to hold the proceeds and buy replacement property (or properties). If you identify replacement property within 45 days and complete the purchase within 180 days after the relinquished property is sold, the capital gain is deferred.

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With a reverse exchange, you engage a QI to acquire replacement property *before* you sell relinquished property. To defer capital gain, you must identify the relinquished property within 45 days and complete the sale within 180 days. To avoid holding title to relinquished and replacement properties at the same time, you must "park" replacement properties with an "exchange accommodation titleholder" until the transaction is completed.

These and other safe harbors (such as trusts and qualified escrow accounts) aren't the only way to complete a Sec. 1031 exchange. But if you do an exchange outside the safe harbors, the IRS may challenge it and treat the transaction as taxable.

Harnessing the power of estate planning

Although a Sec. 1031 exchange is best known as a tax-deferral technique, it's also a powerful estate planning tool. Ordinarily, when you sell appreciated real estate you must pay taxes on the gain at rates as high as 20%, leaving less to pass on to your children or other heirs.

If you hold onto property for life, however, the capital gains disappear. Your heirs receive a "stepped-up basis" in the property equal to its fair market value on your date of death, erasing any previous appreciation in value and allowing them to turn around and sell the property tax-free.

But what if you'd prefer to dispose of it in order to invest in income-producing real estate or to diversify your holdings? That's where a Sec. 1031 exchange comes into play. Rather than selling property, paying capital gains taxes and reinvesting what's left of the proceeds, an exchange allows you to accomplish your goals without losing any of the exchanged property's value to taxes.

Exchanging properties for TIC interests

A tactic to consider is exchanging a single property for several tenancy-in-common (TIC) interests. TIC interests are fractional, undivided interests in larger properties. Exchanging real estate for TIC interests not only defers capital gains taxes, but also gives you access to professionally managed, institutional-grade real estate. And it provides some interesting estate planning opportunities.

Suppose Jim owns a highly appreciated apartment building. He wants to divide his estate equally among his children. But he'd prefer not to leave them the building jointly, for fear it'll lead to conflict over whether to sell the building or hold onto it.

If Jim sells the building, he'll be hit with a capital gains tax bill, leaving less for his kids. Instead, he opts for a Sec. 1031 exchange, trading the building for three equally valued TIC interests in a professionally managed real estate investment. When Jim dies, his children each receive a TIC interest with a stepped-up basis and can decide independently whether to sell or hold their interests.

Work with your tax advisor

When it comes to Sec. 1031 exchanges, you have multiple ways to exchange one or more pieces of business or investment real estate. Your tax advisor can help you structure things in the best way for your estate. ■

Are your employees classified correctly?

Employers gain several benefits by treating workers as independent contractors. Among other factors, you don't need to withhold or pay income or payroll taxes, make federal unemployment contributions, pay overtime or provide employee benefits. But you must make sure workers are properly classified as independent contractors before taking advantage of these benefits.

If the IRS reclassifies an independent contractor as an employee, your company (as well as certain "responsible persons") may be liable for unpaid taxes and unemployment contributions, as well as penalties and interest. And don't share the popular misconception that employers can avoid liability so long as they file Forms 1099 and the workers pay all taxes due. Even if you're not liable for back taxes, the IRS can still hit you with a 20% penalty. Plus, the worker may sue you for unpaid benefits, overtime or other perks of employee status. ■

Donee's liability for unpaid gift tax and interest

In the event that a donor fails to pay gift tax, the Internal Revenue Code allows the IRS to collect the unpaid tax plus interest from the donee(s). In a recent case, *U.S. v. Marshall*, the U.S. Court of Appeals for the Fifth Circuit ruled that a donee's liability for unpaid gift tax and interest is capped by the amount of the gift.

In 1995, the donor in this case made gifts of more than $84 million to several donees. The IRS sought to hold the donees liable for almost $75 million beyond the value of the gifts, much of which consisted of accrued interest on the unpaid gift tax liability. The court, joining the Third and Eighth circuits, held that the donees' gift tax liability was limited to the value of the gift. The court noted, however, that the Eleventh Circuit — which has jurisdiction over cases originating in Alabama, Florida and Georgia — has reached a contrary conclusion. ■

Qualified small business stock offers tax-free capital gains

The Protecting Americans from Tax Hikes (PATH) Act of 2015 extended several expired or expiring tax incentives, among them a particularly valuable tax break for investors: the 100% exclusion for federal capital gains taxes on sales of qualified small business stock (QSBS). The exclusion, which fell to 50% at the end of 2014, has been permanently extended at 100% for all QSBS acquired after September 27, 2010, and held for more than five years.

To qualify, stock must have been issued after August 10, 1993, by a C corporation with gross assets of $50 million or less. Several other requirements apply, so be sure to consult your advisors before taking advantage of this tax break. ■

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