Tax Impact

Year-end tips for reducing NIIT

Is it time to revisit the research credit?

How incomplete nongrantor trusts can help avoid state income taxes

Tax Tips

Year-end tips for reducing NIIT

As 2016 winds down, it's time for many people to begin thinking about taxes. One tax you may want to focus on is the net investment income tax (NIIT). This tax adds 3.8% to individual income tax rates. Here are several year-end planning strategies to consider that can reduce or even eliminate the tax.

Are you subject to the tax?

The NIIT applies to high-income taxpayers, defined as those whose modified adjusted gross income (MAGI) exceeds these thresholds:

- Single: $200,000
- Married filing jointly: $250,000
- Married filing separately: $125,000
- Head of household: $200,000

For most people, their MAGI is the same as their adjusted gross income (AGI). But if you have foreign-earned income, it may be higher than your AGI.

Even if your income exceeds the threshold, the NIIT may not be a concern unless you have significant NII from taxable interest, dividends, capital gains, nonqualified annuities, rents, royalties, passive business activities, or businesses trading in financial instruments or commodities. NII does *not* include wages, self-employment income or income from businesses in which you materially participate. Also excluded are tax-exempt interest, distributions from IRAs and qualified plans, life insurance proceeds, nontaxable gain on the sale of a principal residence, alimony, unemployment compensation, and Social Security benefits.

You can reduce the NIIT by accelerating deductible investment expenses into this year.

If you're subject to the NIIT, it applies to your NII or to the amount by which your MAGI exceeds the applicable threshold, whichever is less.

What are some strategies?

There are three general approaches to easing the impact of the NIIT:

1. Reducing MAGI. This approach can reduce the amount of NII that's subject to tax or, if your income level is close to the threshold, eliminate it altogether. Strategies include:

- Maximizing contributions to IRAs or qualified retirement plans,
- Deferring income to next year,
- Accelerating deductible expenses into this year,
- Postponing the sale of capital assets (also reduces NII), and
- Harvesting capital losses (by selling underperforming securities) to offset capital gains already recognized this year (also reduces NII).

Reducing your trust's tax bill

Nongrantor trusts are subject to the net investment income tax (NIIT) to the extent their *undistributed* adjusted gross income (AGI) exceeds $12,400 (for 2016). Given the low-income threshold, it's difficult to avoid the NIIT by reducing a trust's AGI. But the trustee can reduce or eliminate NIIT by distributing the trust's income to its beneficiaries (provided the trust document authorizes the trustee to do so).

Keep in mind that distributing the trust's income may defeat the trust's purpose if one of your objectives is to restrict or delay the beneficiaries' access to the funds. If so, your estate planning goals may outweigh your interest in saving taxes.

If a trust holds passive business interests, you may be able to reduce or avoid the NIIT by increasing the trustee's level of involvement. As with individual investors, trusts can avoid net investment income by materially participating in an activity.

Finally, if you're selling a business interest or other investment property before the end of the year, consider an installment sale to avoid recognizing the entire capital gain this year. This will reduce NII.

2. Reducing NII. Strategies to reduce your NII include harvesting losses, postponing capital gains and using installment sales, all of which also reduce MAGI.

If you plan to sell a significant capital asset this year, consider gifting it to a family member in a lower tax bracket who can sell it without triggering the NIIT. This also reduces MAGI.

Finally, review your participation in passive activities. It may be possible to raise your level of involvement in an activity to "material participation" by increasing the time you spend on it between now and the end of the year. Under those circumstances, the activity will no longer be passive and won't be subject to the NIIT.

3. Accelerating investment expenses. Remember, the tax applies to *net* investment income. You can reduce the NIIT (and MAGI) by accelerating deductible investment expenses into this year. For example, you might prepay property taxes on investment property, prepay state and local income taxes on investment income or prepay deductible investment interest expenses.

What about trusts?

For trusts, the NIIT kicks in at much lower income levels. In 2016, for example, the tax applies to trusts whose *undistributed* AGI exceeds $12,400. (See "Reducing your trust's tax bill" above.)

Be aware that the NIIT applies to only *nongrantor* trusts. Income earned by grantor trusts passes through to the grantor.

Looking ahead

As you plan for future years, consider investment strategies that will minimize NIIT. Investments that allow you to avoid or defer NIIT include tax-exempt municipal bonds, tax-deferred annuities, permanent life insurance and nondividend-paying stocks.

As you evaluate tax-saving strategies, don't lose sight of your overall financial picture. Reducing taxes is a legitimate goal, but not if it means sacrificing investment returns or hindering your retirement or estate planning goals. Turn to your tax advisor for guidance on which strategies may be appropriate for your situation. ■

Is it time to revisit the research credit?

If your business hasn't been claiming the research credit (often referred to as the "research and development," "R&D" or "research and experimentation" credit), now may be a good time to revisit this valuable tax break. Last year's Protecting Americans from Tax Hikes (PATH) Act made the credit permanent after 34 years of being temporary, including numerous extensions, and expanded the credit's benefits to certain start-ups and other small businesses that were unable to take advantage of it in past years.

A quick overview

The research credit is complex, but in a nutshell it allows businesses to claim a nonrefundable credit equal to 20% of the amount by which their qualified research expenditures (QREs) exceed a base period amount. You can carry back unused credits one year and forward up to 20 years. Be aware that the research has to be conducted within the United States (including Puerto Rico and U.S. possessions).

To determine the base period amount, calculate your ratio of QREs to gross receipts from 1984 to 1988 and apply it to your average gross receipts for the previous four tax years. (The base period amount cannot be less than 50% of your current-year QREs, however.) There are alternative methods of calculating the credit for companies that didn't exist from 1984 to 1988, lacked sufficient QREs or gross receipts during that period, or otherwise have trouble qualifying for the traditional research credit. These include an alternative incremental credit (AIC) and a simplified credit. Whichever method you use, the net cash benefit of research credits typically is 6.5% of QREs.

Many companies overlook the research credit because they think it's limited to companies that conduct laboratory research, such as biotech,

pharmaceutical or high-tech firms. But the credit is available to any company that invests in developing new or improved products or processes, including retail and consumer product companies and even service providers. To qualify, research activities must:

- Strive to discover information that's technological in nature,
- Relate to a new or improved "business component," such as a product, process, computer software, technique, formula or invention,
- Be designed to eliminate uncertainty concerning the development or improvement of a business component, and
- Be part of a "process of experimentation."

Generally, QREs include supplies, W-2 wages for employees conducting research, and 65% of consultants' fees.

The PATH Act allows businesses with average gross receipts of $50 million or less during the previous three years to claim the credit against AMT.

New benefits for smaller businesses

Before the PATH Act, it was challenging for smaller companies to take advantage of research credits, even if they conducted a significant amount of qualified research activities. One obstacle, particularly for partnerships and S corporations, was the alternative minimum tax (AMT), which often restricted or even eliminated the owners' ability to use the research credit. The PATH Act solves this problem by allowing businesses with average gross receipts of $50 million or less during the previous three years to claim the credit against the AMT, beginning this year.

Historically, start-up businesses (companies in operation for less than five years with less than $5 million in gross receipts) haven't been able to take advantage of research credits because they have little or no tax liability. To allow start-ups to enjoy the benefits of the credit without having to wait until they start generating taxable income, the PATH Act permits them to claim the credit against up to $250,000 in employer-paid FICA taxes.

Get the credit you deserve

R&D benefits many businesses and should benefit the company doing it. If your company commits resources to developing new or improved products or processes, it pays to consult your tax advisor to see if you qualify for research credits. ■

How incomplete nongrantor trusts can help avoid state income taxes

With the federal gift and estate tax exemption at $5.45 million for 2016, traditional estate planning may not be helpful for many people. Instead, those whose estates are below the exemption amount are shifting their focus to income tax reduction. High-income taxpayers — particularly those who live in high-income-tax states — may want to consider incomplete nongrantor trusts, which make it possible to reduce or even eliminate state taxes on trust income.

Defining an incomplete nongrantor trust

Generally, trusts are classified either as grantor trusts or nongrantor trusts. In a grantor trust, the "grantor" establishes the trust and retains certain powers over the trust. The grantor is treated as the trust's owner for income tax purposes and continues to pay taxes on income generated by the trust assets.

In a nongrantor trust, the grantor relinquishes certain controls over the trust so that he or she isn't considered the owner for income tax purposes.

Instead, the trust becomes a separate legal entity, with income tax responsibility shifting to the trust itself. By setting up the trust in a no-income-tax state (typically by having it administered by a trust company located in that state), it's possible to avoid state income taxes. The grantor is entitled to receive distributions from the trust, usually at a distribution committee's discretion.

Ordinarily, you make a taxable gift to the trust beneficiaries when you contribute assets to a nongrantor trust. To avoid triggering gift taxes, or using your gift and estate tax exemption, structure the trust as an *incomplete* nongrantor trust. In other words, relinquish just enough control to ensure nongrantor status, while retaining enough control so that transfers to the trust aren't considered completed gifts for gift-tax purposes.

In addition to the positives discussed in this article, incomplete nongrantor trusts offer asset protection against creditors' claims. However, one important caveat: If your home state imposes its income tax on out-of-state trusts based on the *grantor's* state of residence, this strategy won't work.

Using an example

Suppose you live in a state that imposes an 8% income tax and you have a $4 million investment portfolio that earns an 8% annual return, or $320,000 per year, made up of 50% growth, which isn't currently subject to tax, and 50% currently taxable income. By using the incomplete nongrantor trust strategy described above, you can save $12,800 in taxes (8% of $320,000 × 50%) for the first year, assuming your state doesn't extend its income tax to out-of-state trusts established by state residents. Presuming similar results, in subsequent years your savings would be compounded.

Assume, for instance, that you reinvest your tax savings in order to grow your portfolio more quickly. Over a 20-year period, an incomplete nongrantor trust would produce a total benefit (state income tax savings plus earnings on reinvested tax savings) of nearly $1.1 million.

Analyzing the benefits

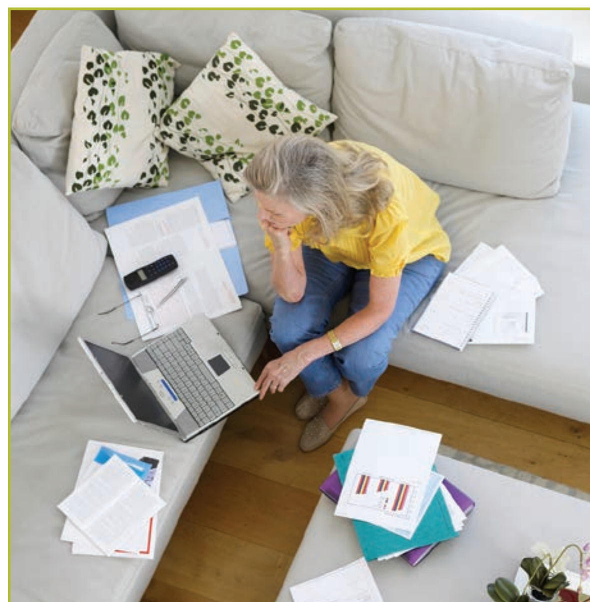
Remember, assets you place in the trust should produce income that the grantor doesn't need. If the grantor takes money out, trust taxable income could follow to the grantor and be taxed in the grantor's state of residence.

Incomplete nongrantor trusts aren't right for everyone. It depends on your particular circumstances and the tax laws in your home state. For example, they've been established in favorable tax jurisdictions, such as Delaware, Florida and Nevada.

While this strategy can produce significant state income tax savings, it may increase federal estate and income taxes. Why? Because incomplete gifts remain in your estate for federal estate tax purposes. And nongrantor trusts pay federal income taxes at the highest marginal rate (currently, 39.6%) once income reaches $12,400 (for 2016).

Is it right for you?

To determine whether an incomplete nongrantor trust is right for you, weigh the potential state income tax savings against the potential federal estate and income tax costs. Ask your advisor to conduct a cost-benefit analysis to find out. ■



Tax Tips

Proposed valuation regulations may have a big impact on estate planning

Earlier this year, the IRS and Treasury Department released proposed regulations regarding valuation discounts commonly used for gift and estate tax purposes. The proposed rules are complex, but the bottom line is that most valuation discounts for transfers of minority interests in family limited partnerships and other family-controlled entities will no longer be available 30 days after final regulations are published.

Talk to your advisors about how the proposed regulations will affect your estate planning strategies. ■

High-income taxpayers can benefit from the AMT sweet spot

The alternative minimum tax (AMT) is a parallel tax system with its own set of tax rates, deductions, credits and exemptions. Each year, you must calculate both your AMT liability and your regular tax liability and pay the higher one. If you find yourself in the AMT system, and your income is high enough, you may be able to take advantage of the AMT "sweet spot."

The sweet spot is an income range, beginning in the neighborhood of $500,000 for a married couple filing jointly, in which the effective marginal AMT rate drops to 28%. It stays at that level for several hundred thousand dollars until the regular income tax kicks in again at a 39.6% rate. If your income falls in the sweet spot, and you expect your marginal rate to be higher in coming years, consider accelerating some income into this year — by doing a Roth IRA conversion, for example — to take advantage of the lower marginal rate. ■

Want to reduce 401(k) plan costs? Consider a safe harbor plan

A safe harbor 401(k) plan allows your business to avoid costly nondiscrimination testing and maximize benefits for highly compensated employees (HCEs). Traditional plans must comply with complex nondiscrimination rules that prevent them from favoring HCEs. If you violate these rules, you may have to increase contributions on behalf of non-HCEs or return a portion of HCEs' salary deferrals to them.

With a safe harbor plan, you avoid the nondiscrimination rules in exchange for making mandatory 100% vested contributions on behalf of non-HCEs. There are two options for making these contributions:

1. Nonelective contributions equal to 3% of compensation for all eligible employees, regardless of whether they make elective salary deferrals, or
2. Matching contributions equal to 100% of an employee's first 3% of compensation deferred and 50% of the next 2% deferred.

Without the constraints of the nondiscrimination rules, you're free to maximize salary deferrals and contributions on behalf of HCEs. ■

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