Tax Impact

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You can't take it with you

Making the most of tax carryovers

For many tax losses, deductions and credits, there are limits on how much you can claim in a given year. Often, unused tax attributes — including passive activity losses, capital losses, charitable deductions and net operating losses — can be carried forward to future tax years. But what happens to these carryovers when someone dies? In some cases, they can be used on the deceased's final income tax return. Otherwise, they're lost forever.

Here's a look at the tax treatment of certain carryovers and some of the planning opportunities available.

Passive activity losses

Generally, losses from passive activities — such as rental real estate activities or businesses in which you don't materially participate — can be deducted only from income from other passive activities. They can't be used to reduce nonpassive income, such as wages, portfolio income and income from businesses in which you materially participate. Unused losses may be carried forward to future years until they're used or the activity is sold or otherwise disposed of in a taxable transaction.

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When a person with suspended passive losses dies, the losses may be claimed on the deceased's final income tax return. But the deduction is limited to the amount by which a loss exceeds the step-up in basis of the related asset. Generally, for income tax purposes, the basis of an appreciated asset is stepped up to its fair market value as of the date of death.

For example, let's say Brian owns a rental property with a fair market value of $1.5 million, an adjusted basis of $1.25 million and suspended passive losses totaling $300,000. When Brian dies, the deduction for those losses on his final income tax return is limited to $50,000 — $300,000 minus the $250,000 step-up in basis.

Whose carryover is it anyway?

For married couples, it's important to determine the spouse to which carryovers are attributable. Typically, carryovers are deductible only by the spouse who incurred the loss and expire when that spouse dies. But in some cases, carryovers are attributable to both spouses. For example, if spouses own capital assets jointly and sell them at a loss, then when one spouse dies half of any carryovers attributable to those assets should be allocated to the surviving spouse, who can continue carrying them forward.

Similarly, if a couple jointly owns a passive activity or operates a business together, then arguably half of any passive activity loss or net operating loss carryovers should be allocated to the surviving spouse. IRS regulations provide a formula for allocating unused charitable carryovers between the spouses.

To avoid losing these deductions, one option is to sell the passive activity during your lifetime — a taxable disposition — and use all of the suspended losses. Another option is to gift the activity to your children or other loved ones. The suspended losses can't be used, but they're added to the recipient's basis in the property, reducing his or her gain when the property is sold. However, if the property's value declines, the suspended losses can't be used to increase the recipient's loss.

Capital losses

In any given year, you may use capital losses to offset capital gains. And if capital losses exceed capital gains, you can use the net loss to offset up to $3,000 of ordinary income. Unused losses may be carried forward indefinitely to offset capital gains, plus $3,000 of ordinary income, in future years. When you die, any unused capital loss carryovers expire — they can't be used by your estate or transferred to your surviving spouse.

To avoid losing valuable tax deductions, it's a good idea to track capital loss carryovers as you get older. There may be opportunities to sell appreciated assets, generating capital gains that can be used to absorb accumulated capital losses. In addition, between the date of death and the end of the calendar year, a surviving spouse can generate capital gain income to offset the deceased spouse's capital loss carryovers on the couple's final joint tax return.

Charitable deductions

The deduction for charitable donations is limited to a certain percentage of adjusted gross income (ranging from 20% to 50%, depending on the type of charity and property). Excess donations may be carried forward for up to five years. Charitable carryovers expire at death, but tax planning may allow a surviving spouse to boost the couple's income and increase the amount of the carryovers that can be deducted on their final tax return. Any remaining carryovers are allocated between the spouses using a formula prescribed in IRS regulations.

Net operating losses

Sole proprietors and owners of pass-through entities can use net operating losses (NOLs) to offset other income. Excess NOLs may generally be carried back up to two years and carried forward up to 20 years to offset income in those years. When the business owner dies, unused NOLs expire and can't be used by a surviving spouse or the estate. There may, however, be an opportunity for a surviving spouse to generate additional income in the year of death to absorb these losses.

Use them or lose them

Older taxpayers with significant carryovers should discuss potential tax-saving strategies with their tax advisor. With a little planning, you can ensure that these valuable tax benefits don't die with you. ■

Does a Roth IRA fit into your retirement plan?

A Roth IRA can offer both income and estate tax benefits. However, it's important to weigh the benefits of each IRA type. Even though converting to a Roth IRA may present a golden opportunity for many taxpayers, it's not right for everyone.

What are the differences between a traditional vs. a Roth IRA?

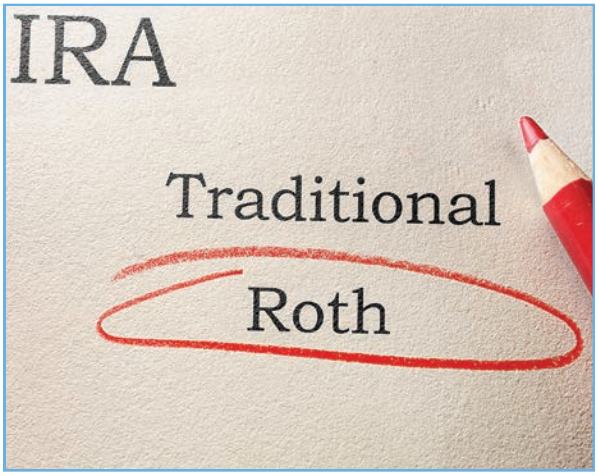
The biggest difference between traditional and Roth IRAs is how taxes affect contributions and distributions. Contributions to traditional IRAs generally are made with pretax dollars, reducing your current taxable income and lowering your tax bill now. You pay taxes on the funds when you make withdrawals.

As a result, if your current tax bracket is higher than what you expect it will be after you retire, a traditional IRA can be advantageous.

In contrast, contributions to Roth IRAs are made with after-tax funds. You pay taxes on the funds now, and your withdrawals won't be taxed (provided you meet certain requirements).

This can be advantageous if you expect to be in a higher tax bracket in retirement or that tax rates will increase.

Roth distributions differ from traditional IRA distributions in yet another way. Withdrawals aren't counted when calculating the taxable portion of the Social Security benefits you receive in retirement.



Any additional Roth advantages?

A Roth IRA may offer a greater opportunity to build up tax-advantaged funds. Your contributions can continue after you reach age 70½ as long as you're earning income, and the entire balance can remain in the account until your death. In contrast, beginning with the year you reach age 70½, you can't contribute to a traditional IRA — even if you do have earned income. Further, you must start taking required minimum distributions (RMDs) from a traditional IRA no later than the April 1 after you reach age 70½.

Avoiding RMDs can be a valuable benefit if you don't need your IRA funds to live on during retirement. Your Roth IRA can continue to grow tax-free over your lifetime. When your heirs inherit the account, they'll be required to take distributions — but spread out over their own lifetimes, allowing a continued opportunity for tax-free growth on assets remaining in the account. Further, the distributions they receive from the Roth IRA won't be subject to income tax.

What are the Roth IRA contribution limits?

The amount you can contribute to a Roth IRA is subject to the same annual limits that apply to traditional IRAs — for 2017, \$5,500 (\$6,500 if you're age 50 or older) — and is reduced by the amount you contribute to a traditional IRA in the same year. Also, as with a traditional IRA, you can't make Roth IRA contributions in excess of your earned income for the year.

The IRS further limits your Roth IRA contributions if your income tops a certain level. For 2017, a taxpayer can contribute the full amount allowed if his or her modified adjusted gross income (MAGI) doesn't exceed \$186,000 (married filing jointly) or \$118,000 (single or head of household). No contributions are allowed when a taxpayer's MAGI hits \$196,000 or \$133,000, respectively.

Keep all options open

As you begin planning for retirement (or reviewing your current plans), it's important to consider all retirement planning vehicles. A Roth IRA is one of them, but consult with your tax advisor to determine whether it's a logical choice. ■

Independent contractor vs. employee

Worker classification matters

Many employers mistakenly believe that the misclassification of employees as independent contractors doesn't really matter, so long as contractors satisfy all of their tax obligations. This couldn't be further from the truth. Improper classification of workers comes at a high cost, and both federal and state authorities have been cracking down on the practice in recent years.

Advantages of independent contractor status

It's no surprise why employers prefer to treat workers as independent contractors. If a worker is legitimately treated as a contractor, the employer avoids a variety of financial obligations associated with employees, including withholding federal income taxes, paying the employer's share of FICA taxes (and withholding the employee's share), and paying federal unemployment taxes (FUTA).

The employer may also avoid obligations under state law, including withholding state income taxes, paying state unemployment taxes, paying or withholding state disability insurance contributions, and furnishing workers' compensation insurance. (However, some states may require employers to provide workers' comp to contractors or pay unemployment tax on amounts paid to contractors in certain situations.) In addition, contractors aren't entitled to employee benefits, minimum wages, overtime and other rights enjoyed by employees.

Why it matters

There's a common misconception that the IRS and state tax authorities don't care about worker classification so long as they're receiving all the taxes they're owed. After all, independent contractors are responsible for the taxes that otherwise would be paid by the employer. But the government does care, for several reasons:

- Employers are less likely to default on their tax obligations.
- It's much easier to collect taxes from a single employer than from many independent contractors.
- Even if all taxes are collected, the government also wants to maximize unemployment contributions.

- The U.S. Department of Labor, state labor departments and other employment security agencies have an interest in expanding the class of workers entitled to employee benefits, wage-and-hour protections, and workers' comp coverage.

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The consequences of misclassification can be harsh. If the IRS determines that contractors should have been classified as employees, it may require the employer to pay back taxes (including the employees' share of unpaid payroll and income taxes), plus penalties and interest. And if the employer lacks the resources to pay these liabilities, the IRS can collect from "responsible persons," including certain executives, partners or managers. And keep in mind that federal and state tax authorities can impose penalties on employers who misclassify workers even if all their contractors satisfy their tax obligations.

How to protect yourself

If your business uses independent contractors, conduct an assessment to determine whether they constitute employees under federal and state law. In making this determination, the IRS examines a variety of factors that reflect the level of behavioral and financial control you have over a worker, as well as the nature of your relationship.

For example, workers are more likely to be considered contractors if they control how and when the work is done, cover their own expenses, invest in their own facilities and tools, make their services available to the relevant market, and can realize profits or incur losses. The IRS also considers the parties' written agreements, any benefits provided to the worker and the permanency of the relationship.

Be proactive

Given the steep price of misclassification, be proactive when it comes to employee vs. contractor status. If you're concerned about potential liability, discuss options with your tax advisor and consider participating in voluntary classification settlement programs. These programs allow you to resolve these issues with the IRS or other government agencies at the lowest possible cost. ■

Charitable deductions: Review written acknowledgments carefully

To substantiate a charitable deduction, you must obtain a "contemporaneous written acknowledgment" from the charity that states, among other things, the amount of cash (or a description of property other than cash) contributed and whether you received any goods or services in exchange for your gift.

Ensuring that the acknowledgment contains the required information is critical. In a recent U.S. Tax Court case, the donor of a historic preservation easement lost a $64.5 million charitable deduction because the acknowledgment letter from the charitable trust that received the easement failed to state whether the trust provided the donor with any goods or services in consideration for the easement. Although the charity later included the required information in an amended Form 990 filed with the IRS, the court found that this didn't satisfy the tax code's requirements. ■

Mortgage interest deduction is good news for unmarried co-owners

Recently, the IRS acquiesced in a decision by the Ninth U.S. Circuit Court of Appeals ruling that the tax code's mortgage interest deduction limits apply on a per-individual basis rather than a per-property basis. Taxpayers are permitted to deduct interest on up to $1 million in home-acquisition debt and up to $100,000 of home-equity debt.

In a case involving unmarried co-owners of a residence, the U.S. Tax Court ruled that the deduction limits applied to their combined indebtedness. The Ninth Circuit disagreed, holding that the limits apply on a per-*taxpayer* basis. In other words, while individuals and joint filers can deduct interest on up to $1.1 million in indebtedness, unmarried co-owners can deduct interest on up to $2.2 million in indebtedness.

By acquiescing in the decision, the IRS has acknowledged that it will follow the Ninth Circuit's ruling nationwide. ■

Accelerate retirement savings with a cash balance plan

Business owners who have fallen behind on their retirement contributions should consider establishing a cash balance plan. These plans combine features of both defined contribution plans (such as 401(k) plans) and defined benefit plans (such as pension plans).

Cash balance plans are defined benefit plans, but they allocate annual credits to hypothetical accounts, giving them the "look and feel" of a 401(k) plan and making it easier for employees to get a handle on their future benefit payouts. However, as defined benefit plans, cash balance plans are subject to limits on payouts to employees in retirement rather than contribution limits.

Contributions may be as high as necessary to fund an employee's retirement benefits. The closer an employee is to retirement, the larger the contribution must be to generate the promised benefit. This enables the business to make substantially higher contributions (as much as three to four times the defined contribution limit) on behalf of older owner-employees, who have fewer years until retirement. ■