Tax Impact

"Small" is bigger than ever
Is your business eligible for expanded tax benefits?

5 tax-planning tips for retirees

Keep future options open with powers of appointment

Tax Tips

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"Small" is bigger than ever

Is your business eligible for expanded tax benefits?

Small businesses enjoy several tax advantages that may allow them to reduce their tax bills, defer taxes and simplify the reporting process. Until recently, federal tax rules generally defined "small business" as one with average annual gross receipts of $5 million or less ($1 million or $10 million in some cases) for the three preceding tax years. But the Tax Cuts and Jobs Act (TCJA) increased the threshold to $25 million for tax years beginning after 2017.

The new threshold expands eligibility for small business tax benefits to a greater number of companies. It also simplifies tax compliance by establishing a uniform definition of "small business." Previously, different thresholds applied depending on the tax accounting rule involved, as well as a company's industry and whether it carried inventories.

Small business benefits

Potential benefits of small business status include:

Cash accounting. Businesses that pass the gross receipts test are eligible to use the cash method of accounting for tax purposes. Typically, but not always, the cash method allows a business to defer more taxable income than the accrual method. (Note: As before, companies that are structured as S corporations, LLCs or partnerships without a C corporation partner — and don't carry inventories — may use the cash method regardless of their level of gross receipts.)

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Avoidance of inventory accounting requirements. Small businesses need not account for inventories, which can be complex, time-consuming and expensive.

Relief from uniform capitalization rules. Small businesses are exempt from these rules, which require companies to capitalize rather than expense certain overhead costs, adding complexity to the tax reporting process and potentially increasing their tax liability.

Eligibility for completed contract method. Small businesses are permitted to use the completed contract method, rather than the percentage-of-completion method, to account for long-term contracts expected to be completed within two years, allowing them to defer tax until a contract is substantially complete.

Full deductibility of business interest. The TCJA generally capped deductions for net business interest expense at 30% of adjusted taxable income. Small businesses are exempt from this limit.

Should you restructure your business?

If your company is ineligible for small business benefits — for example, because related entities push its gross receipts over the threshold or because it's considered a tax shelter — there may be opportunities to restructure your business to qualify.

For example, suppose that three partners each own 30% interests in partnerships A and B, each of which has gross receipts of $15 million. Because A and B are a brother-sister group (the same three people collectively own at least 80% of each partnership), their gross receipts must be combined, so neither qualifies as a small business. If the three partners each transfer 5% of their interests in partnership A to an unrelated fourth partner, they'll own only 75% of partnership A. The brother-sister group will no longer exist, and both partnerships will be eligible for small business benefits.

Tax shelters may be able to avoid that classification by changing the way losses are allocated to inactive owners or by having those owners increase their level of activity.

Related entities' receipts included

When determining your company's gross receipts, you must include not only your own receipts, but also those earned by certain related entities, such as other members of a parent-subsidiary group, a brother-sister group or combined group under common control. A parent-subsidiary group exists when one company owns more than 50% of one or more other companies. For example, if your company owns 51% of another company — or another company owns 51% of yours — you must combine that company's gross receipts with your own when determining whether your gross receipts are below the $25 million threshold.

Your company is part of a brother-sister group if the same five or fewer persons collectively own at least 80% of each company and certain other requirements are met. For example, if the same three partners each own 30% interests in partnerships A and B, the two entities' gross receipts must be combined in evaluating their small business status. A combined group exists when a parent is part of a parent-subsidiary group *and* a brother-sister group. In that case, both groups' gross receipts are combined.

Be aware that, when calculating a person's ownership percentage, you must include interests owned by certain family members.

Tax shelters need not apply

There's an important exception to the general definition of small business: If your company is deemed a "tax shelter," it won't qualify for small business benefits, even if its gross receipts are below the $25 million threshold. Usually thought of as tax-advantaged investment vehicles, tax shelters may also include companies structured as partnerships, S corporations or LLCs that allocate more than 35% of their losses to limited partners or other "limited entrepreneurs."

See the small picture

If your company's average gross receipts are $25 million or less, consult your tax advisor to find out whether you're eligible for small business tax benefits. If you are, determine whether it would be worth your while to change your accounting methods to take advantage of these benefits. If you're not, there may be planning opportunities to qualify for these benefits in the future. (See "Should you restructure your business?" above.) ■

5 tax-planning tips for retirees

There's a common misconception that, when you retire, your tax bills shrink, your tax returns become simpler and tax planning is a thing of the past. That may be true for some, but many people find that the combination of Social Security, pensions and withdrawals from retirement savings *increases* their income in retirement and may even push them into a higher tax bracket.

If you're retired or approaching retirement, consider these five tax-planning tips:

1. Take inventory. Estimate how much money you'll need in retirement for living expenses and inventory your income sources. These sources may include taxable assets, such as mutual funds and brokerage accounts; tax-deferred assets, such as IRAs, 401(k) plan accounts and pensions; and nontaxable assets, such as Roth IRAs, Roth 401(k) plans or tax-exempt municipal bonds. Social Security benefits may be nontaxable or partially taxable, depending on your other sources of income.

Develop a plan for drawing retirement income in a tax-efficient manner, being sure to keep state income tax, if applicable, in mind. For example, you might minimize current taxes by tapping nontaxable assets first, followed by assets that generate capital gains, and putting off withdrawals from tax-deferred accounts as long as possible.

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On the other hand, if you're approaching age 70½ and will have substantial required minimum distributions (RMDs) from tax-deferred accounts when you reach that age, it may make sense to withdraw some of those funds earlier. For example, you might withdraw as much as you can from IRA or 401(k) accounts each year without exceeding the lower tax brackets. That way, you keep current taxes on those funds at a reasonable level while reducing the size of your accounts and, in turn, the size of your RMDs down the road. You can obtain additional funds from nontaxable or capital gains assets, if needed.

2. Consider the timing of Social Security benefits. You can begin receiving Social Security benefits as early as age 62 or as late as age 70. The later you start, the larger the benefit amount — so, if you don't need the money right away, putting it off may be a good investment. Also, benefits are reduced if you start them before you reach full retirement age and continue to work.

Keep in mind that, if your income from other sources exceeds certain thresholds,

your Social Security benefits will become partially taxable. For example, married couples filing jointly with combined income over $44,000 are taxed on up to 85% of their Social Security benefits. (Combined income is adjusted gross income plus nontaxable interest plus half of Social Security benefits.)

3. Reduce RMDs. You're required to begin RMDs from tax-deferred retirement accounts once you reach age 70½, though you're able to defer your first distribution until April 1 of the year following the year you reach age 70½. RMDs generally are taxed as ordinary income and you must take them regardless of whether you need the money. One strategy for reducing the amount of RMDs, at least if you're charitably inclined, is to make a qualified charitable distribution (QCD). If you're 70½ or older, a QCD allows you to distribute up to $100,000 tax-free *directly* from an IRA to a qualified charity and to apply that amount toward your RMDs. The funds aren't included in your income, so you avoid tax on the entire amount, regardless of whether you itemize, and the income limits on charitable deductions don't apply. Any amount excluded from your income by virtue of the QCD is similarly excluded from being treated as a charitable deduction.

4. Pay estimated taxes. Your retirement income sources may or may not withhold income taxes. To avoid tax surprises and penalties, estimate whether your withholdings will be sufficient to pay your tax liability for the year and make quarterly estimated tax payments to cover any expected shortfall.

5. Track your medical expenses. Currently, medical expenses are deductible only if you itemize and only to the extent they exceed 10% of your adjusted gross income. If you have significant medical expenses, track them carefully, and consider bunching elective expenses into the same year, to maximize potential deductions.

If you're nearing retirement age and have questions on how your tax situation may change, contact your tax advisor. ■

Keep future options open with powers of appointment

The amount of flexibility you build into your estate plan will go a long way toward how successful, ultimately, it is at carrying out your wishes after you're gone. Using powers of appointment is one way to achieve that flexibility.

Power of appointment — defined

A power of appointment is simply a provision in your estate plan that permits another person — a beneficiary, family member or trusted advisor, for example — to determine how, when and to whom certain assets in your estate or trust will be distributed. The person who receives a power of appointment is called the "holder."

These powers come in several forms. A testamentary power of appointment allows the holder to direct the distribution of assets at death through his or her will or trust. An inter vivos power of appointment allows the holder to determine the disposition of assets during his or her lifetime.

2 types of power

Powers may be general or limited. A general power of appointment allows the holder to

distribute assets to anyone, including him- or herself. A limited power has one or more restrictions. In most cases, limited powers don't allow holders to distribute assets for their own benefit (unless distributions are strictly based on "ascertainable standards" related to the holder's health, education or support).

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Typically, limited powers authorize the holder to distribute assets among a specific class of people. For example, you might give your daughter a limited power of appointment to distribute assets among her children.

The distinction between general and limited powers has significant tax implications. Assets subject to a general power are included in the holder's taxable estate, even if the holder doesn't execute the power. Limited powers generally don't expose the holder to gift or estate tax liability.

Availability of options

Powers of appointment provide flexibility, and enhance the chances that you'll achieve your estate planning goals, by allowing you to postpone the determination of how your wealth will be distributed until the holder has all the relevant facts.

For example, suppose your plan establishes a dynasty trust designed to benefit multiple generations, decades or even centuries into the future. Currently, the most you can contribute to such a trust without triggering the generation-skipping transfer (GST) tax is $11.58 million. But if Congress repeals the GST tax in the future, the holder of a power of appointment could funnel far more wealth into your dynasty trust.

Get creative

With a little creativity, you can design powers of appointment to address a variety of estate planning issues. The powers can allow your family to make critical adjustments to your plan to reflect changing circumstances. Talk to your estate planning advisor for additional details. ■

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Virtual currency: Handle with care

Recently, the IRS has been sending letters to taxpayers it believes owns virtual currency, such as Bitcoin, urging them to review past tax returns and, in some cases, affirm their accuracy under penalty of perjury. This puts taxpayers in a difficult position, because there are several unresolved issues regarding taxation of virtual currencies that the IRS has yet to address. As of this writing, the only IRS guidance is a five-year-old notice clarifying that virtual currency is "property" for federal tax purposes and, therefore, may generate capital gains taxes when exchanged for other property. If you own virtual currency, consult your tax advisor to ensure that you're properly reporting it and to review your prior-year tax returns, amending them if appropriate. ■

Watch out for gross receipts taxes

Recently, an increasing number of cash-strapped states have enacted, or are considering, gross receipts taxes. As the name suggests, these taxes apply to gross receipts rather than net income. Typically, they're imposed at a lower rate, with fewer deductions and exclusions. And unlike sales taxes, which apply only to the purchase of a product by the end consumer, gross receipts taxes apply at every stage of the production process. Proponents believe these taxes offer states a more stable source of tax revenues, while critics argue that they lead to higher prices, lower wages and fewer jobs. If you do business in states that have or are contemplating a gross receipts tax, talk to your tax advisor about potential strategies for mitigating their impact. ■

The HSA: An overlooked estate planning tool

A Health Savings Account (HSA) coupled with a high-deductible health plan can be a powerful tool for funding medical expenses on a tax-advantaged basis. For 2020, individuals with self-only coverage can make up to $3,550 in tax-deductible contributions to an HSA, while those with family coverage can contribute up to $7,100. These limits are increased by $1,000 for individuals 55 or older. Funds may be withdrawn tax-free to pay qualified medical expenses. Once you reach age 65, you can withdraw funds penalty-free for *any* purpose (subject to tax if not used for qualified medical expenses).

From an estate planning perspective, HSAs have an advantage over traditional IRAs and 401(k) plans: They're not subject to required minimum distributions at age 70½. That means that, to the extent you don't use the account for medical expenses, it can continue growing on a tax-deferred basis indefinitely, providing valuable benefits for your loved ones. If your spouse inherits the account, it will be treated as his or her own HSA. If someone else inherits it, the HSA will terminate and the recipient will be taxed on its value. ■

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