volume 26, number 3

assets
a business, tax, and financial newsletter

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Most people are aware that annuities, purchased from insurance companies for retirement purposes, provide the annuitant with a steady stream of income, often for the remainder of his or her life. But it is less well known that a certain type of annuity, the private annuity, can also serve as an estate planning tool. When structured properly, a private annuity arrangement supplies the annuitant with a stable retirement income, keeps assets within the family, and minimizes the tax burden for heirs.

Keeping Assets within the Family

A private annuity contract is typically drawn up between an older family member who wishes to remove a sizable asset from his or her estate, such as real estate or a family business, and a younger family member who would otherwise inherit the asset. Under the terms of a private annuity contract, the obligor agrees to pay the annuitant a certain sum of money at set intervals, usually for the duration of the annuitant's lifetime, in exchange for receiving the property. For the contract to be considered private, rather than commercial, the annuity obligor may not be an insurance company or other firm in the business of selling annuity contracts.

Transfers of property, whether directly to family members or to a trust, are generally subject to gift tax. While the gift tax exclusion is relatively generous over a lifetime, limits on the amounts that may be transferred to individuals annually make avoiding gift tax complicated, especially for larger estates. The purchase of a private annuity avoids gift tax because it is considered a sale of property for tax purposes. Conflicts with the IRS over gift tax liability can be generally averted when the agreement is structured properly and the assets transferred are appraised at fair market value. The annuitant must also be prepared to relinquish control over the assets sold, including any voting rights in a business or trust.

The private annuity is set up when the obligor receives property from the annuitant. The annuitant is entitled to receive the

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entire asset sales price and accrued interest based on IRS life expectancy and interest rate tables. The arrangement may stipulate that the payment period will extend over the lifetime of a surviving spouse as well.

When the annuitant dies, the remaining principal is kept by the obligor, who pays no estate taxes. In this respect, the private annuity differs from commercial annuities issued by insurance companies. When the holder of a commercial annuity dies, any death benefits or payments to heirs may be included in the annuitant's estate for tax purposes.

Tax Planning Issues

The private annuity arrangement does not, however, avoid taxation altogether. The annuitant is liable to pay capital gains taxes on the appreciated value of the asset sold, but on a deferred basis. If, for example, the property used to buy the private annuity was originally purchased for $300,000 and had appreciated in value to $1 million at the time the annuity was arranged, the annuitant would not owe any capital gains taxes immediately; instead, taxes on the $700,000 gain would come due over time. A portion of each payment would consist of the original cost basis and, therefore, would be tax free. However, the portion of the payment considered the capital gains from the sale would be taxed as capital gains. The portion of each payment received in excess of cost basis and capital gain would be treated as interest taxable as ordinary income.

From the perspective of the heirs, an obvious drawback of the private annuity is that the annuitant could live longer than expected, resulting in no estate tax savings. If the annuitant reinvests the income from the annuity rather than spending it, other estate tax obligations may arise. A further consideration is the financial stability of the obligor: He or she should have the resources to continue to make payments if the annuitant were to outlive the value of the original investment.

Because private annuities are, by definition, unsecured, the annuitant should not enter into the arrangement if he or she lacks other sources of income. Problems could arise for the annuitant if the obligor is unable to make the payments, or if the obligor dies before the annuitant and the obligor's heirs have difficulties taking on the annuity obligations.

Even in cases in which the arrangement works as intended, tension may exist between the obligor and other family members who believe they should have received a portion of the assets tied up in the private annuity. Because of the limitations of this approach, individuals crafting their estate planning strategies should consider a range of options before entering into a private annuity agreement. For specific guidance, consult your qualified tax and legal professionals.

It's a Matter of Time—Do You Know Your IRA Basis?

With the rising popularity of **Individual Retirement Accounts (IRAs)**, many people may have been making yearly contributions without giving much thought to exactly what will happen from a *tax standpoint* when they start taking money out of their traditional IRAs. This lack of concern is understandable, since many IRA contributors may be years away from retirement, and *contributions,* not withdrawals, are a primary focus.

When you begin taking distributions from a traditional IRA, a variety of tax issues arise. In general, your distributions will be included in your gross income. Withdrawals made before the age of 59½ will be subject to a 10% penalty, in addition to ordinary income tax. This process is relatively straightforward for those who have made only deductible contributions to their IRAs, but taxation is more complex for those who have made nondeductible contributions.

If all of your contributions to a traditional IRA were deductible, then you have no **basis** in your IRA, and your distributions are fully taxable. Basis represents the after-tax balance in your account. If you made nondeductible contributions to your IRA, the amount of your contributions equals your basis,

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and this money is not subject to tax upon distribution.

Prior to 1987, all wage earners could make a deductible contribution of up to $2,000 annually. But, the Tax Reform Act of 1986 (TRA '86) limits deductible contributions for employees who are active participants in qualified employer-sponsored retirement plans with **adjusted gross incomes (AGIs)**—subject to certain modifications—exceeding specified amounts based on filing status ($50,000–$60,000 for single filers, $75,000–$85,000 for joint filers in 2006).

While some people were aware that a nondeductible contribution was permitted without regard to active participation in a pension plan, many people who made such nondeductible contributions failed to account for them by filing Form 8606 with their annual tax returns. Form 8606 properly tracks nondeductible IRA contributions in both *current* and *prior* tax years, and it is the only official record of after-tax contributions (i.e., IRA basis).

Without having filed Form 8606 for years in which nondeductible contributions were made, a taxpayer will be exposed to double taxation of contributions when withdrawals are made. From the IRS's point of view, without the proper historical record, no distinction is made between contributions made with *before*- and *after*-tax dollars, and all withdrawals are subject to taxation. (By the way, there is a $50 penalty for failing to file Form 8606 for any year in which nondeductible contributions were made.)

Second, and perhaps just as concerning, is the matter of state taxation of IRA withdrawals. Many states do not permit deductions of IRA contributions and, consequently, *do* provide for a tax-free "return of basis." This means that contributions are not taxed when withdrawn, but that part of the IRA account, consisting of accrued interest and dividends, is then taxed as received. However, this "return of basis" works only if the individual has kept accurate records and knows the value of his or her IRA basis.

One way to determine your total deductible and nondeductible contributions is to examine your tax returns over the entire period of IRA funding. If your record-keeping has been less than ideal, account trustees (insurance companies, banks, mutual fund companies, brokerage firms) may be able to help you reconstruct your total contributions over the years. However, be advised that such trustees usually have no record of whether your contributions were deductible or nondeductible.

Consequently, if you find yourself in "IRA limbo" with respect to your IRA basis, you may want to enlist the help of a qualified tax professional. Going forward, it is important to keep careful records of your contributions, file the appropriate forms, and consult your tax professional. It would be a shame to have a "tax mishap" at the time of withdrawal undo some of the yearly benefits you've enjoyed from tax-deferred savings.

Is It Time to Incorporate?

In the minds of many people, a corporation is a big company whose shares are traded on Wall Street. But a business does not have to be large or public to become a "C" corporation. While you may have started your business as a sole proprietorship or partnership, your firm could benefit from adopting a more complex business structure as it seeks to expand or take on more employees. While a highly regulated business form, the corporation nonetheless offers certain tax and legal advantages that could make it a suitable structure for many growing businesses.

The C corporation is a for-profit, state incorporated business that is considered by law to be a unique entity separate from the individuals

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who own and run it. A corporation is created when shareholders file articles of incorporation with a secretary of state's office. If a corporation conducts business outside the state in which it was organized, the company may be required by other states to register as a "foreign" corporation.

The organizational structure of a corporation involves three main groups: shareholders, directors, and officers. A corporation is owned by the shareholders, who are usually not directly involved in running the company unless they also serve as officers or directors. Instead, most shareholders influence corporate decisions by electing and removing directors, voting on amendments to the articles of incorporation, and approving or disapproving other major changes. The corporation's officers, who manage the company's day-to-day operations, are appointed by the board of directors. In most corporations, the board has a supervisory role, intervening only in major business decisions.

Corporations, like individuals, are entitled by law to enter into contracts, loan and borrow money, own assets, sue and be sued, hire employees, and pay taxes—all without having to directly involve the shareholders. Corporations offer shareholders liability protection: While shareholders participate in profits in the form of stock appreciation and dividends, their personal assets are shielded from debt liability and lawsuits against the company.

C corporations pay corporate taxes, and the shareholders pay tax on the income they receive as dividends. This double taxation can be a disadvantage, particularly for owners who are not in a position to reinvest a significant portion of profits back into their business. On the other hand, corporate federal income tax rates, which start at 15%, may be lower than the shareholders' personal income tax rates. Owners who can afford to do so may leave a

portion of earnings in the company for future investment or to reduce their own income tax liability. The amount of corporate tax owed may, in any case, be relatively low after the cost of paying salaries and benefits is deducted.

Of all the business forms, C corporations have the greatest flexibility in raising money through equity financing. There are no restrictions on C corporation shareholder numbers, and owners are not required to be U.S. residents. C corporations may even be owned by other business entities.

Unlike sole proprietorships and partnerships, which often end upon the death or retirement of the owners, C corporations can last in perpetuity. Ownership in a corporation is easily transferable: When shareholders die or sell their interests, the corporation can continue to exist and do business.

The C corporation is not the appropriate structure for every business. While the independent status of the corporation offers many advantages, there are also some potential drawbacks to choosing this structure. C corporation shareholders cannot, for tax purposes, offset the company's losses against their personal income. As profits grow, the company will be faced with corporate tax rates as high as 39%. Because of the organizational complexity and regulatory burdens associated with this structure, the corporation is more expensive to establish and maintain than other business forms.

Each business structure has its advantages and disadvantages. Your choice will affect the taxes you pay and your personal liability risk, so it is important to choose the right entity for your business. For specific guidance, consult your tax professional.

The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

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