STORIES [1]

Most of us have heard stories about things done wrong and most of us say that a particular story wouldn't happen to them. Every story happened because the person made a conscious decision to either not ask their accountant or to ignore what the accountant advised.

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[1] Some of the examples indicate a New Jersey Estate Tax savings, which was the law at the time of the planning. The New Jersey Estate Tax was repealed a/o 2018.

HOW TO MAKE A TAX-FREE TRANSACTION TAXABLE

The following true story is one that almost everyone can relate to, to some degree. Everyone involved knew me. One adult child was married to a business client, so it wasn't like they didn't have frequent contact with me. Just some numbers were changed to make it easier to follow.

FACTS

Father and Mother owned a house with a basis (cost) of $100,000. In 2001, Father died when the house was worth $200,000. Mother sold the house in 2011 for $260,000, for a gain of $160,000.

Just before Father died, Father and Mother went to see an attorney to transfer the house to the children to make it easier.

WHAT THEY SHOULD HAVE DONE

Nothing.

At his death, his 50% of the house would have been inherited by Mother, and her basis would have been $150,000. The gain on the sale of the house of $110,000 would have been *tax-free*.

WHAT THEY DID

They transferred the deed to the house to their children before he died. Mother continued to live in the house, and upon sale, her children gave her the proceeds from the sale, $260,000. Each child received a 1099-S for the house sale for 50% of the of $260,000.

WHAT THIS MEANT

1. The basis to the children was the basis to the parents, $100,000, and the sale at $260,000 resulted in a taxable gain of $160,000.
2. Gifting the house to the children in 2001 required a gift tax return to be filed by the parents.
3. Gifting the cash to the mother in 2011 required a gift tax return to be filed by each child.
4. The portion of the gift in excess of the annual exclusion reduced the amount of the lifetime exemption available for both Federal and State.
5. The amount of real estate taxes paid and mortgage interest (if there was a mortgage) paid by Mother after the gift and prior to sale is not deductible by anyone because Mother did not own the house and the amount was not paid by the children.
6. Mother (and Father while alive) did not comply with the law and potentially are at risk for tax, penalties, interest.[2]

THEN WHAT HAPPENED?

The first I knew about this was when I saw the 1099-S. When I indicated there would be a tax cost, Mother said she would make her children whole.

The accountant for the other child calculated the 2011 tax both with and without the capital gain, said the Mother owed that child $2,000.

Makes sense, right? Wrong!

[2] I was not their accountant and have no idea about their taxes.

There are 2 areas of impact:

- Income tax effect: On the gain of $80,000 each, there is a Federal capital gain tax ($16,000) and a New Jersey regular tax ($5,000), total **$21,000**.

- Estate tax effect: A future impact on the child's Federal Estate Tax ($32,000), and New Jersey Estate Tax ($12,000), total **$44,000**. Plus the cost to prepare the gift tax returns.

The total is $65,000.[3 & 4]

So what should have been tax-free cost $65,000 each child. Plus the amount of tax not legally deducting the real estate taxes and mortgage interest from gift to sale to the mother.

So the family, instead of paying zero tax, has a tax liability of $130,000.[5]

THE POINT

Simple. Discuss with your accountant before you do. The cost to do so is insubstantial compared to the cost of doing wrong. And in this case, this would have been a 10-minute phone call.

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[3] $33,000 if you assume that the Federal estate tax would be zero, due to high lifetime exemption and portability.

[4] That's a big difference from the $2,000 from the other child.
I did not do the other child's tax return, but I suspect that the capital gain was offset by the child's other capital losses, losses which would not be available in subsequent years to offset subsequent years' capital gains.

[5] $66,000 if you assume that the Federal estate tax would be zero, due to high lifetime exemption and portability.

FIXING BAD ADVICE

When Husband age 88 died, he had joint bank accounts with Wife, age 87, an automobile, and other assets. Everyone knew that youngest daughter was to get the car. And wife did not want the bank accounts, she wanted it to go to her daughters.

But the will said everything to the wife and an unknowledgeable attorney told her she could take the joint accounts.[6]

By the time they came to me, it was too late to effect a Disclaimer. So I had her make a gift to the daughter for the car, and to both daughters for the cash, and gift tax returns were filed. Everyone happy.

PLANNING TO GET RESULTS [7]

Husband was dying and wanted to be sure his wife and family were properly set up. He had a typical I-LOVE-YOU will, no investment plan, and no formal business agreement with his partner.

What we did:

- I put them in touch with a knowledgeable attorney and an investment advisor.
- A written business agreement was done.
- The will was redone.

The effect:

- The business agreement avoided any misunderstandings between wife and partner.
- The revised will is expected to save the family over $100,000 in estate taxes.
- The investment advisor created and is managing a portfolio that is expected to perform better than when he did it himself, with greater diversification, and less risk. The portfolio was created to stay within the wife's comfort level and to be in investments which she could understand.

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[6] Legally she could. But doing so did not accomplish what she wanted. A knowledgeable attorney would have known that.

[7] This item involved an attorney.

PLANNING TO SAVE ESTATE TAXES [8]

Client owned whole life insurance in his name with a death benefit of $2,700,000 and cash value of $1,300,000.

What we did:

- We had him set up an Intentionally Defective Grantor Trust and transfer the policies to the Trust.

The effect:

- The death benefit was removed from his estate.
- The client did not give up anything he could have done with the policies, except for changing the beneficiaries.[9]
- The Federal savings in 2017 is over $200,000,[10] which is a 100% wipe-out of the tax.[11]
- More for the family without giving up what he needed.

PLANNING TO SAVE INCOME TAXES [12]

Client owned real property worth $150,000 which was depreciated to zero basis. A sale of the property would have all of the proceeds taxable, a combined Federal and State tax of $38,000, which would have netted him $112,000.

What we did:

- He gifted the property to his mother, and a deed was filed.
- Mother then gifted the property back the next day while retaining a Life Estate.
  The deed specified the Life Estate.

The effect:

- This meant that as long as she survived 3 years from the date of the gift, the property would be included in her estate and would pass to him with a step-up basis.
- When the mother died, the property was worth $170,000. The sale resulted in a taxable gain of zero, and the taxes saved were $43,000, so he netted $170,000.

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[8] This item involved an attorney.

[9] Most trusts would not permit the client to get any cash, but in this type of trust he can.

[10] See the TAX PLANNING CAVEAT at the end.

[11] There was also a New Jersey savings of $320,000 in 2017 which was a 63% New Jersey tax reduction. With the repeal of the New Jersey Estate Tax in 2018, the New Jersey savings was eliminated. If he moved to another state, depending on that state's estate tax law, there could be additional savings.

[12] This item involved an attorney.

PLANNING FOR POSSIBLE INCOME TAX SAVINGS

The Passive Activity Loss (PAL) rules are complicated, but basically say that if you have a passive activity investment that generates a loss, that loss is deductible (1) only against other passive activity income or (2) if you totally disposed of the passive activity investment; and any losses not deducted can be carried forward to the future.

But what if you have a passive activity investment that invested in other passive activity investments, and one of those sub-investments was disposed of for a loss?

Generally, since you did not dispose of your passive activity investment, that loss and the cumulative suspended PAL would continue to be limited.

What we did:

- We are reporting each sub-investment on the Client's tax return separately, so that each sub-investment stands on its own.

The effect:

- When any sub-investment is disposed of, the PAL on that sub-investment would no longer be limited.
- Now this extra step may turn out to not be necessary, but if it is, the Client's taxes will be reduced in the year of disposition.

IRA PLANNING

Someone will always have taxable income when money is withdrawn from an IRA. Either you during your life or by you beneficiaries after you die.

A client had a substantial IRA and a substantial Net Operating Loss (NOL) carryforward.

What we did:

- In the year he turned 59½, we had him liquidate his IRA. The IRA is picked up as income and the NOL offset that income, with the effect of no Federal taxes.
- The next year, when his wife turned 59½, we did the same for her IRA.

The effect:

- The funds never left him, and the IRAs will never be taxed.
- The chances of a part of the NOL not being used during his life have been reduced.[13]

IRA AND YOUR WILL

There is a way to integrate the IRA and will, so that you can get the tax deduction and specific beneficiaries can get the tax.

Most people who make specific bequests do so in their will, and leave their retirement accounts to spouse and children, which burdens the spouse and children with the income tax.

Instead, remove bequests from the will and make them designated beneficiaries in your IRA or retirement plan; specify amount or percentage. This way, they still get, but they have the income tax, not your spouse or children. It is probable that the designated beneficiary will be in a low tax bracket. They can even choose when to withdraw from their IRA, which could even be when their tax bracket is zero.

The effect:

- You got the deduction.
- You kept the asset until death.
- The spouse or children are not burdened with the tax.
- Designated beneficiary forms are easily changed (unlike a will).
- Designated beneficiaries cannot be challenged (unlike a will).

[13] In many states, state taxes will be saved too, but not in New Jersey. The New Jersey tax paid was a price to pay to save bigger Federal taxes. And New Jersey does not have NOL carryforwards.

NEW TAX LAW

The new tax law, while generally beneficial, did limit or eliminate certain deductions. The news generally only mentions the SALT deduction. For most people, the loss of this deduction was offset by a higher standard deduction and lower rate.

One big item rarely mention was deducting investment expenses. Investment expenses can be incurred directly or as a passthrough item from a partnership. At the partnership level, the total expense and the related tax can be substantial.

In one case I recommended that the investment agreements be modified to change the accounting methodology. The net dollar effect to the partners was unchanged, but the taxation was, and the estimated tax savings is estimated to exceed $2 million per year.

TAX PLANNING CAVEAT

All planning is based on assumptions, which may or may not occur. Tax planning is too.

The assumptions used are the law at the time the planning is done, as well as the anticipation that the law will not be changed prior to the event occurrence.

For example, a lot of planning was based the New Jersey Estate Tax law, which was probably one of the most onerous in the nation, and this law, without expectation, was suddenly repealed in 2018, because of a train crash.[14]

Another example is income tax planning based on the state where you live, and then you move to another state. Move from New Jersey to Pennsylvania, from Oregon to Washington, from New York to Florida, and the state income taxes are reduced.

For an idea about how planning is dealing with a moving target, consider the abovementioned Planning to Save Estate Taxes. The 2017 Federal Estate tax savings is $200,000. If the Estate Exemption was higher, the savings would be reduced. If the total assets increased, savings would increase.

And the New Jersey Estate Tax savings of $320,000 in 2017 became a zero savings in 2018 since the New Jersey Estate Tax is repealed.

No matter how difficult it is to quantify the savings in the future, even with moving parts, and with politics, the use of tax planning devices is beneficial.

[14] It took the 2016 Hoboken train crash to prompt both sides of the New Jersey state government to reach a compromise on a new tax bill. The State Transportation Trust Fund had literally run out of money, and since the republicans and democrats could not agree on a plan to replenish the fund, the Governor suspended all transportation infrastructure spending. But just days after the crash, the parties reached an agreement. Politics.