Spring & Co.
CERTIFIED PUBLIC ACCOUNTANTS

# Tax & Business Alert

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## TAKE NOTE OF THE DISTINCTIVE FEATURES OF ROTH IRAs

For some people, Roth IRAs can offer income and estate tax benefits that are preferable to those offered by traditional IRAs. However, it's important to take note of just what the distinctive features of a Roth IRA are before making the choice.

### TRADITIONAL VS. ROTH

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 current tax bill. 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 if tax rates increase.

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

### ADDITIONAL 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 April 1 of the year following the year 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.

### TCJA ELIMINATED OPTION TO RECHARACTERIZE ROTHS

The passage of the Tax Cuts and Jobs Act late last year had a marked impact on Roth IRAs: to wit, taxpayers who wish to convert a pretax traditional IRA into a posttax Roth IRA can no longer "recharacterize" (that is, reverse) the conversion for 2018 and later years.

The IRS recently clarified in FAQs on its website that, if you converted a traditional IRA into a Roth account in 2017, you *can* still reverse the conversion as long as it's done by October 15, 2018. (This deadline applies regardless of whether you extend the deadline for filing your 2017 federal income tax return to October 15.)

Also, recharacterization is still an option for other types of contributions. For example, you can still make a contribution to a Roth IRA and subsequently recharacterize it as a contribution to a traditional IRA (before the applicable deadline).

### MANY VEHICLES

As you begin planning for retirement (or reviewing your current plans), it's important to consider all retirement planning vehicles. A Roth IRA may or may not be one of them. Please contact our firm for individualized help in determining whether it's a beneficial choice. ■

## ASSESSING YOUR EXPOSURE TO THE ESTATE TAX AND GIFT TAX

When Congress was debating tax law reform last year, there was talk of repealing the federal estate and gift taxes. As it turned out, rumors of their demise were highly exaggerated. Both still exist and every taxpayer with a high degree of wealth shouldn't let either take their heirs by surprise.

### EXCLUSIONS AND EXEMPTIONS

For 2018, the lifetime gift and estate tax exemption is $11.18 million per taxpayer. (The exemption is annually indexed for inflation.) If your estate doesn't exceed your available exemption at your death, no federal estate tax will be due.

Any gift tax exemption you use during life does reduce the amount of estate tax exemption available at your death. But not every gift you make will use up part of your lifetime exemption. For example:

- Gifts to your U.S. citizen spouse are tax-free under the marital deduction, as are transfers at death (bequests).
- Gifts and bequests to qualified charities aren't subject to gift and estate taxes.
- Payments of another person's health care or tuition expenses aren't subject to gift tax if paid directly to the provider.
- Each year you can make gifts up to the annual exclusion amount ($15,000 per recipient for 2018) tax-free without using up any of your lifetime exemption.

It's important to be aware of these exceptions as you pass along wealth to your loved ones.

### A SIMPLE PROJECTION

Here's a simplified way to help project your estate tax exposure. Take the value of your estate, net of any debts. Also subtract any assets that will pass to charity on your death.

Then, if you're married and your spouse is a U.S. citizen, subtract any assets you'll pass to him or her. (But keep in mind that there could be estate tax exposure on your surviving spouse's death, depending on the size of his or her estate.) The net number represents your taxable estate.

You can then apply the exemption amount you expect to have available at death. Remember, any gift tax exemption amount you use during your life must be subtracted. But if your spouse predeceases you, then his or her unused estate tax exemption, if any, may be added to yours (provided the applicable requirements are met).

If your taxable estate is equal to or less than your available estate tax exemption, no federal estate tax will be due at your death. But if your taxable estate exceeds this amount, the excess will be subject to federal estate tax.

Be aware that many states impose estate tax at a lower threshold than the federal government does. So, you could have state estate tax exposure even if you don't need to worry about federal estate tax.

### STRATEGIES TO CONSIDER

If you're not sure whether you're at risk for the estate tax, or if you'd like to learn about gift and estate planning strategies to reduce your potential liability, please contact us. ■

## LLC AND LLP OWNERS SHOULD BEFRIEND THE PAL RULES

The limited liability company (LLC) and limited liability partnership (LLP) business structures have their advantages. But, in years past, the IRS treated LLC and LLP owners as *limited* partners for purposes of the passive activity loss (PAL) rules. This could be a tax negative. Fortunately, LLC and LLP owners can now be treated as *general* partners, which means they can meet any one of seven "material participation" tests to avoid passive treatment.

### RULES TO OWN BY

The PAL rules prohibit taxpayers from offsetting losses from passive business activities (such as limited partnerships or rental properties) against nonpassive income (such as wages, interest, dividends and capital gains). Disallowed (that is, suspended) losses may be carried forward to future years and deducted from passive income or claimed when the passive business interest is disposed in a taxable transaction.

There are two types of passive activities: 1) trade or business activities in which you *don't* materially participate during the year, and 2) rental activities, even if you do materially participate (unless you qualify as a "real estate professional").

### THE 7 TESTS

Material participation in this context means participation on a "regular, continuous and substantial" basis. Unless you're a limited partner, you're deemed to materially participate in a business activity if you meet just *one* of seven tests:

1. You participate in the activity more than 500 hours during the year.
2. Your participation constitutes substantially all participation for the year by anyone, including nonowners.
3. You participate more than 100 hours and as much or more than any other person.
4. The activity is a "significant participation activity" — that is, you participate more than 100 hours but less than one or more other people, yet your participation in all significant participation activities for the year totals more than 500 hours.
5. You materially participated in the activity for any five of the preceding 10 tax years.
6. The activity is a personal service activity in which you materially participated in any three previous tax years.
7. Regardless of the number of hours, based on all the facts and circumstances, you participate in the activity on a regular, continuous and substantial basis.

The rules are more restrictive for limited partners, who can establish material participation only by satisfying tests 1, 5 or 6. If you have questions about meeting the material participation tests, please contact us. ■

## IS YOUR COMPANY OVERPAYING ON SALES AND USE TAXES?

It's a safe bet that state tax authorities will let you know if your business hasn't paid enough sales and use taxes. But the lines of communication may not be so open if you're overpaying. For this reason, many businesses use reverse audits to find overpayments so they can seek reimbursements.

In most states, businesses are exempt from sales tax on equipment used in manufacturing or recycling, and many states don't require them to pay taxes on the utilities and chemicals used in these processes, either. In some states, custom software and other computer equipment are exempt if used for research and development projects. These are just a few examples of potentially available exemptions.

Many companies have sales and use tax compliance systems to guard against overpaying, but if you haven't reviewed yours recently, check to make sure it's functioning properly. Employee turnover, business expansion or downsizing, and simple mistakes all can take their toll.

A formal reverse audit can extend across your business, going back as far as the statute of limitations on state tax reviews. If your state auditors can review all records for the four years preceding the audit, for example, the audit could encompass the same timeframe.

To be clear, reverse audits are often time consuming and complex. But a well-executed one can not only reap tax refund rewards now, but also help update your compliance systems going forward. Let us help you target the exemptions available to your business and ensure refund claims are properly prepared before submittal. ■