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Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor℠

April/May/June 2017

Be Cautious With Hard-to-Value IRAs

Virtually any investment can go into an IRA, other than life insurance and collectibles. In recent years, questionable outlooks for stocks, bonds, and savings accounts have encouraged many IRA owners to consider—or put money into—nontraditional IRA assets.

Assessing alternatives

Consequently, IRA owners can invest in real estate, venture capital pools, even their nephew's Internet startup that hopefully will become the next Google. Such outlays may or may not prove to be good uses for retirement funds. In any case, however, some tax-related issues will arise.

IRAs must be valued for certain purposes, and illiquid assets are not as easy to value as listed securities or mainstream savings instruments. The IRS, which views undervaluation as a potential problem, has made some changes in reporting requirements, in order to spotlight alleged transgressions. IRA owners face painful consequences if they trigger IRS displeasure in this area.

Lower value, less tax

IRAs need to be valued for purposes such as required minimum distributions (RMDs) and Roth IRA conversions.

Example 1: Bill Carson, an experienced real estate investor, has most of his traditional IRA money in private real estate partnerships. Now that he is past age 70½, Bill must take RMDs from his IRA each year and generally pay tax on the distributions. The lower the value of the real estate, the less tax Bill will pay on his RMDs.

There is no readily visible market for the properties held by these private partnerships, and, thus, no way to easily value Bill's IRA. The IRS may suspect Bill of lowering the valuation to reduce taxable distributions.

A similar situation may appear if Bill wants to convert his traditional IRA to a Roth IRA. Converting a traditional IRA with $500,000 in mutual funds to a Roth IRA will generate $500,000 of income to be taxed, but how much income will be generated when an IRA holding real estate assets is converted?

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What's Inside

Happier Returns

Of the 152 million individual income tax returns filed in 2016, about 110 million generated refunds, averaging $2,857.

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Trusted Advice

IRAs for 2017

- For 2017, total contributions to traditional and Roth IRAs cannot be more than $5,500, or $6,500 for those age 50 or older.
- IRA contributions can't exceed taxable compensation for the relevant year.
- Contributions to a traditional IRA are prohibited for those 70½ or older. Contributions to a Roth IRA are permitted, regardless of age.
- If married couples file a joint tax return, one spouse may be able to contribute to an IRA even without taxable compensation for the year. The amount of the couple's combined contributions can't exceed the taxable compensation reported on the joint return.

Cracking down

To prevent undervaluation that can lead to tax underpayments, the IRS is requiring more information from IRA custodians on Forms 5498 and 1099-R for 2015 and later years. On Form 5498, which is filed annually with information on IRA account value and whether a distribution is required, IRA custodians must reveal the presence of hard-to-value assets and the asset type. The same information is required on Form 1099-R, which reports the amount of any IRA distribution. (For Form 1099-R, this rule affects in-kind distributions of hard-to-value assets.)

With this information, the IRS will be able to focus on IRAs that hold illiquid assets, which are subject to RMDs. The agency can follow up to see if the reported valuation was arrived at fairly.

Impact on IRA owners

Individuals who want hard-to-value assets in their IRA, for their growth potential, should be vigilant about providing reliable valuations.

Example 2: Bill Carson's IRA holds $100,000 in liquid assets as well as private real estate investments. Bill's IRA custodian has listed Bill's cost—$400,000—as the value of the real estate.

This year, Bill will be 71, so the IRS Uniform Lifetime Table gives him a "distribution period" of 26.5 years. Using the historical $400,000 cost of the real estate, Bill would divide the total account value ($500,000) by 26.5 to get an RMD of $18,868.

Now, however, Bill's IRA custodian requires him to get a current appraisal of the real estate holdings in the IRA. Suppose the appraiser finds the real estate interests in Bill's IRA are worth $750,000. This would drive the account value up to $850,000, as reported on Form 5498, and the RMD to more than $32,000. If Bill withdraws less, he could owe a 50% penalty on the shortfall.

For IRA owners, finding an IRA custodian that will hold hard-to-value assets can be a challenge. Once that's accomplished, the next step may be discovering the custodian's valuation policy. A custodian could require an IRA owner to provide a valuation once per year, from an independent source. A valuation might come from the sponsor of the deal, from an executive of a private company with stock in the account, or a reputable third party. For real estate, an annual comparative market analysis might be required. ■

Drawing Down Your Portfolio in Retirement

Retirees often need money from their investment portfolio, if they have little or no earned income. For many seniors, tax-efficient withdrawals require two levels of decisions. First, should the dollars come from regular taxable accounts or from tax-deferred accounts such as IRAs? Second, regardless of where the money is coming from, how will a portfolio be liquidated to provide spending money?

Taxable or tax-deferred?

Some people enter retirement holding an IRA as well as a taxable account. If cash is needed, they often choose to take the money from the taxable account.

Example 1: Joy Larson needs $4,000 a month from her portfolio in retirement to supplement her Social Security income. The money in her traditional IRA was rolled over from

Did You Know?

About 84% of large employers will offer high-deductible health plans in 2017. Indeed, 35% of large employers will offer only high-deductible plans to their workforce. Some workers' deductibles will be offset by employers' contributions to health savings accounts: tax-free funds that workers can use to pay for out-of-pocket health care costs.

Source: wsj.com

Joy's 401(k) plan at work. All the money in her 401(k) was pretax, so IRA withdrawals will be taxed at ordinary income rates. Consequently, Joy decides to take money from her taxable account. Those withdrawals may be tax-free, if no investment gains are triggered. And, even if Joy takes some gains, they may be taxed at favorable long-term capital gains rates.

Drawing down the taxable account may be a common practice for retirees. However, there may be drawbacks. In time, the taxable account might be depleted, leaving only pretax IRA money for distributions later in retirement. Those distributions may be heavily taxed at whatever tax rates apply in the future.

In addition, holding on to IRA money can lead to a sizable amount of tax-deferred dollars left to your heirs. Your beneficiaries will have required minimum distributions (RMDs) from the inherited IRA, and those distributions probably will be taxable. (Special rules apply to IRA money left to a surviving spouse, but those dollars eventually may pass to younger relatives.) If the IRA beneficiaries inherit while in their prime working years, the tax on those distributions could be especially steep.

On the other hand, if you take some cash from your IRA and leave highly appreciated assets in your taxable account, you may be able to pass those appreciated assets to your heirs. Under current law, they'll get a basis step-up, usually to a date-of-death value. Then, your heirs can sell the assets and avoid paying tax on the appreciation during your lifetime.

The bottom line is that you might want to use some IRA money as well as money from taxable accounts to cover living expenses in retirement. This approach may be helpful before you reach age 70½, when RMDs from your IRA begin. Withdrawing some money from your IRA before 70½ may help you hold down taxable RMDs in the future.

Know how to fold 'em

Regardless of where the money will come from, you should have a plan for drawing down your portfolio in retirement. Your specific circumstances will influence your decisions, but one approach is to start retirement with a sizable "cash bucket." This money can be used for living expenses, regardless of what happens in the financial markets.

Example 2: In example 1, Joy Larson needs $4,000 a month from her portfolio in retirement, or $48,000 a year. Joy decides she wants enough cash to cover three years' outlays, or $144,000. Therefore, in advance of her retirement, Joy puts together $144,000 in bank CDs and money market funds. This money can flow into her checking account to help pay her bills.

From time to time, Joy will liquidate other assets to replenish her cash bucket. There are many ways to do so, so Joy should have a plan. For instance, she may check her asset allocation every year to see whether it's still in keeping with her current wishes. Suppose Joy wishes to keep a 50-50 asset allocation between stocks and bonds, but a stock market slide has tilted her portfolio towards bonds, which have been stable. Then, Joy might sell some bonds and bond funds, putting the proceeds into her cash bucket while bringing her portfolio into a better balance.

No portfolio drawdown plan will work for everyone, but you should approach retirement with a well-reasoned plan and attempt to stick with it. Having a substantial amount of cash may enable you to ride out any market downturns, while having a thoughtful mix of equities and fixed income can provide income and growth potential throughout your retirement. ■

How Investments in Gold Are Taxed

Investment asset classes include precious metals, especially gold. Enthusiasts cite several reasons for including gold in a diversified portfolio. If governments print money to cover increasing obligations, gold may act as an inflation hedge. Moreover, gold can offer a safe haven in times of geopolitical upheaval: in mid-2016, for example, when Great Britain voted to leave the European Union (Brexit) and financial markets were unsettled, the price of gold reached a two-year high.

If you decide to allocate some investment dollars to gold, there are many options to choose. The tax treatment can vary, depending on how you invest, and you might be unpleasantly surprised.

Classed as a collectible

Gold investors may prefer to invest in "physical" gold: mainly, coins and bars. If the price of gold increases over time, so will the value of these holdings. Investments in gold mining companies, on the other hand, don't have this direct relationship.

However, physical gold is considered a "collectible," under the tax code, similar to paintings or rare stamps. Any profits on the sale of collectibles is taxed as ordinary income, with a top rate of 28% if the item has been held for more than one year.

Example 1: Dave Adams bought gold coins several years ago. He sells them in 2017. This year, Dave's taxable income is $250,000, which puts him in the 33%

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federal tax bracket. His profits on the sale of the gold coins is taxed at 28%, the top rate on collectibles.

Suppose that Dave had invested in a gold mining stock or in a fund holding shares of mining companies. In that situation, Dave's profitable sale would have been taxed no higher than 15%, the typical tax rate on long-term capital gains. The highest tax rate on long-term capital gains, owed by investors with extremely high incomes, is 20%—which is still lower than the maximum 28% tax rate on long-term collectibles gains.

Funds can be collectibles

Increasingly, investors are choosing bullion-backed exchange-traded funds (ETFs) for gold investing. Essentially, these funds buy huge amounts of physical gold, store that gold, and issue shares to investors. The value of the shares is directly related to the price of gold.

Example 2: When gold trades at $1,250 an ounce, Jenny Brown invests $25,000 in a gold-backed ETF. If gold prices go up 20%, to $1,500 an ounce, Jenny's shares will be worth approximately $30,000, for a 20% gain. If gold falls 20%, to $1,000 an ounce, Jenny's shares will be worth around $20,000, for a 20% loss.

Gold-backed ETFs can be bought and sold like any stock or fund, so they can fit easily into the rest of your portfolio. As indicated, they offer a direct play on the price of gold. On the downside, gold-backed ETFs are taxed as collectibles, even though they seem to be similar to traditional traded securities. If you sell one of these ETFs at a profit after a holding period of more than a year, you won't get the benefit of low long-term capital gain tax rates. Instead, long-term gains will be taxed as ordinary income, with tax rates as high as 28%.

Mining stocks and funds

Another way to put gold into your portfolio is to buy shares of a gold mining company, or shares of a fund holding mining-company stocks. Generally, rising gold prices are good for these securities. In fact, if you're truly bullish on gold, such investments might be ideal because operating leverage can boost your gains.

Example 3: Wayne Douglas buys shares of ABC Gold Mining Corp. when gold is priced at $1,250 an ounce. ABC can mine and deliver gold to the market at $1,000 per ounce, with costs that are mainly fixed, for a profit of $250 an ounce, in this example.

Suppose that gold goes up to $1,500 an ounce, for a 20% gain. Here, ABC's profit goes from $250 an ounce to around $500 an ounce, for a 100% gain. With a leap in profitability of that magnitude, it's possible that ABC shares will rise far more than the 20% rise in the price of gold. This is a simplified example, but a successful investment in mining shares might be more lucrative than an investment in physical gold or in bullion-backed ETFs, if gold rises in price.

In addition, gains on the sale of mining shares held more than one year will get long-term capital gain tax treatment, as mentioned. Depending on the investor's income, such gains would be taxed at 20%, 15%, or even 0%.

Nevertheless, operating leverage can work against investors, too. A drop in the gold price could reduce or eliminate profits and send ABC's share price tumbling. Moreover, any investment in an operating business takes on business risk: exposure to poor management, labor problems, lagging production, and so on. Thus, buying mining shares is not a direct play on gold's valuation.

There are still other ways to invest in gold, from closed-end funds to exchange-traded notes. Each may have pros and cons and well as varying tax treatment. If you are considering an investment in gold via an unfamiliar vehicle, our office can explain the tax consequences. ■

Did You Know?

The U.S. economy is the world's largest, with gross domestic product (GDP) over $18.5 trillion in 2016. China ranks second, with $11.4 trillion in GDP, followed by Japan ($4.4 trillion), Germany ($3.5 trillion), the U.K. ($2.8 trillion), France ($2.5 trillion), and India ($2.3 trillion). Italy, Brazil, and Canada round out the top 10.

Source: statisticstimes.com

Foreign Stock Funds Can Be Doubly Taxing

Many U.S. investors hold foreign stocks. One of many advantages to holding foreign stocks is diversification because some foreign companies might outperform domestic stocks in bear markets. Some foreign countries, especially those in the developing world, are posting stronger economic growth than the American numbers. What's more,
virtually every sizable nation boasts some excellent companies that are likely to reward investors. To find the best opportunities abroad, many U.S. investors use foreign stock mutual funds, to benefit from the fund companies' research and portfolio management expertise.

There may be another reason to invest in a foreign stock fund: Some foreign companies pay relatively high dividends. However, that may lead to double taxation and lower effective yields.

Example 1: Sheila Tucker invests $40,000 in a foreign stock fund. This fund pays a 5% dividend, so Sheila would earn $2,000 (5% of her $40,000 investment) a year. However, the host countries where the companies are based might withhold, say, 20% of the dividend payments ($400), to cover the tax due on those dividends. Thus, Sheila effectively pays tax on that $2,000 in dividends to the host countries, and pays tax again, to the IRS this time, when the foreign stock fund reports the dividend income generated by the foreign stocks.

Trimming the tax

Fortunately, there may be a way for investors such as Sheila to reduce this double tax burden. Foreign stock funds will report taxes paid via withholding on Form 1099-DIV. Then, investors may be able to claim a foreign tax credit up to $300 a year ($600 for couples filing jointly) directly on their Form 1040. (A deduction for foreign taxes paid may be taken on Schedule A, instead, but the credit is generally a greater tax saver.)

However, taking a foreign tax credit can become complicated if your foreign tax withholding exceeds the amounts mentioned in the previous paragraph, or if the tax withheld exceeds the tax due to the IRS. Then, the deduction cannot be taken directly on Form 1040, and Form 1116 must be filed; our office can assist with that form, if it's necessary.

Tax relief through the foreign tax credit (or a foreign tax deduction) won't help, though, if you hold a foreign stock fund in a tax-deferred account such as an IRA.

Example 2: As mentioned, Sheila Tucker has $2,000 in dividends from a foreign stock fund in 2017, and the host countries withhold $400 in tax, at a 20% rate. In this example, though, the fund is held in her IRA. Sheila does not report this dividend income to the IRS for 2017, because the money is in her IRA, so she can't claim a tax credit. Eventually, when Sheila withdraws the dividend income from her IRA, she'll owe tax at ordinary income rates.

As these examples indicate, the amounts involved may be modest, for many investors. If the advantages of investing in foreign stock funds appeal to you and your only practical choice is to use a tax-deferred account, double taxation may not be a meaningful drawback. If you do have options, though, you may find it more tax-efficient to hold foreign stock funds in a taxable account and use the credit. Similarly, if you invest in individual dividend-paying foreign stocks, you may want to hold them in a taxable account, if possible. ■

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Foreign Tax Credit

- You may be able to claim a credit for foreign taxes imposed by a foreign country or U.S. possession.
- To claim the foreign tax credit, generally you file Form 1116. However, you may be able to claim the foreign tax credit without filing Form 1116 if you meet all of the following conditions:
    - All of your foreign source gross income was passive income, which includes most interest and dividends.
    - All the income and any foreign taxes paid on it were reported to you on a qualified payee statement such as Form 1099-DIV, Form 1099-INT, or Schedule K-1.
    - Your total creditable foreign taxes are not more than $300 ($600 if married filing a joint return).
- This opportunity is not available to estates or trusts.

Profit-Sharing Plans for Your Small Business

Business owners who want to sponsor a retirement plan for employees (including owner-employees) have many options from which to choose. Knowing the basics can help entrepreneurs make an astute decision.

One choice is a profit-sharing plan. Despite its name, your company needn't tabulate its earnings every year and divide that amount among its workers. Instead, the term indicates a plan in which contributions to employees' retirement accounts are made by the employer. Therefore, a profit-sharing plan may help your company to attract, motivate, and retain valued employees. These plans are flexible, so employers can contribute more in good years and less (or nothing at all) when business is slow.

Considerable contributions

Profit-sharing plans may permit employers to make relatively large, tax-deductible contributions to employees' retirement funds. Employees won't owe income tax until the money is withdrawn; in the interim, any investment earnings can compound, untaxed.

In 2017, employer contributions can be up to 100% of compensation, with a ceiling of $54,000. Of those contributions, the company can deduct amounts up to 25% of total compensation for all participants.

A traditional profit sharing plan usually calls for prorata contributions to all covered employees' accounts.

Example 1: PSP Corp. makes a $6,000 contribution to an account for Al, who earns $30,000 (20% of pay), $10,000 to Barb, who earns $50,000, $20,000 for Chet, who earns $100,000, and $50,000 for Doris, the company owner who earns $250,000.

Profit sharing plans must have a set formula for determining how the contributions are allocated among plan participants, but they needn't be traditional prorata plans, as illustrated in example 1. Instead, profit-sharing plans may be structured to put a greater percentage of compensation in the accounts of certain employees. Such a plan might result in a contribution of around $8,000 or even $2,500 to the account for Barb, earning $50,000, while Doris, earning $250,000, still gets $50,000 contributed to her account. These sophisticated profit-sharing plans must be constructed with care, to comply with federal rules; our office can help if you're interested in this type of arrangement.

Nuts and bolts

Participation in a profit-sharing plan typically must be offered to all employees age 21 or older who worked at least 1,000 hours in a previous year. Employer contributions may vest over time, according to a plan's specific terms. Annual filing of IRS Form 5500 is required. Withdrawals generally will be permitted at retirement, plan termination, and perhaps at other times, such as after age 59½. Distributions will be taxed. A profit-sharing plan may permit loans and hardship withdrawals, but withdrawals before age 59½ may trigger income tax plus an additional tax of 10%. ■

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