

Strategy Corner

Tax-Mitigating Ideas: Place Your Bet and Act Accordingly

More than ever, tax strategies have become bets.

Tax mitigation generally entails shifting taxable gains both to entities who would pay lower taxes (for example, children) and into a future where your taxes are expected to be lower (for example, retirement years). To make such long-term decisions, you need confidence in your ability to predict the future tax environment. Today, uncertainty about that future is unusually high. So high, indeed, that it might make more sense to bring future tax liabilities forward rather than the reverse!

Consider the following:

- The president proposes to raise the top two income tax rates from 33% and 35% to 36% and 39.6%, respectively, and to raise taxes on dividends and capital gains from 15% to 20%.
- The House recently passed HR 3962, commonly known as the Affordable Health Care for Americans Act. Among the revenue-generating items in the bill are: (1) a 5.4% surtax on individuals earning more than \$500,000 and on married couples earning more than \$1,000,000; (2) a tax of 2.5% on the price of any medical device; and (3) a limit of \$2,500 on contributions to Health Savings Accounts, whose use would now be restricted to reimbursements for prescription items.

It is quite possible that we will see even more innovative proposals to fund current and probable future deficits.

With this caveat, we will review possible tax-mitigation strategies. In the field of taxation, all actions need to be decided in light of very specific personal circumstances. We encourage you to reach out to your advisor to discuss your situation, and we remind you that this article is for informational purposes only and should not be construed as legal or tax advice.

Idea One: Deferred Compensation

This strategy defers current earned income to a later taxable year. Income is not reported or taxed until it is actually received in subsequent years.

For an individual whose income is subject to volatile swings or who is likely to have only a limited period of high earnings potential, the tax savings from income deferral may be significant. Moreover, deferral of income to even out cash flow can be an important aspect of an individual's financial plan. Of course, if an individual will remain at high income levels for a long time, it is likely that deferring income will not result in tax savings.

- Because deferred compensation plans must be offered by an employer, a major consideration in choosing deferral is the risk of allowing the deferred amounts to remain with your employer. Beneficiaries of deferred compensation plans are

unsecured creditors of the employer. If the employer is financially unstable, in a volatile business, or in a highly cyclical industry, it may not be wise to be in a plan in which you are paid only in a distant future.

Idea Two: Qualified Retirement Plans

The most commonly used tax-advantaged retirement plans today are those that promise no specific amount of benefits but rather distribute whatever happens to be in an employee's account to the employee or the employee's beneficiaries at the time selected for payment under the plan. These are called defined contribution plans, the most familiar being the 401(k).

Another type of plan regaining popularity because of its powerful tax savings potential for individuals and small groups is the defined benefit plan, which promises the participant a specific benefit based on a formula contained in the plan. The employer will make actuarially determined contributions to the plan in an amount necessary to provide the participants with the promised benefits. These plans, once offered to all employees by large corporations, can have striking benefits for small firms. Consider the following illustration:

Mr. C owns a small but profitable business. He is 55 years old and has two employees aged 28 and 35. Mr. C has W-2 income of \$400,000, while Employee 1 earns \$35,000 and Employee 2 earns \$45,000. Mr. C establishes a defined benefit plan in 2009 that focuses on age and earnings. To create a qualified plan, Mr. C must contribute for all of his employees. Mr. C's maximum allowable contribution for himself is \$162,400, while his contribution for Employee 1 is \$4,000 and for Employee 2, \$8,100. Note that 93% of the contributions are for Mr. C. Because of the contributions to the qualified plan, the earnings of the business are reduced by the contribution expense. The 2009 income tax savings would be approximately \$61,700 and would continue for each year that Mr. C funds the plan. Mr. C plans to exit the business when he is 62 years old, in seven years. At that time, Mr. C would terminate the defined benefit plan and roll the proceeds into IRAs for each participant.

Maximum tax-advantaged contributions for 401(k) and analogous defined contribution plans are much smaller. However, they can be used in addition to a defined benefit plan to further benefit the participants.

Idea Three: Employee Stock Ownership Plans (ESOPs)

Technically, ESOPs are a special form of defined contribution plan that is designed to invest primarily in qualifying employer securities. "Qualifying employer securities" refers to the common stock of the employer's company.

ESOP transactions allow the owner of a company to sell all or a portion of the company to its employees in a very tax-advantaged way. The rules allow for the non-recognition of gain at the election of the seller from the sale of at least 30% of "qualified securities":

- If they are sold to an ESOP, and
- If, within a qualified period (three months before the sale and twelve months after the sale), the seller acquires securities of certain domestic corporations called "Qualified replacement property."

This non-recognition of gain lasts until you sell your qualified replacement property. Currently, because of the step-up in basis rules, if you die owning this property, no income tax will be paid on your sale.

Because of the overly conservative nature of the types of securities that can be purchased as qualified replacement property, many sellers ask if there is a way that they could have their cake and eat it too by investing differently. The answer is that via a loan against the replacement securities, a seller can use the loan proceeds to invest in a diversified portfolio to better meet their needs.

From the company side, an ESOP can borrow money to purchase employer stock. This strategy provides immediate cash inflow for the company along with a tax-advantaged repayment opportunity.

In a typical leveraged ESOP transaction, the ESOP obtains a bank loan to purchase stock from a selling owner. The seller receives full payment for the stock. The company repays the loan by making contributions to the ESOP. By doing this, the company effectively receives a tax benefit for its payments of both interest and principal.

An employer's ESOP contributions are deductible up to 25% of eligible compensation, provided the contributions are used to repay principal on an ESOP loan. Further, IRS rules provide that contributions used to repay interest on an ESOP loan are deductible to the employer without regard to a compensation limitation.

Example:

G wishes to sell his 40% interest in H Corporation to the corporation's ESOP. G's stock is valued at \$2,000,000. H pays eligible compensation of approximately \$700,000 per year. The ESOP borrows \$2 million to purchase G's stock. The loan is fully amortized over 20 years at an interest rate of 8%, resulting in payments of approximately \$200,000 per year. Although \$200,000 is greater than 25% of eligible compensation, the full \$200,000 annual ESOP contribution will be allowable.

In the first year, the \$200,000 ESOP contribution includes about \$160,000 of interest and \$40,000 of principal. The \$40,000 is an allowed expense because it does not exceed 25% of eligible compensation. The \$160,000 is allowable in full because it is used to pay interest.

Toward the end of the amortization period, most of the \$200,000 payment will be used to repay principal. To be able to deduct the full \$200,000 payment, eligible compensation must equal at least \$800,000. Because this situation will occur many years after the initial transaction, it is hoped that compensation will have increased enough to meet this requirement

This means that a leveraged ESOP can provide a tax deferral opportunity for a selling shareholder and an infusion of cash to the corporation.

Idea Four: Gifts to children and other family members

Once you make a gift of income-producing property, the income will be taxed to the recipient and not to you. If the recipient is in a lower income bracket than you, family income tax will be saved. To achieve maximum savings, the child should not be subject to the kiddie tax.

If a child is subject to the kiddie tax, some of the child's income may be taxed at the parent's highest marginal rate but some savings are still possible. If you own a business, consider that employing a child aged 18 or a full-time student aged 19-23 could cause earned income to exceed more than half of his or her support. This, in turn, could help to avoid the kiddie tax on the child's unearned income. Note, however, that for children under age 18, there is no earned income escape hatch from the kiddie tax. In all cases, earned income can be sheltered by the child's standard and other deductions, and earnings in excess of allowable deductions will be taxed at the child's low brackets.

Lastly, you can shift income to a lower-bracket family member by giving appreciated property that the recipient can sell at a gain. A valid gift of property that is completed before the property is sold generally shifts the tax liability on the gain from you to the recipient.

Conclusion

If you would like to discuss these or any other tax savings strategies, please contact your advisor.

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