MANAGEMENT & *TAX CONCEPTS*

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WILL YOU QUALIFY FOR THE HOME SALE GAIN EXCLUSION?

MORE IN THIS ISSUE...

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Will you qualify for the home sale gain exclusion?

For most people, the home sale gain exclusion is the biggest tax break they'll ever get. But the exclusion is subject to several complicated rules and limitations, so it's important to plan carefully before you sell to shield as much of your profit from tax as possible.

EXCLUSION BASICS

Normally, when you sell appreciated real estate or other capital assets you've held for more than one year, your gains are subject to capital gains taxes at a rate of 15% or 20% (depending on your tax bracket). If your income is high enough, you may also be subject to an additional 3.8% net investment income tax. So, a high-income taxpayer who sells real estate for a $250,000 profit will potentially be liable for $59,500 in taxes ($250,000 x 23.8%).

Fortunately, the tax code offers a generous tax exclusion for gain from the sale of your principal residence. The exclusion allows single filers to avoid taxes on up to $250,000 in gain. For married couples filing jointly, the exclusion is doubled, to $500,000.

MEETING THE REQUIREMENTS

If you're planning to sell your principal residence, don't assume that you automatically qualify for the exclusion — check to be sure you meet the eligibility requirements. If you're single, you must have owned the home and used it as your principal residence for at least 24 months of the five-year period preceding the sale.

If you're a married couple filing jointly, then *at least one of you* must have owned the home for at least 24 months of the preceding five years and *both* of you must have used it as your principal residence for at least 24 months of the preceding five years. Technically, two different homes could meet these requirements at the same time, but you're not permitted to claim the exclusion more than once in a two-year period.

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The eligibility rules get more complicated for couples who are separated or divorced, homeowners who move to nursing homes, and military personnel. Also, if work or health circumstances require you to move before you meet the 24-month

threshold, you may qualify for a partial exclusion. Be sure to consult your tax advisor if any of these situations apply to you.

Special rules apply to the conversion of an ineligible residence into a principal residence. Suppose you and your spouse have owned a home for 10 years and have used it as a rental property for six years and as your principal residence for the past four years. If you sell the home for a $500,000 profit, only 40% of that amount (4/10) is eligible for the exclusion. That means $200,000 in gain is excluded and the remaining $300,000 is taxable.

OTHER FACTORS

It's important to keep track of home improvements. Your gain on the sale of a home is generally equal to the selling price minus your cost basis, which is the purchase price plus or minus certain adjustments. Some home improvements (for example, an addition or a kitchen remodel) may increase your basis, thereby reducing your gain. So, it's critical to document these expenses.

In addition, if your spouse dies, you can still claim the full $500,000 exclusion if you sell your principal residence within two years and haven't remarried. Be aware, however, that if you and your spouse owned the home jointly, you'll be entitled to significant tax benefits regardless of when you sell. That's because your spouse's share of the home's value receives a "stepped-up" cost basis. In some community property states, the full value of the home gets a step-up.

Does a home office affect your home sale gain exclusion?

If you have a home office, be sure you understand its impact on your tax bill when you sell your home. If the office is located within your home, you need not allocate your gain between the personal and business portions. In other words, you can claim the home sale gain exclusion for your entire gain. But if the office is outside your home — for example, in an unattached garage, guesthouse or other structure — you'll have to allocate your gain between the home and office. You'll then pay taxes on the gain attributable to the office.

Regardless of the office's location, however — and regardless of the amount of your home sale gain exclusion — your gain will be taxable to the extent you deducted depreciation of your home (after May 6, 1997) as part of a home office deduction. These "recaptured" depreciation deductions are taxed at ordinary income tax rates, with a 25% maximum. Note: This deduction currently applies only to business owners or the self-employed. Employees don't qualify for the home office deduction because the miscellaneous itemized deduction was suspended under the 2017 Tax Cuts and Jobs Act. Keep in mind, though, that prior depreciation — that is, any amount taken before the law change — still has to be considered.

PREPARING FOR A SALE

Before you sell your principal residence, be sure you understand the tax implications. Calculate your expected gain (selling price minus adjusted cost basis) and determine the amount of your home sale gain exclusion. Your tax advisor can help you navigate the ins and outs and ensure you obtain the proper exclusion amount for your circumstances. •

How a life insurance trust could lower your estate taxes

The old saying about death and taxes being the only certainties in life might be true, but there's one tax that most Americans currently aren't worrying about owing: the federal estate tax. That's because in 2017, the Tax Cuts and Jobs Act significantly boosted the estate tax exemption, which is the amount of an estate that is exempt from taxation.

For 2022, the exemption is $12.06 million, or $24.12 million on a combined basis for married couples. This means that no federal estate tax will be assessed on any estate that's worth less than this at the time of death. As a result, less than 0.1% of the estates of Americans who have died in recent years have owed federal estate tax, according to the IRS.

All of this could change, however, if the estate tax exemption is cut in half in a few years as is currently scheduled.

ESTATE TAX CHANGES AHEAD

Unless Congress intervenes, the estate tax exemption will be lowered to the pre-TCJA amounts of an inflation-adjusted $5 million, likely ending up at a little more than $6 million ($12 million for married couples) on Jan. 1, 2026.

In this scenario, many more affluent families could be subject to the federal estate tax, which is as high as 40%. So, if a family patriarch died after 2025 and left behind an estate worth $12 million, his estate could end up paying federal estate taxes of around $2.4 million (assuming the 40% estate tax rate), compared with $0 if he died before 2026.

This potential change makes it important to start thinking about how you can reduce or eliminate federal estate taxes if your estate will be larger than the new exemption amounts in 2026 and beyond. One idea is to set up an irrevocable life insurance trust (ILIT). This will reduce the value of your taxable estate by removing life insurance proceeds from the estate, thus shielding them from federal estate taxes.

HOW ILITS WORK

As the grantor, you set up and fund an ILIT with a life insurance policy. You can transfer ownership of an existing life insurance policy to the trust after it is formed, or the trust can purchase a new life insurance policy directly. The transfer of an existing policy is subject to federal gift tax, which may be sheltered from tax by applying a portion of your lifetime gift tax exemption. Note, also, that tax rules include a transferred policy in your estate if you die within three years of the transfer.

Whether it holds a new or existing policy, the trust will pay the life insurance premiums. You can fund the premiums by transferring assets to the trust annually. If you arrange for a "Crummey Power" that gives beneficiaries the right to access funds for a limited time, you can apply your annual gift tax exclusion ($16,000 per beneficiary for 2022) to shield the funding of the premium payments from gift tax without dipping into your lifetime exemption.

When you die, proceeds from the policy's death benefit will be paid to the trust where they will be held on behalf of your beneficiaries according to the terms of the trust. You must name a trustee when setting up an ILIT — this may be, for instance, your spouse, an adult child, a close friend, or an attorney or financial institution. The trustee may be granted discretionary authority to distribute proceeds to beneficiaries — either in full upon your death, or at a specific beneficiary age or life milestone, such as graduating from college, getting married or having a child.

PROS AND CONS

One non-tax benefit of ILITs is that they can protect assets from creditors. Any coverage amounts that are held in the trust are generally protected from the grantor's and the beneficiaries' creditors.

It's important to keep in mind that the biggest drawback of ILITs is that, as the name suggests, they are irrevocable. You can't make any changes to the trust or dissolve it after it has been established. Further, you will no longer have ownership or control of any assets once they're placed in the trust. You should give this careful consideration before deciding to set up an ILIT.

HELP AVOID ESTATE TAXES

Depending on your situation, an irrevocable life insurance trust could help minimize or avoid owing federal estate taxes after you die, leaving more for your heirs. Be sure to seek expert advice and legal counsel before moving forward with this strategy. •

Shopping around to get the best financing for your business

In an ever more complex economy, it can be difficult to discern what type of financing will best serve your small business and help it thrive through difficult financial times. Whether it's the need for new, more technologically advanced equipment or an opportunity to expand operations, you'll need to shop around to familiarize yourself with the different financing options available before you "buy into" a particular borrowing strategy.

DIFFERENT SHAPES AND SIZES

Bank loans come in a variety of shapes and sizes, but most fall into one of several broad categories:

Lines of credit. A line of credit is the most common type of small business loan, primarily because of its simplicity and flexibility. Once your business is approved for a line of credit, you can borrow up to your credit limit whenever you like without having to reapply. It's often a good idea to apply for a line of credit *before* you need it. That way, you can quickly tap your line when a need arises.

Term loans. As the name suggests, term loans are issued for a specific period of time. They're repaid with interest over a set number of years and used mainly to buy fixed assets like machinery and equipment.

Commercial mortgages. A commercial mortgage is a specific type of term loan used to buy new or existing commercial real estate. Examples include retail store space, industrial warehouses and office buildings.

Government loan programs. While various programs available during the COVID-19 pandemic crisis to help struggling businesses have expired, many non-pandemic-specific programs are still available. Among the most popular are Small Business Administration (SBA) loan programs, such as the SBA 7(a), SBA 504 and SBA Express loan programs. The SBA guarantees a portion of these loans, enabling banks to lend to companies that might not ordinarily be able to use normal underwriting criteria.

It's important to know *why* you need capital so your banker can suggest the right type of loan to meet your financing needs. For example, if you need a capital infusion to meet periodic cash flow shortfalls or fund accounts receivable, a line of credit is probably the best option. But you typically wouldn't use a line of credit to buy equipment or real estate — a term loan or commercial mortgage is the right type of loan for these capital needs.

ALTERNATIVE SOURCES

In addition to banks, some businesses today are seeking capital from alternative sources, such as commercial finance companies and peer-to-peer lenders. The former provide alternative financing solutions such as factoring. In this scenario, you receive an advance against uncollected receivables and asset-based and accounts receivable loans, in which real estate, equipment, inventory and receivables are pledged to secure capital.

Meanwhile, peer-to-peer lending is becoming popular as a way for businesses to access capital via the internet. Sometimes referred to as "crowdfunding," it allows businesses to borrow money from individuals or internet lenders that focus on lending to small businesses.

Finally, when it comes to acquiring equipment, *leasing* is often a better capital option than borrowing. This is especially true for equipment with built-in obsolescence like computers, because they can be replaced or upgraded when the lease is up. Equipment leasing is 100% financing, which frees up cash flow. And it also may offer tax benefits.

THE BEST LOAN FOR YOUR BUSINESS

Many small businesses are still struggling to recover from the economic volatility resulting from the pandemic's effects — both globally and locally. It's more important than ever to be aware of all the options before seeking financing so that your business stays profitable over the long term. •

Corporations: Beware the accumulated earnings tax

One disadvantage of C corporation structure is the possibility of double taxation. A C corporation's income is subject to two levels of income tax: once at the corporate level and a second time at the shareholder level when income is distributed in the form of dividends.

To avoid — or at least defer — double taxation, many corporations retain earnings rather than distribute them to shareholders. This strategy can backfire, however, by triggering the accumulated earnings tax (AET).

WHAT IS THE AET?

The AET is a 20% penalty on undistributed taxable income. The IRS may impose the tax if it finds that a corporation has accumulated an unreasonable amount of earnings with the intent of avoiding income tax.

The IRS may conclude that such intent exists if, for example, the corporation: 1) retains earnings beyond its reasonably anticipated future needs, 2) places undistributed earnings in investments that aren't business related, or 3) makes personal loans to shareholders or otherwise spends money for their benefit.

An AET credit shields the first $250,000 in accumulated earnings ($150,000 for some personal service corporations) from the AET. After your corporation exceeds that threshold, though, you should take steps to avoid AET liability. Options include:

- Documenting the business reasons that justify a higher level of accumulated earnings (for example, with detailed plans and budgets for expansion of the business), or
- Documenting how the corporation's investments are related to its business (for example, by showing how these investments provide a hedge against inflation, fund employee benefit plans or generate additional working capital).

Alternatively, you could simply pay sufficient dividends to shareholders to reduce your accumulated earnings below the threshold.

WHAT ABOUT THE PHC TAX?

It's important to distinguish the AET from the personal holding company (PHC) tax. Like the AET, the PHC tax is a 20% penalty tax on a PHC's undistributed income.

A corporation is a PHC if: 1) at any time during the last half of the tax year, more than 50% of the value of its outstanding stock was held, directly or indirectly, by or for five or fewer individuals, and 2) at least 60% of its adjusted ordinary gross income is attributable to certain types of passive income, such as dividends, interest, rents, certain royalties or income from personal service contracts.

The PHC tax doesn't apply to tax-exempt entities, banks, life insurance companies and some other types of corporations. Unlike the AET, the PHC tax applies to corporations that meet the tests mentioned above regardless of any intent to avoid income tax.

BEST STRATEGIES

We can help you evaluate how the AET or the PHC tax may affect your business. The next step is to determine the best tax strategies for your situation. •

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