Getting the Tax Of It

Some New Wrinkles in the IRS Code Provide Good Tax Shelter Opportunities

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For too long the principle thrust of estate planning for owners of closely held businesses was based on the idea that tax liability for the increase in value (appreciation) of the owner’s capital stock would be eliminated if he held onto the stock until he died.

The reasoning was quite simple. If he held on until death did from all depart the heirs could simply peddle the stock if they wished. Furthermore, they could sell it at whatever value was assigned to it in the estate tax return. This way, reasoning went, they wouldn’t be liable for any capital-gains tax because what the original owner (the contractor who just died) paid for his stock (his “basis”) was of no importance.

That’s all changed now, though. The IRS code now requires that the heirs carry over the decedent’s basis, subject to certain adjustments. The most important of these adjustments is the so-called “fresh-start” rule. Under it, the value of the stock is determined under a formula designed to fix the value as of Dec. 31, 1976.

There’s a potential timebomb in all of this, though. The IRS assumes that, should there be any appreciation in the stock, that the appreciation occurs at an equal rate over the years it was held.

An example may demonstrate this matter. If stock were acquired by the decedent for $50,000 on Dec. 31, 1966, and held until he dies in 1986, its value may be some $550,000.

The IRS would then assume that the stock has grown by $25,000 for each year to Dec. 31, 1976. This means that the assumed value (whether it is based on fact or not) is $300,000 (the computation assumed is $25,000 times 10 years plus $50,000). Thus the heirs must take $300,000 as their basis, or cost.

On the other hand, let’s say that the heirs can prove beyond a shadow of a tax payment that the stock was actually worth $1-million in 1976 but in the 10 years since then that it has actually declined in value to a mere $550,000.

The law ignores that drop. In other words, if the heirs sell the stock for $550,000 in 1986 they can expect to be taxed as though they made a capital gain of $250,000. This, in spite of the fact that they really had a loss.

There are a number of ways to avoid or blunt the impact of such tax problems.

With a little judicious use of insurance, heirs can be certain that the construction corporation is sufficient-

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ly liquid when the owner dies to cover the payment of capital-gains tax, or

Prior to the owner’s death should the drop in the company’s value be predictable (or even suspected), efforts should be expended to sell off the company via a tax-free exchange. Even when top dollar can be obtained, the overall estate gain would probably offset the loss opportunity.

Remember, now, all the foregoing information is predicated on the idea that the contractor hasn’t provided — or been able to achieve — any successor planning. That is, the heirs just want to liquidate the contracting business.

Contractor Planning on Tax Shelters

Depending on his age, a contractor may shelter more than 50% of his total compensation from taxes in a properly designed pension plan. There are four basic plans that should be considered when the decision is made to divert money into a pension program. These are:

15% Profit-Sharing Plan: In this plan, employer contributions to a profit-sharing plan depend on level of profits. Contributions are based on a percentage of compensation. The maximum is 15%.

Money Purchase Plan: Instead of providing a definite amount of benefit at retirement, the plan obligates an employer to contribute a specified amount each year to provide benefits. The maximum contribution is 25% of the executive’s compensation.

Defined Benefit Plan: This is a pension plan that provides a definite amount of benefit at retirement. The benefit cannot be more than 100% of compensation for the participant’s three best years and is subject to a current ceiling of about $80,000 (this is subject to increase with the cost of living).

1.4 Rule Program: This is a defined benefit plan combined with a 100% money purchase plan. The combined benefits are not to exceed a certain ratio.

The contributions to any of these plans are tax deductible by the corporation and aren’t currently taxable to the shareholder-executives. Income on the contributions accumulates within the plan tax-free until distributed.

Then, qualified distributions of both principal and income are taxed on favorable terms. This naturally makes it possible for a far more rapid accumulation of capital than would be possible if the amounts contributed to the plan were currently distributed in cash and invested by the recipients. At the salary levels of about $80,000 per year, the Federal income tax would account for 50% with state and city income taxes, if any, raising that amount.

It is critical, of course, that any contractor setting up a pension plan obtain expert assistance so the right plan can be designed.

With the arrival of the Employee Retirement Income Security Act (ERISA), the cost of covering non-shareholder employees must be taken into consideration.

These costs can vary with the number, age, and periods of service by the employees.