

ClientLine®

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TRUSTS AND ESTATES May Owe Income Taxes

The tax-filing season has started, and taxpayers nationwide are gathering the information needed to file individual and corporate income-tax returns. What many people don't realize, though, is that trusts and estates can also owe income taxes. According to the latest IRS tally, for one year alone (2013), some 3.1 million federal income-tax returns reporting more than \$160 million of total income were filed for trusts and estates.

The questions and answers below give some details about the requirements.

WHEN IS A RETURN REQUIRED?

With limited exceptions, a return must be filed if the trust or estate has gross income for the year of \$600 or more or if there is a nonresident alien beneficiary. A trust also has to file if it has any taxable income. Certain "grantor" trusts are exempted from filing an income-tax return. For example, many people create revocable living trusts for estate planning purposes. They name themselves (and perhaps a spouse) as the beneficiary and may serve as the trustee. In this situation, there are simplified reporting options and no separate return has to be filed for the trust.

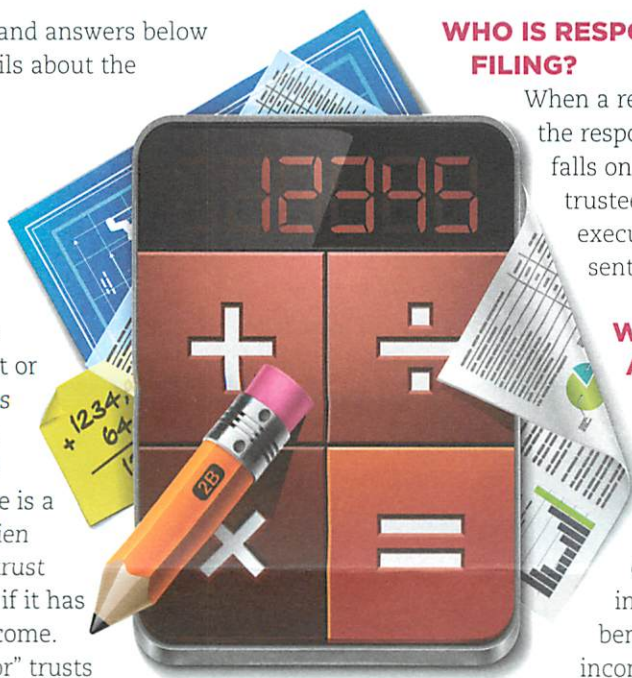
WHO IS RESPONSIBLE FOR FILING?

When a return is required, the responsibility for filing it falls on the fiduciary — the trustee of a trust or the executor (personal representative) of an estate.

WHAT TAX RATES APPLY?

A trust or estate that distributes income to a beneficiary is generally not taxed on the distributed income. Instead, the beneficiary reports the income for tax purposes.

Where income is taxable to the trust or estate itself, the tax is computed using a separate rate schedule. The rates are the same as the individual rates except that there is no 10% rate or 35% rate. The rate brackets, however, are compressed. In 2016, a trust or estate pays tax at the top 39.6% rate on taxable income over \$12,400.



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Remodeling?

Are you planning to give your retail establishment or restaurant a makeover this year? In a recent revenue procedure, the IRS offers a new, easier method for determining whether the costs of "remodel-refresh" projects are for repairs and maintenance or for improvements.

The distinction is important because businesses can currently deduct repair and maintenance expenses but must capitalize the cost of improvements. Businesses that use the new method simply treat 75% of the year's qualified costs as the deduction portion and the other 25% of the costs as the capital expenditure portion.

To be eligible for the new method, a taxpayer must have an "applicable financial statement" and be in the trade or business of (1) selling merchandise to customers at retail or (2) preparing and selling meals, snacks, or beverages to customer order for immediate on-premises and/or off-premises consumption. A taxpayer that leases or sublets a building to a retailer or restaurant that incurs remodel-refresh costs may also qualify. Certain types of businesses are excluded, and various other requirements apply.

WHAT'S TAXABLE

to an S Corporation Shareholder?

S corporation shareholders have extra reason to worry about their company's annual performance: It has a direct impact on their own income taxes.

HOW IT WORKS

Unlike a regular C corporation, an S corporation usually doesn't pay federal income taxes itself. Instead, each shareholder is allocated a portion of the corporate income, loss, deductions, and credits on a special "K-1" tax form. The shareholder then must report the items listed on the K-1 on his or her personal tax return.

The K-1 allocations are based on stock ownership percentages. So, for example, if an S corporation has \$100,000 of taxable business income for the year, a person who owns 75% of the stock in the corporation would be allocated 75% of that income, or \$75,000.

This scheme can get complicated. Case in point: The K-1 may show more income than the shareholder actually received from the company during the year. That's because the K-1 figure is based on the corporation's actual taxable income — not on the distributions made to the shareholder.

Example. Tom starts a new corporation, electing S status. In the first year, Tom draws a \$30,000 salary and receives no other distributions from the company. The company's

ordinary business income (after deducting his salary) is \$10,000. Since Tom is the only shareholder, all the company's \$10,000 of income is allocated to him on his K-1. Tom must include both the \$30,000 of salary and the \$10,000 on his personal income-tax return, even though all he actually received from the corporation was his salary.

This result seems harsh, but it's not the end of the story. Special rules in the tax law prevent the same income from being taxed again. Essentially, Tom will be credited with already having paid taxes on the \$10,000 so that any future distribution of the funds will not be taxable.



TRACKING BASIS

To determine whether non-dividend distributions* are tax free, S corporation shareholders must keep track of their stock basis. The computation generally starts with a shareholder's initial capital contribution (or the stock's cost if it was purchased) and changes from year to year

as the shareholder is allocated corporate income, loss, etc. Non-dividend distributions that don't exceed a shareholder's stock basis are tax free.

* Most distributions made from an S corporation are non-dividend distributions. Dividend distributions can occur if the company was previously a regular C corporation (or in other limited situations).

Client PROFILE....

Bill wants to keep his small business's financial information up to date so he can better manage the business.

Last year, Bill experienced some cash flow problems during his company's busy season. He is determined to get a better handle on his financial situation so it doesn't happen again. He needs a reliable system that allows him to track key figures, such as how much cash his business has on hand.

Knowing who owes his business money and how much they owe will make it easier for Bill to follow up on overdue accounts. He also should have a list, in due-date order, of all his company's accounts payable (amounts owed).

Regularly monitoring inventory levels will allow Bill to keep track of what he has in stock and what items should be ordered. While he doesn't want to lose sales because of shortages, keeping too

much inventory in stock is expensive and takes up valuable space.

Bill will be able to get a more complete picture of his business's finances if he has monthly or quarterly financial statements. He will be able to monitor profitability, respond to requests for financial information from lenders and suppliers, and ensure that business loan requirements are being met.

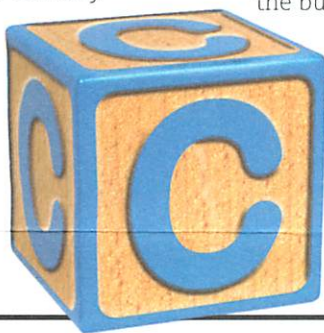
Having accurate, up-to-date financial information is critical to the successful management of a small business. A reliable recordkeeping system can provide that information.

Client Profile is based on a hypothetical situation. The solutions we discuss may or may not be appropriate for you.

Obtaining Credit — **THE FIVE Cs**

What do lenders look for when they're determining whether to extend credit to a small business? Here are five important factors, commonly referred to as the "five Cs" of credit:

- 1. Character.** Are the business owners in good standing in the community? How well do they present themselves and their business? Are they knowledgeable about the industry? Do they have good personal credit histories?
- 2. Capacity.** Is the business generating the income necessary to repay the debt?
- 3. Collateral.** What property (equipment, real estate, inventory, accounts receivable, etc.) will be pledged to secure the financing?
- 4. Capital.** How much money have the owners personally invested in the business?
- 5. Conditions.** Are the current economic climate and industry trends favorable for the business?



Do People Spend Less **AFTER THEY RETIRE?**

In a recent study,* researchers examined this important retirement planning question by analyzing household spending patterns for up to six years after retirement. The table shows some of the results.

Average Household Spending

	Preretirement	After being retired for:		
		1-2 years	3-4 years	5-6 years
Non-durables	\$29,817	\$28,070	\$27,324	\$24,885
Transportation	\$13,671	\$10,745	\$10,231	\$10,042
Housing	\$11,414	\$10,830	\$9,377	\$8,626
Durable goods	\$618	\$483	\$407	\$408

The figures on housing exclude mortgage principal payments because these can be viewed as savings or investments. All spending figures are in 2013 dollars.

Non-durables include gifts, clothing, charity, dining out, medication and medical supplies, utilities, food and beverages, health insurance, telecommunications, tickets, trips and vacations, personal care, hobbies, sports, housekeeping services and supplies, and yard services and supplies. The *transportation* category includes up to three automobile purchases, vehicle insurance, vehicle maintenance, car payments or vehicle financing, and gasoline. *Housing* includes rent, homeowners or renters insurance, property taxes, home repair and

maintenance, and mortgage interest. *Durable goods* are items such as refrigerators, washers, dryers, dishwashers, televisions, and computers.

All told, in the first two years of retirement, average household spending dropped by 7.7%. By the sixth year of retirement, average spending had dropped by 14.7% compared to spending levels immediately before retirement.

* *Change in Household Spending After Retirement: Results from a Longitudinal Sample*, Sudipto Banerjee, Ph.D., Employee Benefit Research Institute, 2015

... Q&A

Q For the past few years, my company has employed several people who travel frequently to different areas of the country on business. Is there a simple way to reimburse them for their travel expenses that satisfies IRS requirements?

A Consider using per diem rates. Instead of reimbursing employees' actual expenses for away-from-home lodging and meal and incidental expenses, you'd use an IRS-approved maximum per diem rate. The rates vary based on locality. An even simpler approach would be to use the IRS's "high-low" per diem method. With this approach, there's one rate for travel to designated high cost areas within the continental U.S. (CONUS) and another for all other CONUS areas. The per diem rates are currently \$275 and \$185 (for travel after September 30, 2015).

Q I'm concerned that I won't be able to file my tax return by the April filing deadline. Does the IRS grant filing extensions?

A Individual taxpayers can get a six-month filing extension by filing an application with the IRS (on a paper form or electronically) on or before the April filing deadline. You'll have to show the full amount of your properly estimated tax for the tax year and pay any tax due to avoid interest and late payment penalties. Members of the military and others serving in combat zones have additional time to file their returns without the need to request an extension.

ClientLine ITEMS.....

> OWNERS OF TRADITIONAL INDIVIDUAL RETIREMENT ACCOUNTS

(IRAs) who turned age 70½ in 2015 have until April 1, 2016, to take their first required minimum distribution (RMD). The second RMD must be withdrawn by December 31, 2016. RMDs for each subsequent year must be taken by December 31. The penalty for withdrawing less than the RMD is 50% of the amount that should have been withdrawn but was not.

> **THE TYPICAL AMERICAN HOUSEHOLD LACKS ENOUGH LIQUID SAVINGS** to replace one month of income in the event of a financial shock, according

to Pew Charitable Trusts research. The general recommendation is to have enough emergency savings to cover three to six months' worth of expenses.

> **EVEN WITH MEDICARE, RETIRED INDIVIDUALS** should have savings to cover their out-of-pocket health expenses. According to the latest Employee Benefit Research Institute findings, a man who turned 65 in 2015 needs to have \$124,000 set aside and a woman needs \$140,000 for a 90% chance of having enough to pay future health care costs. The projections do not factor in potential long-term care expenses.

> **WHEN ASKED TO NAME THEIR SINGLE MOST IMPORTANT PROBLEM**, small business owners surveyed by the NFIB Research Foundation in October 2015 named government requirements and red tape (22%), taxes (21%), quality of labor (13%), and poor sales (12%). Various other problems were cited less frequently.

> **CONSUMERS MAY REQUEST ONE FREE CREDIT REPORT** every 12 months from each of the three nationwide credit reporting companies. The Federal Trade Commission's website (www.ftc.gov) has the details.

The general information provided in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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