FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

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PROTECTING YOUR ESTATE-TAX EXEMPTION

Even though the federal estate-tax exemption is $5.49 million, just a tad shy of $11 million for a couple, you still need to think carefully about whether to pass that "exempt" amount of wealth on to your surviving spouse through a trust.

That federally 'exempt" wealth is, for example, still subject to state estate taxes, and your spouse might want to pass it on to the grandkids in a tax-efficient way. The classic handoff is through credit-shelter trusts, also called bypass trusts, which basically protect assets exempt from federal estate taxes, minus any gifts made to your children while you're alive. The newer option, which Congress made permanent in 2012, is called "portability," which allows that same estate-tax-exempt wealth to be transferred on death to the surviving spouse without a trust. But portability carries serious limitations.

Today, there is no easy answer. Twenty years ago, the answer was clear. In 1997, the estate-tax exemption was only $600,000 and the top estate-tax rate was 55%. So, credit-shelter trusts were the go-to vehicles for avoiding at least some onerous taxes. Then, the exemption began to shoot up to the current $11 million for a couple.

In 2010, Congress temporarily enacted the provision that allowed portability, making it permanent two years later. Portability was designed to remove the necessity of credit-shelter trusts for married couples.

Some estate planners now draw a bright line between couples whose estates top $11 million and those below that level. The thinking goes that if you don't need a trust, why bother? It costs money to set up and manage, and once funded, that's it.

But, not so fast. Portability doesn't, for example, exempt state estate taxes.

Currently, 18 states plus the District of Columbia have either estate or inheritance taxes of various amounts and rates. Washington state's top estate-tax rate is the highest in the nation at 20%, according to the Tax Foundation, while Oregon and Massachusetts tax any estate valued at more than $1 million, the lowest threshold of any state.

Also, there's no generation-skipping with portability. The surviving spouse can't, for example, take that $5.49 million estate-tax exemption she received through portability, then put it in a tax-free trust for her grandchildren. Nor can she protect appreciating assets from capital gains.

Let's assume that a surviving spouse inherits a stock portfolio worth $5 million through portability, but doesn't need to cash in, and its value grows. She dies two decades later, and the stocks are worth $20 million, a value well over the current exemption threshold. Her heirs are going to have to write the Internal Revenue Service a big check. By contrast, in a credit shelter trust, the value of the portfolio upon death of the first spouse is frozen. This saves the couple's children, or other beneficiaries, from huge tax exposure upon the second death.

And, there's a control issue. Portability doesn't protect assets from a new spouse if the surviving spouse remarries, or from step-children, common in this age of blended families. The point: The low-hassle, low-cost option of portability in the end could cost your heirs a lot more in stress and taxes.

Not that credit-shelter trusts are devoid of issues. Put a primary residence in a trust and you are going to have mortgage headaches, since most banks are loath to lend money to a trust. What's more, a house in a trust doesn't get the benefit of a further stepped up value after the surviving spouse dies. If, say, the children want to sell the house, they would be liable for capital gains taxes that are levied on the difference in value between the two deaths.

So, what do you do? For states with an estate tax, one compromise is to put the amount of the state tax exemption in the credit-shelter trust and elect portability for the balance of the estate up to the $5.49 million.

Of course, any significant change in the amount of the estate-tax exclusion or the capital-gains rate—or doing away with them altogether—will dramatically affect decision-making. The odds of that occurring have increased since the election, which is why flexibility is the best answer.

Our tip: Don't blindly set up a trust; understand the character of your assets and what kind of pass-along best suits it.

Employee or Independent Contractor? Know the Rules

The IRS encourages all businesses and business owners to know the rules when it comes to classifying a worker as an employee or an independent contractor.

An employer must withhold income taxes and pay Social Security, Medicare taxes and unemployment tax on wages paid to an employee. Employers normally do not have to withhold or pay any taxes on payments to independent contractors.

Here are two key points for small business owners to keep in mind when it comes to classifying workers:

1. Control. The relationship between a worker and a business is important. If the business controls what work is accomplished and directs how it is done, it exerts behavioral control. If the business directs or controls financial and certain relevant aspects of a worker's job, it exercises financial control.

This includes:

- The extent of the worker's investment in the facilities or tools used in performing services
- The extent to which the worker makes his or her services available to the relevant market
- How the business pays the worker, and
- The extent to which the worker can realize a profit or incur a loss

2. Relationship. How the employer and worker perceive their relationship is also important for determining worker status. Key topics to think about include:

- Written contracts describing the relationship the parties intended to create
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation or sick pay
- The permanency of the relationship, and
- The extent to which services performed by the worker are a key aspect of the regular business of the company
- The extent to which the worker has unreimbursed business expenses

The IRS can help employers determine the status of their workers by using Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. IRS Publication 15-A, Employer's Supplemental Tax Guide, is also an excellent resource.

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