Tax Diversification for Business Owners

Situation

- In a "pass-through" entity like an S corporation, a limited liability company (LLC), or a partnership, the owners pay income tax on company earnings whether distributed or not.
- To the extent income is not distributed to the owners or used to run the company, pay expenses, etc., it can be invested for later use.
  - ◊ Taxes (e.g., on dividends, capital gains, etc.) can have a significant impact on growth.
- When cash is needed in the future, the withdrawal of funds or the sale of assets may generate income tax and/or capital gains tax.
- Just as spreading investments among different asset classes can help reduce risk, tax diversification can optimize income regardless of prevailing tax conditions.

Alternatives

- Many business owners find themselves in a very high marginal tax bracket and wish to reduce their currently taxable income with tax-deductible contributions.
  - ◊ A company-sponsored qualified plan can enable owners to reduce their taxable income by contributing on a "pre-tax" basis to their and their employees' retirement.
    - ❖ Though it may be possible to channel a greater than pro rata share to owners' accounts, contributions must generally be made to accounts of non-owners.
  - ◊ An individual retirement account ("IRA") can also allow for tax-deductible contributions.
    - ❖ Deductibility may be limited depending on whether a taxpayer or his/her spouse participates in a qualified plan at work.
- Because tax-deductible contributions may be limited, the "next best thing" for many business owners is to find alternatives that will not result in taxes while the asset is held, i.e., tax-deferred assets.
  - ◊ Deferring income and capital gains taxes means more dollars remain invested.
  - ◊ Any growth in the aforementioned retirement plans is tax-deferred.
    - ❖ So, too, is accumulation in a deferred annuity.

    - ◊ Certain non-dividend paying securities may increase in value without corresponding taxes along the way.
    - ◊ Real property might also be considered a tax-deferred asset.
        - ❖ Keep in mind that property or other taxes may be due periodically.
- ♦ Some assets not only defer taxes on earnings, but can provide tax-free income.
    - ◊ Examples:
        - ❖ Certain types of municipal bonds can provide tax-free payments to the owner.
        - ❖ Contributions to a Roth IRA are not tax-deductible, but any earnings are tax-deferred and qualified distributions are tax-free as long as certain conditions are met.
        - ❖ Where there is a need for the death benefit from a life insurance policy, permanent coverage can provide tax-deferred growth and tax-free access to policy cash value.
            - ♦ Policy cash surrender value can often be withdrawn income tax-free to cost basis (normally the amount of premiums paid), assuming the policy is not classified as a Modified Endowment Contract ("MEC").
            - ♦ When cost basis has been reached, loans can be taken against the cash surrender value.
                - ◊ Cash value and death benefit proceeds would be reduced by the total policy indebtedness, including accumulated interest.
    - ◊ This category may be especially valuable where – due to increases in income and/or changes in the rates – one's tax bracket may be higher in the future.
- ♦ Keep in mind that, while taxes play a part in income planning, planning should not be governed by tax issues.
    - ◊ Moreover, you should consult your Certified Public Accountant for a thorough analysis of the various tax consequences involved in any transaction.