Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

July 2012

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New JOBS Act Offers Flexibility to Small Companies

President Obama has signed the Jumpstart Our Business Startups (JOBS) Act. Literally a job creation effort, the new law is designed to help small companies and entrepreneurs raise capital and operate with less regulation. Politicians from both parties have expressed belief that small business growth will provide more employment opportunities.

The new law has three major provisions:

- **Crowdfunding**. Small companies and new ventures will be allowed to raise a total of up to $1 million per year from a large number of investors.
- **More relief from federal requirements.** Generally, companies seeking to go public must conform to certain Securities and Exchange Commission (SEC) rules. Small firms raising less than $5 million had been exempt from some of these rules; the new law raises this threshold to $50 million.
- **Still more relief**. Currently, companies that go public have up to two years after their initial offering to comply with the Sarbanes-Oxley Act of 2002 disclosure and auditing requirements. The new law extends this regulatory holiday for up to five years.

Crowd pleasers

Among the major provisions of the JOBS Act, crowdfunding is attracting the most attention. Traditionally, so-called "accredited investors" have had most of the opportunities to invest in private ventures. To be considered, individuals generally must have specified amounts of income or net worth.

Crowdfunding is designed to bring potentially lucrative private opportunities to investors of moderate means. Fundraising will be done online via companies regulated by the federal government; many investors will be able to participate with relatively few dollars. Supporters of this provision speak of the "democratization" of private equity investing, envisioning the time when a startup company raises, say, $1 million by having 1,000 people invest $1,000 apiece.

The SEC will spell out specific guidelines for crowdfunding, probably before the end of 2012. Business owners seeking to raise capital may want to

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Boost in Borrowing

Among participants in defined contribution plans, which include 401(k)s, 18.5% had loans outstanding at the end of 2011, up from 13% in 2001 and 15% in 2006.

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consider this procedure, perhaps to raise money for equipment purchases or expansion. Nevertheless, some caution is necessary.

If your company raises small amounts of money from 1,000 people, for instance, you will have more investors who might call frequently and try to get involved in your business. People you don't know will be shareholders with access to your company's financial information. What's to stop your competitors from investing a few thousand dollars to find out how your private company is doing?

Moreover, traditional private equity investors anticipate the need to wait years before any (hopefully large) payout. Accredited investors typically have the means to buy and hold without selling their stakes in embryonic companies. With many smaller investors, your company is more likely to have shareholders who will want or need to cash out sooner, so you may have to develop some mechanism for providing investors with liquidity.

Providing protection

Although businesses trying to raise money via crowdfunding may have to be concerned with extra administration and loss of confidentially, investors risk being ripped off. Many people will be lured by the idea of ground floor participation in the next Google or Facebook.

Several investor protections have been built into the JOBS Act. The new law requires that all crowdfunding must be done through businesses that are registered with an industry organization and regulated by the SEC. Also, investors' investments in crowdfunding will be limited to a percentage of their income and net worth.

Despite such precautions, investing in private companies is a risky activity, and crowdfunding won't reduce those risks. For investors and business owners alike, crowdfunding will be worth exploring but also worth a hard look before leaping in. ■

Did You Know?

From 1926 to 2011, large company U.S. stocks have returned 9.6% per year. Although stocks have disappointed in the past 10 years (returning 2.9% per year), they have done better in the last 20 years (7.8% per year), 30 years (11.0% per year), and 40 years (9.8% per year).

Source: Morningstar

401(k) Loans and Hardship Withdrawals

Many employers offer 401(k) or similar retirement plans. As the word *retirement* indicates, these plans are meant to help employees build wealth, long term, to support a lifestyle after the paychecks stop.

Life isn't always ideal, though. You may find you need a substantial amount of money while you are still working, and your 401(k) account might hold a great deal of cash. Therefore, you could be tempted to tap your 401(k) for spending money. On-the-job access to your 401(k) typically falls into one of two categories: loans and hardship withdrawals.

The lure of loans

Most employers permit employees to borrow from their 401(k) plans. Generally, you can borrow up to 50% of the amount you have vested, with a cap of $50,000. You can borrow with little paperwork, regardless of your credit score, and the interest payments go back into your own retirement fund rather than to a bank or some other lender.

Nevertheless, 401(k) loans have drawbacks, too. By removing money from your account, you'll have less in your retirement fund for tax deferred accumulation. You also will have to face two tax traps:

- **Double taxation.** When you borrow from a 401(k), you'll repay the loan by having future paychecks reduced. You won't get a tax break on those loan repayments, though, so you're actually putting after-tax dollars into your 401(k). Then, you'll pay tax in the future when you take money out, so you'll be paying tax on money that's already been taxed.
- **Forced repayment.** Typically, you can repay a 401(k) loan over an extended time period—generally five years—with paycheck reductions. However, if you leave your company, repayment will be accelerated; you might have to repay the loan in full within 60 days. If you fail to meet that deadline, you'll owe income tax on the unpaid loan amount, and you

may owe a 10% early withdrawal penalty, too, if you are younger than age 55.

Extraordinary emergencies

In some cases, you might find that a 50% or $50,000 401(k) loan won't be enough, or you might not be able to get *any* loan from your 401(k). As an alternative, you may be eligible for a hardship withdrawal from your 401(k).

The IRS says you might be able to take a hardship withdrawal to meet a so-called "immediate and heavy" financial need. Examples include medical, higher educational, and funeral expenses. You also can qualify for a hardship withdrawal if you're buying a principal residence, repairing it, or preventing a foreclosure. (The same is true if you rent your home and need cash, so you won't be evicted.)

You can get such a distribution only if you can't meet your financial obligations from other resources. You must state to your employer that you don't have other resources (for example, an investment account or a vacation home) you could sell to raise the necessary cash. If you are eligible for a 401(k) loan, you might have to borrow as much as possible before getting a hardship withdrawal.

On the other hand, your employer can't withhold a hardship withdrawal if using your other resources will increase your need. If you're buying a home, for instance, borrowing from your 401(k) might disqualify you from obtaining a third-party loan large enough to close the deal. In such a circumstance, you'll be eligible for a hardship withdrawal without taking out a 401(k) loan.

For tax purposes, you may be better off with a 401(k) loan than a hardship withdrawal. Loan proceeds aren't taxable. Hardship withdrawals are subject to ordinary income tax and, perhaps, a 10% early withdrawal penalty. Before pursuing either tactic, see if there are other solutions that don't involve raiding your retirement account. ■

Learning the A-Bs of Estate Tax Planning With Trusts

As we head into the second half of 2012, some crucial tax deadlines are approaching. Unless Congress acts before year-end, income tax rates will rise for most taxpayers. Investors will pay higher taxes on dividends and capital gains if current law remains in effect.

Now, paying income tax at 39.6% instead of 35% certainly would have an impact on affected taxpayers. Similarly, investors will not welcome paying 20% instead of 15% on long-term capital gains, if that comes to pass. However, the possible changes in federal estate tax law could be much greater.

For instance, the federal estate tax exemption is scheduled to drop to $1 million in 2013, from $5.12 million in 2012. In addition, so-called exemption "portability" between spouses would no longer be in the tax code. This feature, which became effective in 2011, now allows a surviving spouse to use any federal estate tax exemption not used by the first spouse to die, if an election is made by the estate of the first spouse to die.

Planning in such an environment is difficult. Six months from now, the federal estate tax exemption might be $1 million, or it might be $5.12 million plus an inflation adjustment. Alternatively, it might be somewhere in between; President Obama's 2013 budget proposes a $3.5 million estate tax exemption. This budget also calls for a 45% tax on assets over the exemption amount, up from 35% in 2012.

Double play

No matter what changes may be ahead for estate tax law, it's likely that the IRS will make an effort to collect tax from individuals with taxable estates. Our office can help you prepare for changing your estate plan, or developing a new one, after you see what federal estate tax law is in effect for 2013.

If you're married, and your net worth runs into seven figures, your estate plan may include so-called "A-B trusts." This strategy, fundamental to estate tax planning, calls for the creation of two trusts:

- **The "A" or marital trust.** With this approach, the first spouse to die leaves some assets to a trust for the benefit of the surviving spouse. If the surviving spouse is an American citizen and entitled under the terms of the trust to all of the trust's income, the first spouse's estate may not owe estate tax on this transfer due to the estate tax marital deduction. The marital deduction is unlimited and applies to a qualifying bequest of any size.
- **The "B" or bypass trust.** Assets of the deceased spouse up to the amount of the deceased spouse's remaining estate tax exemption are transferred to the "B" trust, also known as a credit shelter trust. If the B trust is drafted properly, its assets won't be included in the surviving spouse's estate. Therefore, B trust assets can bypass estate tax at the second spouse's death.

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Favoring flexibility

In a traditional A-B trust plan, the first spouse to die leaves as much to the B trust as possible in order to fully utilize the estate tax exemption. Therefore, some older trusts may deliver unforeseen results.

Example: Paul Wagner created his estate plan in 1997 when the federal estate tax exemption was $600,000, and his net worth was $2 million. Paul's plan called for enough assets to go to the B trust to use the entire estate tax exemption; the balance would go to the A trust for his wife, Ruth. The couple's children were the beneficiaries of the B trust, and Ruth would get all the income from the A trust for the rest of her life. With this plan, if Paul died in 1997, Ruth would enjoy the income from a $1.4 million A trust, and the $600,000 would be available to the children, free of estate tax.

By now, Paul's net worth has climbed to $4 million. If he dies in 2012, all of his assets will pass to the B trust because the federal estate tax exemption ($5.12 million) is larger than Paul's $4 million estate. None of Paul's $4 million in assets will go into the A trust for Ruth.

Although Paul's estate plan is outdated, fixing it requires careful thought. If Paul revises the plan so that the B trust is limited to, say, $1 million, then $3 million could go into the A trust for Ruth. In the future, her estate might owe federal as well as state estate tax. A large bequest to the B trust, on the other hand, might leave Ruth short of income from the A trust. If future tax law retains exemption portability, the A trust-B trust structure might not be needed.

Paul might confront such challenges by putting flexibility into his estate plan. Among several approaches, Paul could leave most or all of his assets to a marital trust for Ruth. At Paul's death, Ruth could consider all the circumstances, including her net worth and current tax law. Then, Ruth could disclaim as much or as little of Paul's bequest as she desires. With a properly drafted estate plan, any assets disclaimed by Ruth within nine months of Paul's death could pass into a B trust for their children. Such a plan could give Ruth ample assets for the rest of her life while minimizing the impact of estate tax. ■

Trusted Advice

Portability Provision

- Under current law, the unused estate tax exemption of the first spouse to die can be used by the surviving spouse, if an election is made by the estate of the first spouse to die.
- Say that Paul Wagner dies in 2012 with a $4 million estate. He leaves $2.5 million to his wife, Ruth, tax free, and $1.5 million to their children.
- The federal tax exemption in 2012 is $5.12 million. If Paul uses $1.5 million of that exemption, fully sheltered by the $5.12 million exemption for this year, he will leave $3.62 million of his exemption unused.
- At Ruth's subsequent death, if portability is still in the tax code, she can use that $3.62 million exemption from Paul, as well as her own full estate tax exemption then in effect.

TAX CALENDAR

JULY 2012

July 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

July 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2012. Deposit any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year-end, file Form 5500 or 5500-EZ for calendar year 2011.

AUGUST 2012

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

August 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

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