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INSTALLMENT SALES AND TAX PLANNING

An article in this month's *Tax & Business Alert* discusses the potential income tax and estate tax advantages of installment sales when selling a business. We believe that the article oversimplifies the tax issues (income, gift, and estate) as well as non-tax issues involved in considering an installment sale of a business. For example, the article mentions only the current individual federal long-term capital gain tax rates of 0%, 15%, and 20%. It's not quite that simple. There are also state income taxes and, for high-income taxpayers, the 3.8 percent net investment income tax. The top total tax rate on long-term capital gains for a Louisiana resident is 28.05 percent (23.8 percent federal plus 4.25 percent Louisiana).

The article states that the use of installment sale of a business allows one to defer and possibly reduce taxes. While that is generally true, it is not necessarily so. Some installment sales include taxable gain from depreciables that will be ordinary income that is fully taxed in the year of sale at the highest ordinary tax rate. In other words, it is possible to sell a business using an installment sale and have a tax liability for the year of sale that exceeds the cash received in that year.

Also, using an installment sale to defer taxable gain carries the risk that tax rates will be increased in those future years resulting in a higher tax than would have occurred in the sale year. The article also does not adequately (to us) emphasize what is often the most important consideration, which is the credit worthiness of the buyer and the possibility of default.

Nevertheless, although there are many tax and non-tax issues to consider, an installment sale can be a viable method of selling a business to an unrelated party in the right circumstances. Also, both gifts and installment sales to younger generation family members can be used as ways to transfer a business to family members with potentially significant future family tax savings. Such techniques can involve the use of limited liability companies and certain types of trusts. We would be happy to discuss these with you.

IRS AUDIT TRENDS

The Government Accountability Office (GAO) issued in May a report concerning audit rates on individual tax returns filed for the years 2010 through 2019 for all income levels. According to the GAO, the audit rates for all individual returns decreased from .9 percent to

(*Continued on reverse*)

.25 percent. The decrease in audit coverage was attributed by the Internal Revenue Service (IRS) to inadequate funding.

The change in hours spent per audit for the fiscal years 2010 through 2021 was an increase of 103 percent for returns between $200,000 and $500,000. For returns with incomes of more than $500,000 to $5 million, the increase in hours required per return was 118 percent. For returns above $5 million the time per return increased by 209 percent.

From our perspective, increased complexity in the law has significantly increased the amount of time required to audit and to prepare returns with income above $200,000. Congress has with almost all tax changes increased complexity by adding credits, limitations, phase-outs, etc. at many different income levels. In addition to paying more tax, higher income taxpayers are required to pay more for the preparation of their returns and, if unfortunate enough to attract (or randomly draw) an audit, pay more for professional assistance with the audit.

For fiscal years 2010 through 2021, the majority of audited returns with additional taxes assessed were for taxpayers with incomes below $200,000. The total of additional taxes assessed per audited return increased as taxpayer income increased. As one might expect, the highest amount of additional tax dollars collected per audit hour came from the highest income taxpayers. Surprisingly, audits of the lowest-income taxpayers (below $25,000) resulted in the second highest amount of additional tax per audit hour. The IRS explained that Earned Income Tax Credit audits are primarily pre-refund audits conducted through computer generated correspondence and require much less time and result in more additional tax due per hour expended. The GAO also reported that lower income audits tended to have a higher rate of change in total taxes owed.

From our perspective, it appears that tax audits have decreased, but that the time required for a tax audit (and for preparation of tax returns) has, as the result of increased complexity, significantly increased for those taxpayers above $200,000 of income or with significant investment or other non-compensation income. Accordingly, such taxpayers will likely continue to receive the more intensive audits. Lower income returns will be handled primarily by computer-generated notices and assessments.

We continue to suggest that you contact your tax return preparer if you receive a written notice concerning your returns from the IRS (or from a state tax authority). It is best to decline to discuss your income tax returns with any caller claiming to be an IRS representative (or state representative) as almost all such calls are scams.

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Tax & Business Alert

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USING ALTERNATIVE ENERGY FOR BUSINESS CAN BRING TAX BENEFITS

If you're a business owner, you might be wondering if using alternative energy technologies in your company can help you manage energy costs and improve your bottom line. If this sounds interesting, you should know there's also a valuable federal income tax benefit (the business energy credit) that applies to the acquisition of many types of alternative energy property.

The credit is intended primarily for business users. But be aware that other energy tax breaks apply if you use alternative energy in your home or if you produce energy for sale.

WHAT PROPERTY IS ELIGIBLE?

The business energy credit is equal to 30% of the following types of property (with the caveat that construction must be begun before 2024):

- Equipment that uses solar energy to generate electricity for heating and cooling structures, for hot water, or for heat used in industrial or commercial processes (except for swimming pools),
- Equipment that uses solar energy to illuminate a structure inside using fiber-optic-distributed sunlight,
- Specific fuel-cell property,
- Certain small wind energy property,
- Specific waste energy property, and
- Certain offshore wind facilities with construction beginning before 2026.

If construction of equipment that uses solar energy to generate electricity for heating and cooling structures, for hot water, or for heat used in industrial or commercial processes begins this year, the credit rate is 26% and is reduced to 22% for construction beginning in calendar year 2023; and, unless the property is placed in service before 2026, the credit rate is 10%. For the other types of property mentioned above, if construction begins this year, the credit rate is 26%, and is reduced to 22% for construction beginning in 2023; and, unless the property is placed in service before 2026, the credit rate is 0%. The only exception to this is the final type of property mentioned above — certain offshore wind facilities. This type of property isn't subject to a phase-out.

The business energy credit is equal to 10% of the following types of property with construction beginning before 2024:

- Specific equipment that is used to produce, distribute, or use energy derived from a geothermal deposit,
- Certain cogeneration property,

- Some microturbine property, and
- Certain equipment that uses the ground, or ground water, to heat or cool a structure.

THE DOWNSIDE AND THE UPSIDE

There are several restrictions related to the credit. For example, it isn't available for property acquired with certain non-recourse financing. Additionally, if the credit is allowable for property, the "basis" of that property is reduced by 50% of the allowable credit.

On the other hand, a favorable aspect is that, for the same property, the credit can sometimes be used in combination with other benefits. Examples include federal income tax expensing, state tax credits or utility rebates.

There are business considerations unrelated to the tax and nontax benefits that may influence your decision to use alternative energy. And even if you choose to use it, you might do so without owning the equipment, which would mean forgoing the business energy credit.

STILL WONDERING?

As you can see, there are many issues to consider and you may have remaining questions. We can help you work through these alternative energy tax considerations. ■

SELLING YOUR BUSINESS? AN INSTALLMENT SALE MAY YIELD TAX BENEFITS

You've spent years building your company and now you're ready to move on, possibly to a new business, retirement or something else. Whatever your plans, you want to get the best return from your business that you can after all the time and money you've put into it.

Not only do you need to get a good price, but also to minimize the tax hit on the proceeds. One option is an installment sale, which allows you to defer and possibly reduce taxes.

GIVING PROPERTY AWAY VS. SELLING IT

If you have a taxable estate, it may be more advantageous to give property to your children than to sell it to them. By gifting the asset, you'll deplete your estate and reduce your potential estate tax liability. In a sale, the proceeds generally will be included in your taxable estate.

But an installment sale may be desirable if you've already exhausted your $12.06 million (for 2022) lifetime gift tax exemption or if your cash flow needs preclude you from simply gifting the assets. Selling property at fair market value to your children or other loved ones rather than gifting it lets you avoid gift taxes on the transfer and freeze the property's value for estate tax purposes as of the sale date. Future appreciation benefits the buyer and won't be included in your taxable estate.

Of course, if the transaction is structured as a sale rather than a gift, your buyer must have the financial resources to buy the property. Using an installment note allows the buyer instead to make the payments over time. Ideally, the purchased property will generate enough income to fund these payments.

PROS VS. CONS

One advantage of an installment sale is the flexibility you have to design a payment schedule that corresponds with the property's cash flow, your financial needs and those of your buyer. You can arrange for the payments to increase or decrease over time or start with interest-only payments and an end-of-term balloon payment of the principal.

One disadvantage of an installment sale — as opposed to gifting property — is that you'll owe tax on any capital gains recognized from the sale. Fortunately, you can spread this tax liability over the life of the installment note. As of this writing, the long-term capital gains rates are 0%, 15% or 20%, depending on the amount of your net long-term capital gains plus your ordinary income.

Also, you'll have to charge interest on the note according to the IRS minimum interest rate guidelines and pay ordinary income tax on those interest payments. Then again, any capital gains and ordinary income tax you pay further reduces the size of your taxable estate.

A WORTHWHILE APPROACH

An installment sale is an approach worth exploring for anyone with high-value assets. It can play a key role in your estate plan and it may help keep a family-owned business in the family.

Of course, this simple technique isn't right for everyone. To determine whether an installment sale is the best path for you and your business — and to find out about other tax-smart options — please contact us. ■

A TAX BREAK FOR EDUCATORS GETS AN UPDATE

Teachers who are setting up their classrooms for a new school year often pay for some of their classroom supplies out-of-pocket. They can recoup some of that cost by taking advantage of a special tax break for educators. This deduction gained new importance after the 2017 passage of the Tax Cuts and Jobs Act (TCJA). For 2022, the deduction amount has been bumped up and the list of qualifying expenses has expanded.

THE OLD-SCHOOL WAY

Before 2018, employees who had unreimbursed out-of-pocket expenses could potentially deduct them if they were ordinary and necessary to the "business" of being an employee. A teacher's out-of-pocket classroom expenses could qualify. Those expenses were claimed as a miscellaneous deduction, subject to a 2% of adjusted gross income (AGI) floor. That meant that only taxpayers who itemized deductions could enjoy a tax benefit, and then only to the extent that their deductions exceeded the 2% floor.

For 2018 through 2025, the TCJA has suspended miscellaneous itemized deductions subject to the 2% of AGI floor. Fortunately, qualifying educators can still deduct some unreimbursed out-of-pocket classroom costs using the educator expense deduction.

THE NEW-SCHOOL WAY

Back in 2002, Congress created the above-the-line educator expense deduction. An above-the-line deduction is one that's subtracted from your gross income to determine your AGI. It can be claimed even by taxpayers who don't itemize deductions. This is especially significant because as part of the TCJA, the standard deduction has nearly doubled, and that means that fewer taxpayers now itemize deductions.

For 2022, qualifying elementary and secondary school teachers and other eligible educators (such as counselors and principals) can deduct up to $300 of qualified expenses. Two married educators who file a joint tax return can deduct up to $600 of unreimbursed expenses — limited to $300 each.

Qualified expenses include amounts paid or incurred during the tax year for books, supplies, computer equipment, related software, services, and other equipment and materials used in classrooms. The cost of certain professional development courses may be deductible. Also, protective items to prevent the spread of COVID-19 such as hand sanitizers, disinfectant and other items recommended by the Centers for Disease Control for this purpose are also deductible. However, homeschooling supplies and nonathletic supplies for health or physical education courses aren't deductible.

MORE DETAILS

Some additional rules apply to the educator expense deduction. If you're an educator or you know one who might be interested in this tax break, please contact us for more details. ■

TAX CALENDAR

July 15

If the monthly deposit rule applies, employers must deposit the tax for payments in June for Social Security, Medicare, withheld income tax and nonpayroll withholding.

August 1

Employers must file Form 941 for the second quarter (August 10 if all taxes are deposited in full and on time). Also, employers must deposit FUTA taxes owed through June if the liability is more than $500.

August 15

If the monthly deposit rule applies, employers must deposit the tax for payments in July for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 15

Third quarter 2022 estimated tax payments are due for individuals, calendar-year corporations, estates and trusts.

- If an extension was obtained, partnerships should file their 2021 Form 1065 by this date.
- If an extension was obtained, calendar-year S corporations should file their 2021 Form 1120S by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in August for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 30

Calendar-year trusts and estates on extension must file their 2021 Form 1041.

MEDICARE PREMIUMS MAY LOWER YOUR TAXES

Do you pay premiums for Medicare health insurance? If so, you may be able to combine them with other qualifying health care expenses and claim them as an itemized deduction for medical expenses on your individual tax return. This includes amounts for "Medigap" insurance and Medicare Advantage plans, which cover some costs that Medicare Parts A and B don't cover.

For 2022, you can deduct medical expenses only if you itemize deductions and only to the extent that total qualifying expenses exceeded 7.5% of your adjusted gross income. The Tax Cuts and Jobs Act nearly doubled the standard deduction amounts for 2018 through 2025. For tax year 2022, the standard deduction amounts are: $12,950 for single filers; $25,900 for married joint-filing couples; and $19,400 for heads of households. Higher standard deductions mean that fewer individuals are itemizing deductions. However, if you have significant medical expenses, including Medicare premiums, you may be able to itemize and enjoy some tax savings.

Important note: Self-employed people and shareholder-employees of S corporations can generally claim an above-the-line deduction for their health insurance premiums, including Medicare premiums. That means they don't need to itemize to get the tax savings from their premiums.

In addition to Medicare premiums, you can deduct a variety of other medical expenses, including those for ambulance services, dental treatment, dentures, eyeglasses, hospital services, lab tests, qualified long-term care services and prescription medicines. You may also qualify to deduct transportation costs to get to medical appointments. If you drive, track your mileage and you can deduct 18 cents per mile for 2022.

Contact us with your questions about Medicare coverage options or claiming medical expense deductions on your personal tax return. We can help you identify an optimal overall tax-planning strategy based on your personal circumstances. ■