CONTRA COSTA TIMES

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Timing most important for severance payout

Q: My husband, 58, is thinking about retiring. His employer is offering a $250,000 severance package if he retires between March and June. We can receive the severance pay in a lump sum or 18 monthly payments. He has been told that the lump sum is taxed as a bonus, but the monthly payments are taxed as income -- I am unsure if this is correct.

Also, I am planning to retire and sell my home of 20 years. I have a very large gain on my home and wish to reduce my capital gains, if possible.

I have read that when your property is in a trust, the trust can "pay" the property owner for the property in the form of a private annuity. The trust then sells the property and there are zero taxes, since the property is in a private annuity contract. I can then choose to defer payments and won't pay capital gains until the annuity payments begin. Of course at that time, I would only pay a portion of capital gains in proportion to the number of years I receive the annuity payments.

Can I get the investment panel to give me their take on this?

-- Nanci Harrison, Danville

A Taking your severance as a lump sum or a stream of payments will have an impact on your taxes -- not because the payment is designated income or a bonus, but due to the possible timing of payments over two different tax years.

A bonus is treated just like ordinary income on your tax return, but the withholding rules for your paycheck are different. You can designate how much of your paycheck you want your employer to withhold for your state and federal taxes. A bonus is subject to higher withholding limits than your regular salary because it is treated as supplemental wages and subject to 25 percent withholding.

When you file your income tax return, all your income (regular pay and bonus) are treated the same.

What matters is the timing of the payments. Would you owe less tax if you received the windfall all in one tax year or if you split it into two? If you take the lump sum, then you may be taxed at a higher income tax rate. If you spread the payments out into another year, it will be subject to another year's round of Medicare and social security tax.

You should consult a financial planner or tax professional to determine which option is better for you.

Now, onto your second question. A private annuity trust (PAT) is a fairly new tax planning strategy. It is a very complicated and costly strategy to set up and maintain, and is also irrevocable -- once entered into, it cannot be changed.

A PAT is used to spread out the gain on a sale of highly appreciated property and provide the owner with a steady stream of income for life. You are still paying the capital gain taxes, but just spreading it

out. It also removes the asset from the owner's estate so it is not subject to estate taxes.

Warning: Before you make the decision to implement this strategy, it is essential to review your income tax and estate tax situation as well as your income needs in retirement. This strategy is only effective in cases in which taxable gains are well over $1 million and there are estate planning issues.

In most cases, the costs and the lack of flexibility makes the PAT a poor solution with minimal potential tax deferral benefits.

The first step is to estimate the tax impact of selling your home if you do not use the PAT.

Start with calculating how large the taxable gain will be on your home. Gain is computed by subtracting your basis from the sale price of your home. Basis is computed by adding up the original purchase price of your home, the costs of buying and selling the home, and the costs of any improvements you've made to your home over the years.

After you subtract your basis from the sale price, you also get an exemption. For your primary residence you get to reduce your gain by $500,000. The remaining portion of the gain is your taxable long-term capital gain. It will generally be taxed at the more favorable federal capital gains rates (maximum rate is 15 percent).

You'll also owe taxes at the state level. The tax ramifications of the sale on your total tax return may be complicated, depending on your income level and other investments, so it is important that you seek professional help.

After you confirm your taxable gain and the taxes due, you can begin to assess if the PAT is a reasonable strategy for you.

If your taxable gain is less is $1 million, this probably isn't the strategy for you. Instead of selling your home, you transfer it to a PAT -- the trust would sell your home and place the funds in trust.

You can opt to receive up front the amount that represents your cost basis plus your exemption. You would then receive the rest of the funds as a stream of payments called an "annuity" over the rest of your life. The payments are determined based on interest rates and IRS tables that estimate your life expectancy.

You do not pay capital gains taxes at the time of the sale. Instead, the capital gain taxes are spread over the annuity payment.

The annuity payments have three components for tax-planning purposes: a non-taxable return of basis; capital gains; and interest taxed at income tax rates.

If you outlive your life expectancy, then your annuity payment will become 100 percent taxable at income tax rates because you will have recouped all of your basis and capital gains. If you die before you reach your life expectancy, the trust will have to pay any remaining capital gains taxes.

You may defer the beginning of the annuity payments up until age 701/2, but the payments will have to be larger when you eventually begin receiving them because your life expectancy will be shorter. You would be receiving large capital gain distributions for the last 15 years of your life with no way to plan around them -- and there is no way to guarantee what capital gain tax rates will be at that time.

Basically, the IRS wants to ensure you will still pay all the capital gains taxes on the sale of your home, the PAT simply spreads the tax payment over a number of years.

Here is an important catch: You cannot have any control over the trust, nor over how the funds are invested. You can only choose a trustee -- after that, your hands are tied.

Aside from income tax considerations, there may be estate tax issues related to the sale of your home.

Do you have a very large estate that will be subject to estate taxes at your death?

When you and your spouse die, the annuity payments cease and the annuity becomes null and void, leaving nothing in the estate. The assets left in the trust will pass to the beneficiaries completely free of estate and gift taxes.

The downside is, each annuity payment you receive is included in your estate. If you live past your IRS-determined life expectancy, the entire value of your home plus interest would be back in your estate.

Another important question is, what are your income needs in retirement?

If you are like many Californians you have a large gain on your house but perhaps not enough saved for retirement. In years when you need extra money, your annuity payment may be insufficient. You will not have the ability to withdraw extra money from the trust. At the same time, each payment you receive will be taxed at capital gains rates and a portion will be taxed at income tax rates.

If you outlive the IRS's estimates then the annuity payments are 100 percent taxable at your income tax rates and you can't stop them. If you had sold your home and paid the capital gain taxes and invested the principal, then you would be paying primarily just capital gain taxes which are lower than income tax rates.

If your estate is less than $4 million (if married), your taxable gain from the sale of your residence is less than $1 million and you have few other assets saved, you may do better to sell your home and invest the proceeds yourself. Then you can withdraw only the money you need each year and most of the gains in your account will be taxed at the more favorable capital gains rates rather than income tax rates.

Remember: it is essential that this complicated strategy be set up correctly or you will lose the tax benefits it was designed to provide.

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