CPA

Client Bulletin

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

Calculating Retirement Needs

July 2017

A staple in retirement planning is the search for "your number." That is, how much money do you need to accumulate in savings and investment accounts so you can afford to stop working? Life expectancy is increasing, so the amount you have when you retire might have to last for decades.

To find the number, you can start with a target for cash flow in retirement. Then determine how much you can expect from all anticipated sources of income: Social Security, a pension, rental income from investment property, and so on. The gap will probably be filled from your financial resources.

Example 1: Linda Morgan, age 52, hopes to retire at 65. Linda expects to need about $75,000 a year for a comfortable retirement, with approximately $25,000–$30,000 coming from Social Security. She will not receive a pension from any employer and has no other obvious source of retirement income. Therefore, Linda will need about $45,000–$50,000 a year from her savings and investment accounts.

Doing the math

How can Linda find "her number," the amount of financial assets she'll need to generate $45,000–$50,000 a year in retirement? One tactic is to go online, where she'll find many retirement calculators to crunch the numbers. Social Security, for instance, has a "Quick Calculator" at ssa.gov/OACT/quickcalc/ to help you estimate future payouts from that source.

Many other websites offer more comprehensive retirement calculators. Frequently, they allow people to enter their personal information, then make various adjustments to future plans to see what methods might increase their chances for financial security after the paychecks stop.

Example 2: Linda uses a retirement calculator provided by the AICPA at www.360financialliteracy.org/Calculators/Retirement-Planner. She enters the information from example 1 and other requested data into the calculator. In this hypothetical illustration, Linda is single, earning $100,000 a year, and saving 15% of her earnings for retirement. Her future

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What's Inside

Exporting Energy

From January to February 2017, U.S. oil exports jumped by 35% to a record high of over 1 million barrels per day.

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Trusted Advice

Tracking Tax Efficiency

- An investment's tax efficiency can be measured by its tax efficiency ratio. This shows how much of an investment return the investor keeps after taxes: after-tax return divided by pre-tax return.
- Say Jim Jones invests $100,000 in ABC Corp. stock. The stock produces an annual return of $10,000 and generates $2,000 in tax.
- ABC has a tax efficiency ratio of 80% ($8,000 after-tax divided by $10,000 pre-tax).

expectations include salary increases (2% a year), investment returns (6%), inflation (3%), and living until age 95. Linda has $300,000 in current retirement savings.

Changing plans

The good news for Linda is that, with the inputs listed in example 2, her retirement savings will top $880,000 by the time she retires at age 65. The not-so-good news is that Linda's retirement savings will run out at age 83 if all of those expectations are met.

Fortunately, online calculators allow you to modify the data you enter and view the projected results. Some options for Linda include the following:

- **Increase her savings rate from 15% to 20%.** That would extend her retirement savings to age 86.
- **Decrease her desired retirement income from 75% to 70% of current income.** Again, her retirement savings would last until age 86.
- **Delay retirement from age 65 to 67.** This would allow her savings to last until age 90 because Linda would have two more years of earnings, boosting her nest egg over $1 million and taking away two years of relying on her portfolio for support. (Annual Social Security payouts would also increase.)

What if Linda were to do all of the above? Work until age 67, save 20% of her income, and live on 70% of her current earnings in retirement? Now the calculator shows Linda retiring with nearly $1.15 million, tapping her portfolio until age 95, and having nearly $475,000 of portfolio assets remaining.

Fine tuning

With such calculators, there are countless modifications you can make to wind up with a satisfactory plan, at least on paper. In addition, you can go back to the calculator every year or two and update the data to see your current status, as well as make any indicated changes in your retirement plans. As you can see, retirement calculators provide a valuable service, enabling pre-retirees to make informed decisions about working, saving, and spending.

Nevertheless, these calculators may not be able to pinpoint your specific situation, including any plans to work part-time or tap home equity. Our office can go over retirement calculator results with you and suggest possible changes to enhance accuracy. We can also look at your plans in terms of pre-tax and after-tax cash flows, which may provide an even clearer picture of your retirement finances.■

Taxable Versus Tax-Deferred Accounts

Some people do all of their investing in an employer-sponsored retirement plan where earnings are untaxed until withdrawn, and perhaps in an IRA as well. Withdrawals are generally taxed at ordinary income rates, which now go up to 39.6%.

Conversely, others have taxable accounts as well; each year, income tax is due on investment interest, dividends, and net capital gains in these taxable accounts. Some dividends and gains qualify for favorable rates, currently no higher than 20%. (Taxpayers who are subject to the 3.8% surtax on net investment income might actually owe 23.8%.)

Therefore, investors with a foot on both sides of the tax-now-or-tax-later line must make some decisions about their savings and investments. Which types of assets go into tax-deferred territory and which assets work better in taxable accounts? Making informed decisions can help you substantially in long-term results from your investments after tax.

Financial advisers and investment managers may have differing preferences in this area. Stocks inside retirement accounts and bonds outside? Bonds inside and stocks outside? There are no universal rules to follow and there are many factors to consider when making decisions about asset location. The "correct" mix may vary from investor to investor. Nevertheless, some basic principles can help you in this decision.

Liquidity

Emergency funds should be held in taxable accounts where you can reach them if the money is needed. That's also the case if you're saving for a major outlay, such as a home purchase or higher education. With the money in a taxable account, you can access the funds without owing ordinary income tax or worrying about a 10% early withdrawal penalty before age 59½.

Historically, liquid dollars were often held in bank accounts and money market funds. Yields on these instruments are so low now that investors may be using short-term bond funds or something similar to get some return on their money. Even so, if you are holding assets for use in emergencies or for an anticipated expense, they probably should be in a taxable account.

Availability

If you're saving for retirement in a 401(k) or similar plan, you'll be limited to the menu options presented to plan participants. Therefore, if your investment plan calls for an allocation to precious metals, you may have to use a taxable account for a fund that holds mining stocks, say, or a gold bullion ETF. The same could be true if you want to own an emerging markets bond fund or a small company growth fund, if no acceptable option in these categories is on your plan's menu.

Note that you can hold virtually anything in an IRA (except for life insurance and certain collectibles). Thus, your IRA could be used for hard-to-find assets.

Tax magnitude

Assuming that liquidity and availability are not concerns, tax treatment will drive the decision about where to hold specific assets. One aspect to consider is the expected return of an investment. The lower that return, the lower the annual tax bill, and the smaller the advantage of deferring that tax. On the other hand, deferring large amounts of tax each year may be a good reason for using a tax-deferred account for a given asset.

Example 1: Martin Miller's asset allocation includes a high-quality corporate bond fund, now yielding around 2%. The fund seldom distributes capital gains to investors, so Martin expects to owe tax on that 2% payout this year and in succeeding years. In his 25% tax bracket, Martin would save 0.5% of his investment (25% bracket times the 2% yield) per year. That much tax deferral might not be enough to warrant holding the fund in a tax-deferred plan, so a taxable account could be the better choice.

Suppose that Martin's asset allocation also includes a high-yield corporate bond fund, now yielding 5%, which has a history of distributing taxable gains to shareholders. In his 25% tax bracket, Martin can expect to save 1.25% or more in tax each year. This fund could be a better choice for his tax-deferred retirement account.

Tax efficiency

As mentioned, municipal bonds and muni funds often generate no income tax, so they are very tax efficient, whereas high-yield bond funds might generate steep annual tax bills, making them tax inefficient. As a general rule, you should try to hold assets with the least tax efficiency in your tax-deferred retirement plan.

Example 2: Phil Grant has an asset allocation that includes stock market index funds and funds that hold real estate investment trusts (REITs). Equity index funds tend to be tax efficient because they may have modest dividend payouts and seldom generate taxable gains, so Phil holds these funds in his taxable account. REIT funds may be tax inefficient, with relatively high dividends that might be fully taxable, as ordinary income. Phil puts his REIT funds into his tax-deferred account to avoid the annual tax bite.

Our office can go over the tax efficiency of investments you're considering to help you decide on the best location. As the saying goes, you shouldn't let the tax tail wag the investment dog. If you have a plan regarding which investments will help you attain your goals, you can get an added return when you know where to hold them. ■

Small Companies Can Do Well While Doing Good

The federal Small Business Administration reports that about 75% of small business owners donate some portion of their profits to charity each year. The average contribution is around 6% of earnings. Fulfilling philanthropic intentions has emotional rewards, and there can also be tangible benefits for your business. The more you align your charitable intentions with your own passions, the greater the potential payoff.

One possible advantage is that your company's employees may truly get involved in your charitable activities. Consequently, they may become more productive overall and stay at your firm longer.

Example: Janice Peters is the primary owner of a company that does printing and mailing. She is also heavily committed to animal rescue; she owns multiple dogs and cats that have been rescued from shelters, she temporarily fosters other animals for eventual adoption, and she contributes to animal welfare charities. Janice's donations come from her business profits and from her personal funds.

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To get her employees involved, Janice provides financial incentives for pet rescue and volunteering in shelters. Selected departments have days for bringing their well-behaved pets to work, and Janice's company sponsors relevant fundraisers. The result of these efforts, Janice has discovered, has been the ability to hire likeminded people and exceptional retention of valued workers.

Such opportunities to mix business, charity, and advocacy are unlimited. A business owner who is a sports fan might back a youth team, for instance. If the cause you support relates to the environment, you might mention that your company is supporting a sustainability initiative, an idea that will resonate with many people. Yet another approach is to allow employees to have a voice in choosing charities the company will support.

Spreading the word

Business benefits from charitable endeavors can be external as well as internal. Janice highlights her company's animal rescue activities on its website and through its social media presence, all of which makes her company memorable to potential customers. She also sits on the board of some local animal rescue groups, where the other board members include business owners who share her interest. When they need printing and mailing, Janice's company often comes to mind.

Tax treatment

Companies may very well reap tax benefits from their donations. C corporations can deduct charitable contributions against business income. Pass-through entities (S corporations, partnerships, LLCs) may pass through such deductions to business owners who itemize deductions on Schedule A of their personal tax returns. Note that if your company receives a direct benefit from its philanthropy—say you support a Little League team that advertises your company's name on its uniforms—the outlay may be deductible as a business expense rather than as a charitable contribution.

Services provided by you or your employees are not deductible. However, expenses involved while volunteering may count as a charitable contribution. Donations of property might be deductible at fair market value; special rules apply to donations from inventory.

Our office can help you determine whether a philanthropic outlay is a business expense or a charitable contribution. We can also explain how to obtain an acceptable valuation for any goods you might be donating. Maximizing the tax benefits will help your business get the most from its efforts to help others.■

TAX CALENDAR

JULY 2017

July 17

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 2017. 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 2016.

AUGUST 2017

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2017. 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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tax report

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Telecommuting Employees: Are Your Home Office Expenses Deductible?

If you are an employee who telecommutes, you may be eligible to deduct some of your home office expenses. But you must first comply with certain rules.

Employer's Convenience

The first requirement is that your use of the home office be for the convenience of your employer. You may be able to satisfy this test if your employer requires you to have a home office and to work there, if the home office is necessary for the operation of your employer's business, or if the home office allows you to perform your work duties properly. You will not be able to satisfy this requirement if the home office is for *your own* convenience.

Business Use

The next step is to look at your use of the space. Generally, the office must be the *principal* place of business for your work as an employee.

Even if the office is not your principal place of business, a deduction may be available if you use the office space as a place to meet with patients, clients, or customers of your employer. An office in an unattached structure on the same property as your home and used in connection with your work may also qualify.

Exclusive and Regular Use

Last, you must use the space *exclusively and regularly* as your home office. The rule requires that the space be used as your home office *only*. However, the area doesn't need to be a

separate room — it may be a portion of a room, provided it otherwise meets the relevant tests.

Calculating the Deduction

There are two potential ways to calculate the amount of your home office expenses: the "actual expense" method or the "simplified" method. The actual expense method generally involves dividing various expenses of operating your entire home between personal and business use and claiming for deduction only those expenses that pertain to your home office. The simplified method entails taking the square footage of the home office (up to 300 square feet) and multiplying it by $5.

An employee's unreimbursed home office expenses are taken as an itemized "miscellaneous expense" deduction. They are therefore deductible only to the extent that they, when combined with other miscellaneous expenses, exceed 2% of your adjusted gross income. ■

S Corp Shareholders

An S corporation must observe certain requirements to preserve its status as an S corporation. These include having only one class of stock and no more than 100 shareholders at any time. In addition, each shareholder generally must fall within specifically defined categories:

- Individual U.S. citizens or residents
- Decedents' estates
- Bankruptcy estates
- Certain tax-exempt charitable organizations
- Specific types of domestic trusts (grantor trusts, voting trusts, certain testamentary trusts, Qualified Subchapter S trusts (QSSTs), electing small business trusts (ESBTs), and tax-exempt qualified retirement plan trusts)

Transfer of shares to an ineligible shareholder will cause the S corporation to automatically lose its eligibility. As a precaution, provisions in the corporation's charter, bylaws, and/or the individual shareholder agreements will typically prohibit transfers to ineligible entities.

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short takes

Medical Expense Deduction for Home Improvements

Potentially deductible medical expenses *include* expenses incurred to make permanent home improvements for the primary purpose of providing medical care for you, your spouse, or your dependent. Although the deductible amount is reduced by any amount by which the improvement increases the value of the property, the IRS presumes that certain improvements do *not* increase the value of the residence. These include entrance ramps, widened doorways, support railings installed in bathrooms, etc. Deductible medical expenses are subject to a deductibility threshold equal to 10% of adjusted gross income.

Depreciation Limits on Autos, Light Trucks, and Vans

The IRS has announced the depreciation limits for business automobiles, light trucks, and vans first placed in service in 2017. Four sets of limits apply — two sets for passenger autos and two for light trucks and vans. For 2017, the limits are as follows: autos — \$3,160 (first year of service); \$5,100 (second year); \$3,050 (third year); and \$1,875 (each succeeding year). The respective limits for light trucks and vans are \$3,560, \$5,700, \$3,450, and \$2,075. Where the auto, van, or truck is eligible for bonus depreciation, the limit that applies to the first year of service (2017) is increased by \$8,000.

Hiring Your Child for the Summer

If you own your own business, you might want to consider employing your child for the summer. Not only will your child have the opportunity to learn some valuable workplace skills, but you might be able to reduce your taxes as well.

Potential Tax Savings

The wages you pay your child can qualify as a deduction from your business income, which would otherwise be taxed at your own rates. In addition, your child would be able to offset the wage income with his or her own standard deduction (\$6,350 in 2017) and then have the rest taxed at his or her potentially lower rates. For 2017, a 10% rate applies to a single individual's taxable income of \$9,325 or less.

Requirements

For your child's wages to be deductible, the work must be done in connection with your trade or business, and the services your child performs must be reasonable in relation to the wages paid. You should be able to document that the usual conditions of employment — duties, regular hours, and wages — were agreed on and adhered to just as with any other employee.

Another Possible Advantage

If you are a sole proprietor — or operate a partnership with only your spouse — wages paid to your child would be exempt from Social Security and Medicare (FICA) taxes until your child turns 18 and from federal unemployment taxes until age 21. ■

Deducting Mortgage Refinancing Costs

Many homeowners are considering refinancing their home mortgages before rates increase further. Following are some of the general tax rules for deducting the charges associated with refinancing.

Interest

Interest on a refinanced loan will be deductible to the extent the loan refinances up to \$1 million of *home acquisition debt,* plus up to \$100,000 of *home equity debt* (limits are \$500,000/\$50,000 for married taxpayers filing separately). Home acquisition debt is a mortgage loan used to buy, build, or substantially improve a first or second home. Home equity debt is generally any other debt secured by a first or second home.

These limits, however, operate separately. For example, if a couple had \$500,000 remaining in principal on their original mortgage loan and then refinanced that debt with a new \$750,000 mortgage, they would be able to deduct the interest on only \$600,000 (\$500,000 plus \$100,000). Interest on the remaining \$150,000 would be nondeductible because it exceeds the combined limits.

Points

Points paid for the refinancing of a loan that does not exceed these limits are deductible over the life of the loan. Any points paid in connection with the portion of a mortgage used to finance home improvements may be deductible in the year of the refinancing.

Penalties and Fees

Generally, a prepayment fee paid on the old mortgage is considered a payment of interest on that mortgage and, therefore, is deductible in the year it is paid.

However, other fees, such as those for credit reports, appraisals, and loan origination, are not deductible. ■

Small Business Retirement Plans

Whether you've recently started a business or have been operating one for some time, setting up a retirement plan can be beneficial to both you and your employees. Besides providing strong tax incentives to defer income and save for retirement, retirement plans can help you reward and retain employees. Employer contributions are tax deductible, within certain limits.

SEP Plans

A Simplified Employee Pension (SEP) plan is relatively easy and inexpensive to set up and administer. You have complete discretion in determining whether or not to make annual contributions. To set up a SEP plan, you establish SEP individual retirement accounts (IRAs) for yourself and your employees. Qualifying contributions are tax deductible and not included in the employees' current income. Taxes are deferred until money is withdrawn from the plan.

The maximum amount of your contribution for each employee is the lesser of 25% of annual compensation or $54,000, and no more than $270,000 of compensation may be considered (for 2017). There is a special computation for figuring the maximum contribution to a self-employed individual's own SEP account. Additionally, contributions may not discriminate in favor of highly compensated employees.

Solo 401(k) Plans

A solo 401(k) plan may be a suitable option if you work alone or employ only your spouse. The chief advantage of a solo 401(k) plan is that it allows you to save as both the employee and the employer. As an employee, you may defer the first $18,000 of your compensation (or $24,000 if you're age 50 or older). As the employer, you may also make a profit sharing contribution (subject to tax law limits). The combination of all contributions — including deferrals, profit sharing, and any others — may not exceed the lesser of (1) 100% of your compensation or (2) $54,000 ($60,000 if you're age 50 or older). Contribution limits are adjusted for inflation annually.

SIMPLE IRAs

Like a SEP, a Savings Incentive Match Plan for Employees (SIMPLE) IRA plan entails setting up IRAs for yourself and each participating employee. You and your employees can elect to defer compensation to the plan (no more than $12,500 in 2017; $15,500 if age 50 or older). Additionally, employers must make an annual contribution by either (1) matching employee contributions up to 3% of pay (a lower 1% match is allowed in certain years) or (2) contributing 2% of pay for each employee who's eligible to contribute, even if the employee chooses not to contribute.

A SIMPLE plan generally isn't an option if you have another retirement plan or more than 100 employees.

Defined Benefit Plans

The chief advantage of a defined benefit plan is the high deduction ceiling, which allows owners to rapidly build up their retirement benefits. For 2017, deductible contributions may allow for an annual benefit that will, when the participant reaches 65, equal the lesser of $215,000 per year or 100% of the participant's average compensation for his or her three highest consecutive years of active plan participation.

The disadvantages of this type of plan include the funding and administrative requirements. Complicated actuarial formulas must be used to calculate the contributions to be made each year.

Tax Credit To Start a Plan

Eligible small employers that set up a new retirement plan may claim a credit of as much as $500 for each of the first three plan years. The credit can help defray plan start-up and employee retirement-related education costs. All of the plans mentioned above can qualify.

We would be happy to review your retirement plan options with you and help you choose a suitable plan. ■

Calendar of Filing Dates

JULY

31 Employee Benefit Plan Sponsors: File 2016 Form 5500 Annual Return/Report of Employee Benefit Plan. If your plan is not a calendar-year plan, file the form by the end of the seventh month after the plan year ends.

31 Employers: File Form 941, Employer's Quarterly Federal Tax Return; quarterly deposit due.

AUGUST

10 Employers: Extended due date for Form 941, if timely deposits were made.

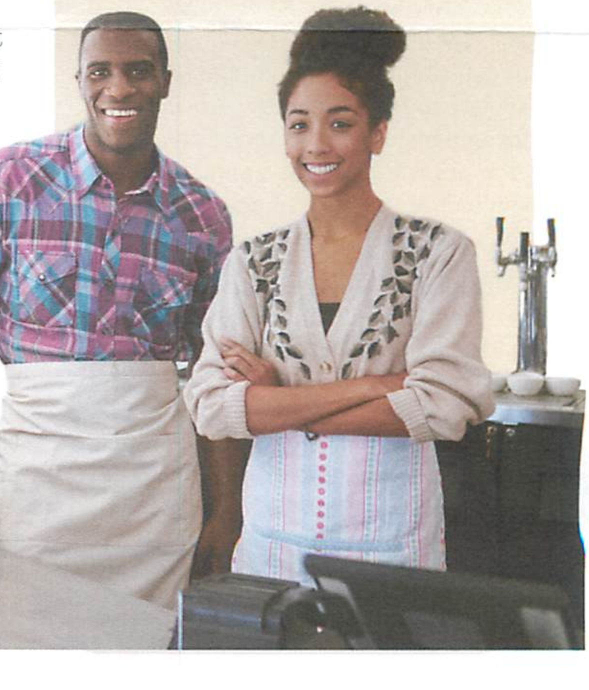
SEPTEMBER

15 Individuals: Third installment of 2017 estimated tax due; file Form *1040-ES*.

15 Partnerships: Last day for filing 2016 return (Form 1065) by a calendar-year partnership that obtained a six-month extension.

15 S Corporations: Last day for filing 2016 income tax return (Form 1120S) by a calendar-year S corporation that obtained an automatic six-month filing extension.

15 Corporations: Due date for depositing the third installment of estimated income tax for 2017 for calendar-year corporations.



Taxation of Social Security Benefits

If your income exceeds certain tax law thresholds, a portion of your Social Security retirement benefits will be subject to federal income taxes. Here's an overview.

The Thresholds

The IRS uses your "provisional income" to determine the percentage of benefits subject to tax. Generally, provisional income includes your modified adjusted gross income *plus* tax-exempt interest and half of the Social Security benefits you received during the year.

Individuals with provisional income between $25,000 and $34,000 and married couples (filing jointly) with provisional income between $32,000 and $44,000 are taxed on up to 50% of their benefits. And up to 85% of benefits are taxable for individuals with provisional income over $34,000 and married couples with provisional income over $44,000.

Because these thresholds are not inflation-adjusted, more taxpayers tend to be affected as overall income levels increase. Government research projects that between 1998 and 2014, the percentage of Social Security beneficiaries affected by income taxation of their benefits nearly doubled — from 26% to 49%.*

Minimizing the Tax Bite

If you are collecting Social Security, certain actions, such as taking a large retirement account distribution or recognizing capital gain from the sale of a second home, could push your provisional income past a threshold and/or increase your overall tax rate.

To help lessen the impact of taxes on your benefits, you might consider:

■ Structuring a vacation home sale or traditional individual retirement account distribution so that income is received over more than one year.

■ Liquidating assets in a taxable investment account rather than a retirement account if it will mean recognizing only a small capital gain rather than a larger addition to gross income. ■

* *Social Security: Calculation and History of Taxing Benefits,* Congressional Research Service, October 2016