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Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor℠

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Are Tax Refunds Good or Bad?

Few people pay exactly the correct amount of income tax during the year. When you filed your return for 2014, you probably discovered that you paid too little (and owed more tax) or paid too much (and could request a refund). Typically, refunds are due to employees who have too much tax withheld from their paychecks.

Example 1: Arlene King is paid twice a month. From each paycheck, her employer withholds $1,000 for federal income tax, so Arlene's tax payments for 2014 were $24,000. When Arlene filed her 2014 tax return, she learned that her tax obligation for last year was $21,000. Thus, Arlene could request a $3,000 tax refund.

Does over-withholding and getting a refund in this manner make sense financially? That depends on a taxpayer's situation.

Positive features

The advantage of getting a tax refund is, well, who wouldn't want to receive a large check from the federal government? Moreover, federal income tax refunds aren't taxable. (A state or local tax refund may increase the tax you'll owe.)

Thus, Arlene could decide to use her $3,000 refund check to invest or to pay down debt or to make a special purchase. In effect, her $3,000 of excess tax withholding becomes a form of forced saving, which she can utilize every year when the check comes in.

Now for the negatives

On the other hand, having too much money withheld for income tax has been likened to making an interest-free loan to the IRS. It's your money—you earned it—so why wait for months to get your hands on it? This strategy can be especially unappealing if your over-withholding results from a major change in your life.

Example 2: In early 2014, Bianca and Craig Carter bought a house, using a large mortgage for the purchase. Bianca left her job to stay home with their young child. Thus, the Carters had lower income and higher deductions than in 2013, resulting in a smaller tax bill.

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What's Inside

Home Trend

U.S. home ownership has declined from 69.1% in 2005 to 64.8% in 2014.

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However, Craig did not adjust his tax withholding at work. Thus, he paid more tax than necessary throughout the year. It's true that the Carters got back the overpayment with a 2015 tax refund, but they went through 2014 with less cash flow than required, forcing them to struggle to cover the costs of a new home and a growing family.

Winning the numbers game

If you feel that you need the disciplined forced savings of over-withholding, then relying on an annual tax refund may make sense. Conversely, if you prefer to get your money as you earn it, you can reduce the amount withheld by filling out IRS Form W-4, Employee's Withholding Allowance Certificate, and submitting it to your employer. Our office can help you fill out Form W-4 so you get the right amount withheld, avoiding either a large refund or a large tax obligation with next year's tax return. ■

Trusted Advice

Adapting allowances

- On IRS Form W-4, employees can claim a number of personal allowances.
- The more allowances you claim, the lower your withholding and the more income you'll receive with each paycheck.
- Two income couples can calculate the total number of allowances to which they're entitled.
- For such couples, withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the higher earning spouse.
- The lower earning spouse then can claim zero allowances on his or her Form W-4.

Above-The-Line Tax Deductions

Going over your 2014 tax return can help with future tax planning. For instance, you should take a close look at the adjustments to income you reported on the bottom of page 1 of your Form 1040 or Form 1040A. These adjustments, which reduce the taxable income you'll declare, are known as *above-the-line* deductions—you enter them just above the last line on the page, where you report your adjusted gross income (AGI).

Above-the-line deductions offer two key advantages. First, you are allowed to take the page 1 deductions regardless of whether you itemize deductions on Schedule A of your tax return.

Second, above-the-line deductions reduce your AGI and, in many situations, also reduce your modified adjusted gross income (MAGI). A lower AGI or MAGI, in turn, can provide tax savings on various tax return items. For instance, most taxpayers now can deduct medical expenses only to the extent they exceed 10% of AGI. With a lower AGI, you may qualify for a larger itemized medical deduction.

Looking at the lineup

There are more than a dozen categories of above-the-line deductions. They include:

IRAs. You can make contributions for 2015 until April 15 of 2016. Although many taxpayers won't be able to deduct IRA contributions because of income and participation in an employer plan, some people might qualify for deductions.

Example: Alice Baker is a home-maker with no earned income in 2015; her husband, Carl, is employed and participates in his

Did You Know?

The federally sponsored Pension Benefit Guaranty Corp. provides benefits to participants in terminated private sector plans. The maximum guaranteed benefit for a 65-year-old retiree getting a single-life annuity is $60,136 in 2015. For joint-and-50% survivor annuities, the maximum payment this year to a 65-year-old couple is $54,123.

Source: pbgc.gov

company's retirement plan. The couple's MAGI for 2015 is over $118,000, so Carl cannot make a deductible IRA contribution for this year. However, if the couple's 2015 MAGI is less than $183,000, Alice can make a fully tax deductible contribution of up to $5,500 ($6,500 if she is 50 or older).

Other retirement accounts. Contributions to such accounts also reduce your AGI. Moreover, if you have self-employment income in 2015, you can contribute to a simplified employee pension (SEP) plan until the due date of your 2015 tax return. Thus, with a filing extension, the SEP deadline can be October 17, 2016. You generally can contribute nearly 20% of your self-employment income, with a SEP contribution cap of $53,000 for 2015.

Health Savings Accounts (HSAs). With certain high deductible health insurance plans, you can make tax-deductible contributions to an HSA; you can tap these accounts for health care costs without owing income tax. Again, if you qualify for a 2015 HSA contribution, the deadline is April 15, 2016. Contribution limits go up to $7,650 for someone age 55 or older with family coverage.

Self-employed health insurance. Self-employed individuals can deduct the premiums paid for any medical insurance, dental and long-term care insurance. Policies also can cover the worker's spouse, dependents, and non-dependent children who were under age 27 at the end of the previous year. What's more, the IRS has said that Medicare premiums paid by self-employed individuals can be taken as an above-the-line adjustment to income. There are some conditions that must be met to claim this deduction; our office can help you report the appropriate amount.

Alimony. Amounts you paid to your spouse or a former spouse under a divorce or separation decree that qualify as alimony for tax purposes are deductible here.

Other above-the-line deductions include job-related moving expenses and interest payments on student loans. Our office can help you make the most of the various above-the-line adjustments to income on your 2015 tax return. ■

Trusted Advice

Self-Employment Health Insurance

You may be able to deduct the premiums you paid if

- you had a net profit from self-employment, reported on a Schedule C or a Schedule F;
- you had self-employment earnings as a partner;
- you used an optional method to figure your net earnings from self-employment on Schedule SE; or
- you were paid wages as a shareholder who owns more than 2% of an S corporation.

Holding Stocks in Retirement Accounts

The stock market goes up and, as we've learned, it goes down. Despite the volatility, stocks have been excellent long-term investments for many decades, and there's no reason to think that the future will be different. Regular investing in equities, through bull and bear markets, probably should be part of your strategy for building an investment portfolio you can tap in retirement.

Many people do virtually all of their investing in 401(k) and similar employer-sponsored retirement plans. They often roll those accounts into IRAs, continuing the tax deferral. If you're in that category, you'll do your stock market investing inside your retirement account; you can decide what portion to allocate to equities.

Mixing your money

On the other hand, you may have both a tax-deferred retirement account and a taxable investment account. That is, in addition to your retirement accounts, you might have one or more accounts with brokerage firms or mutual fund companies where any investment income is taxed each year. In that situation, where do your stocks belong? Individual circumstances may dictate the decision.

Example 1: Jim Morgan is 33 years old with no plans to retire for at least 35 years. With such a long time horizon, Jim invests mainly in equities, where he expects the greatest long-term returns. Jim invests his 401(k) contribution in the stock market and also holds stock funds in his taxable accounts.

Other investors, especially those closer to retirement, may prefer to hold a mix of stocks, bonds, and other asset classes. Investors with such a diversified portfolio as well as taxable and retirement accounts must decide where to hold their stocks.

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Example 2: Barbara Owens, age 50, has a 401(k) account, a traditional IRA and a brokerage account. Her desired asset allocation is 50% in equities and 50% in fixed income. Barbara can choose among these accounts for holding her stocks.

Bigger buildup

The case for holding stocks inside a retirement account is straightforward: They have higher expected returns. Morningstar's Ibbotson subsidiary reports that large company stocks historically have returned around 10% a year for patient investors. If Barbara contributes a maximum $24,000 to her 401(k) in 2015 and puts that money into stocks that return, say, 9% per year, that contribution would grow to around $96,000 in 16 years. Invested in bonds that earn, say, 6% a year, Barbara's $24,000 contribution would grow to about $60,000 in 2031, which is when she plans to retire, roll her 401(k)into an IRA and start taking distributions.

Naturally, Barbara would rather have $96,000 in her IRA than $60,000. Keep in mind that difference is from one year's contribution. If Barbara keeps investing her 401(k) money in stocks, year after year, and stocks approach historic norms, her retirement fund would be much larger than it would be with bonds. To keep her desired asset allocation and moderate portfolio volatility, Barbara can contribute to bond funds in her taxable brokerage account.

Tax treatment

If projected returns from stocks are higher than they are from bonds, why not hold your stocks in tax-deferred territory? In a 401(k) account or an IRA, the higher returns can be compounded without an annual reduction for income tax.

However, holding stocks in a tax-deferred retirement account means giving up some key tax advantages. Under current law, stock dividends taken in a taxable account usually are taxed at only 15%; some taxpayers owe 0% on dividends, whereas a 20% tax rate applies to investors in the highest tax bracket. The same bargain tax rates apply to long-term capital gains realized in a taxable account. What's more, investors can take capital losses in taxable accounts—losses that can provide valuable tax advantages.

In a 401(k) or an IRA, taking capital losses won't provide any tax benefit. Moreover, any distributions from such retirement accounts will be taxed as ordinary income, at rates that now go up to 39.6%. (The tax rates mentioned may actually be higher, because of various tax code provisions.) What could have been bargain-taxed stock dividends and long-term gains may be transformed into fully taxed IRA distributions.

Looking ahead

Today's tax rates are meaningful, but what really will count are the tax rates in effect in the future, when you draw down your portfolio for retirement income. Perhaps you'll have a low tax rate then, without earned income, so paying ordinary income tax on IRA distributions won't be terribly painful. Alternatively, ordinary income tax rates may be much higher in the future, so the IRS' share of your stock market gains could be greater when you withdraw those profits from your IRA.

No one has a crystal ball about future personal income and tax rates. Nevertheless, you should keep the tax aspects in mind when you decide whether to hold your stocks and stock funds in a taxable or tax-deferred account. Our office can help you crunch the numbers, so you can make informed decisions. ■

Finding a Low-Tax State

Many people today are not tethered to a job location, so they can choose where to live. Those in this category range from retiring Baby Boomers, ready to relocate, to new graduates about to enter the work force. Others who can pick their place of residence include certain self-employed individuals and people who are employed but able to work remotely, thanks to today's technology.

If you can choose where to live, you might weigh many factors, from desirable weather to the proximity of family and friends. A low cost of living, especially when it comes to housing, also can play a role. Another key living cost will be the level of taxation you'd face in a given state.

Income taxes

When you think of taxes, income tax might be your primary concern. Some states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming) have no personal income tax, whereas New Hampshire and Tennessee tax only certain amounts of investment income. At the other end of the spectrum, many counties, cities, and school districts across the nation impose an income tax, in addition to state tax. For example, it's common for New York City residents to be in a combined (city and state) income tax bracket of over 10%.

That said, you should look closely at an area's complete income tax situation before crossing it off your list. Some states offer attractive tax benefits to retirees, including full or partial tax exemptions for Social Security benefits, pensions, and distributions from tax-favored retirement accounts such as IRAs. Thanks to federal legislation, people who relocate to a different state won't owe tax to their old state on retirement plan distributions. Seniors might owe little tax, even in a supposedly high-tax state, if they have scant earned income or taxable investment income.

In addition, the state or local income tax you pay might be deductible for federal income tax purposes, reducing the effective tax rate.

Example: Walt and Vicki Taylor are in the 25% federal tax bracket. This year, they pay 8% of their $100,000 taxable income in state and local income tax, taking an $8,000 itemized deduction for those outlays. By reducing their federal taxable income by $8,000, the Taylors save $2,000 in tax (the $8,000 deduction times their 25% federal tax rate), reducing their net state and local tax cost from $8,000 to $6,000, or 6% of their income.

That's a simplified example, as the actual calculation can be complicated. If the Taylors wind up owing the alternative minimum tax (AMT), they'll get no deduction for their state and local income tax payments, so their actual cost would be 8%. The same is true if the Taylors take the standard deduction, so they don't deduct their state and local taxes. Our office can help you determine the true income tax rates of a given area.

Other taxes

Although income taxes are certainly noticeable, you shouldn't focus solely on them. In most states and cities, you'll owe other types of taxes, which you should include in your comparison.

Previously, an example showed the Taylors owing $8,000 in state and local income tax. If the Taylors are homeowners, they could pay $10,000 or more in property tax, in some areas. Moving to a state with little or no income tax might not be a good choice if the area where you plan to buy a home charges extremely high property tax. Indeed, steep property taxes that increase in the future could make a retirement home unaffordable, forcing you to sell. As is the case with income tax, you should calculate the net cost of property tax payments, after any likely federal tax deduction.

Sales taxes also should be considered. Altogether, comparing taxes from one residential location to another can be complicated. Again, our office can help you estimate your tax burden in an area you're considering for a new home. Just keep in mind that taxes are only part of the cost of living at a particular address, and the total cost of living is merely one aspect to consider when deciding where to live. ■

Turn Relatives Into Employees to Reduce Taxes

High-income business owners may have noticed the impact of new tax laws when they prepared their 2014 tax returns. Those laws can be especially painful if your company is structured as an S corporation or a limited liability company (LLC), with all income reported on your personal return. Besides the recently added 39.6% top income tax bracket, your income may be subject to the 3.8% Medicare surtax as well as the phaseout of itemized deductions and personal exemptions. Including state taxes, you might be in a marginal tax bracket in excess of 50%.

Savvy shifting

You may receive some tax relief by hiring relatives. The money you pay will reduce business profits, so you might have less taxable income to report. That compensation will be taxable to the relatives you hire—or it might not. The standard deduction is $6,300 in 2015, so your children can each receive up to that much, tax-free.

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Example: Jennifer Boyd has a mail order clothing business that makes enough money to put her into a high tax bracket. She hires her two children and pays them $3,500 and $5,000 this year. Jennifer reduces her reported income by $8,500, saving her thousands of dollars a year in tax, while her children owe no income tax.

Jennifer also hires her widowed mother, who is in the 15% tax bracket. (That rate goes up to $37,450 of taxable income in 2015.) Again, Jennifer saves tax by reducing her income, while her mother owes relatively little in tax.

To justify the tax savings, family members on the payroll must be paid fairly for work they actually perform. Thus, tasks should be suited for each individual's capabilities. Jennifer's teenage son, for instance, might help with her company's website and its IT operations; her daughter, who goes away to college, could generate market research reports that relate to Jennifer's business and play a role in keeping the company's social media activities up to date. Jennifer's mother, a retired fashion designer, could provide advice on product trends and selection.

No matter what kind of work relatives perform, business owners should keep records showing their production. Compensation should be in line with the amounts paid to other employees.

Weighing the tradeoff

If your business is a partnership between spouses or a sole proprietorship or a certain type of LLC, you won't be required to pay Social Security and Medicare taxes on the wages you pay to your children if they are under age 18. Similarly, with an unincorporated business, you won't need to pay federal unemployment tax on wages paid to a son or daughter under age 21.

Except for those situations, the wages you pay relatives will be subject to payroll taxes. Those payments may reduce the family's tax savings. Our office can help you calculate the net tax benefit of hiring family members and assist in setting up the required paperwork.

Beyond tax savings, hiring relatives can be rewarding. Your children may gain valuable life lessons, and your retired parents can continue to perform worthwhile tasks. Tax savings, while undoubtedly welcome, might turn out to be the icing on the cake. ■

When Workers Are Independent Contractors

As business owners know all too well, hiring an employee costs more than just paying a salary. Employers generally provide benefits to employees, which can be expensive. Moreover, employers must pay a share of Medicare, Social Security, and state unemployment taxes.

None of the above applies when your company hires an independent contractor—a publicist to get your company's name in the news, for example, or a freelance website designer. You pay these people the agreed-upon amount and let them worry about funding their retirement or handling payroll tax. If that's the case, why not just use a group of independent contractors to work for your company and do with few or even no employees?

Defining the difference

The answer is that the IRS is well aware of the advantages of using contractors. Therefore, the IRS has established rules governing how independent contractors are classified, as opposed to employees. Drilling down, the major difference is a matter of control.

Hiring an independent contractor to do a specific task is fine. You tell the contractor what you want done, and you pay for results. However, if you tell the worker how and when and where the work is to be done, you risk having that worker re-cast as an employee by the IRS.

In some cases, common sense will apply. If that freelancer works on your website while doing other paying jobs for other companies, chances are the IRS will go along with independent contractor classification. On the other hand, if you have a person who works from home as a freelancer but works only on your website, does it more or less full time, and takes direction from your IT people, you may have a difficult time treating him or her as a contractor.

If you have been misclassifying employees as contractors, the penalties can be steep. Our office can discuss your workers with you, letting you know how to proceed in order to legitimately treat them as independent contractors. ■

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