CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

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What's Inside

Trim the Tax on Your Social Security Benefits

While politicians consider changes in Social Security, millions of people continue to receive benefits. Are those benefits taxable? That's determined by a complicated formula, and if you know how it works, you may be able to reduce or eliminate the tax that you owe on your Social Security benefits.

To begin the calculation, determine your combined income (CI) for this purpose. To find your CI

- start with half of your Social Security benefits, then
- add that number to all of your other income, including tax-exempt income and other exclusions from income.

Once you've determined your CI, compare it with certain base amounts. The first base amounts are $25,000 for single taxpayers and $32,000 for married couples filing jointly.

Numbers crunch

If your CI is over the relevant base amount, you'll owe tax on some of your Social Security benefits.

Example: Kim Phillips receives $14,000 in Social Security benefits in 2012. She also has $20,000 in other income. Thus, Kim's CI is $27,000: $7,000 (half of $14,000) plus $20,000.

Kim is single, so her base amount is $25,000. With $27,000 of CI, Kim is $2,000 over the threshold.

The next step is to compare the excess ($2,000) with half of Kim's Social Security benefits ($7,000). The smaller of the two numbers—$2,000, in this example—will be added to her taxable income. Here, Kim receives $14,000 in benefits and owes income tax on $2,000 of those benefits.

If your CI is high enough, you will encounter a second set of base amounts: $34,000 for singles and $44,000 for joint returns. Over those thresholds, up to 85% of your Social Security benefits may be added to your taxable income. Note that this doesn't mean that you would owe 85% tax on your Social Security benefits. If you receive $20,000 in benefits, and you owe the maximum tax, you'd add $17,000

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(85% of $20,000) to your taxable income. Assuming a 28% tax rate, you would owe $4,760 in tax on the $17,000. That's an effective tax rate of less than 24% on your Social Security benefits.

Tax tactics

Once you understand the process, you can see whether tax planning makes sense.

- If your CI is under $25,000 (single) or $32,000 (joint) and likely to stay there, you don't need to do anything. You won't owe any tax on your Social Security benefits.
- If your CI is now or is expected to be above $25,000 (single) or $32,000 (joint), you may be able to profit from tax planning. Our office can let you know if practical strategies exist that you can use. By lowering your CI, you might be able to reduce the tax on your Social Security benefits.
- If you expect your CI to be far above the $34,000 (single) or $44,000 (joint) thresholds, there might be nothing that you can do in this area. Our office can help you determine whether you are in this category. If so, you may have to resign yourself to having 85% of your benefits taxed.

Possible tactics for reducing your CI include taking losses to offset capital gains and investing in growth stocks rather than dividend paying stocks. Tapping an immediate annuity for income or taking out a reverse mortgage also may provide cash flow that won't count toward your CI. Make such decisions carefully because their impact can go beyond the tax on your Social Security benefits. Our office can help you evaluate possible strategies for reducing this tax. ■

Dodge a Real Estate Tax Trap With a Like-Kind Exchange

The real estate slump of recent years has reduced the value of many investment properties. Therefore, you may expect to owe little or no tax on a sale. You may, however, have to pay a surprising amount to the IRS because of a "recapture" provision in the tax code.

Repaying prior deductions

Owners of investment property generally reduce their taxes each year with depreciation deductions. Those deductions, however, also reduce your basis in the property and, thus, result in increased tax on a future sale.

Example: Paul Matthews bought a small apartment building many years ago for $500,000, of which $50,000 was allocated to nondepreciable land. The remaining $450,000 of the purchase price has been fully depreciated over the years.

Paul has seen the building's value rise to $800,000 and then fall back towards $500,000 in recent years. He wishes to relinquish property management responsibilities and relocate to a distant state in retirement. He assumes that a sale that nets him $500,000 would result in no tax: paid $500,000, received $500,000.

However, Paul has taken $450,000 worth of depreciation deductions, as noted. Consequently, his basis in this property is only $50,000, not $500,000. If Paul sells the property for $500,000, his $450,000 of depreciation deductions would be recaptured at 25%, and he would owe the IRS $112,500.

Trusted Advice

Deferred Like-Kind Details

- In a deferred like-kind exchange, you must identify potential replacement properties, in writing, within 45 days of the date that you sell your original property. This notification can go to the accommodator.
- You can name up to three potential replacement properties of any value.
- Alternatively, you can name more than three properties. If you name more than three, their total value can be no more than 200% of the value of the property that you relinquished.
- You must receive the replacement property within 180 days after the sale of your original property or the due date (with extensions) of the relevant tax return for your property sale, whichever is earlier.

Trading places

In this scenario, Paul can execute a so-called "like-kind exchange" under Internal Revenue Code (IRC) Section 1031 of the tax code. If he meets all the requirements of IRC Section 1031, some of which are outlined in the following section, taxes can be deferred. Such exchanges can involve any kind of investment property, and they don't have to be a straight one-for-one trade.

To give a simplified illustration of how a like-kind exchange might work, suppose Paul lives in New Jersey and wants to retire in North Carolina. He sells his New Jersey apartment building, and nets $500,000 from the sale, but he does not pocket the money. Instead, Paul arranges for the proceeds to be held by a qualified intermediary, sometimes known as an accommodator. (The accommodator can't be Paul's agent or relative. Many financial and real estate companies offer to serve as qualified intermediaries; if you are interested in a like-kind exchange, check prospective accommodators' experience and safety procedures carefully.)

Next, Paul finds a storage facility near his desired retirement home that he can buy for $500,000. He instructs the accommodator to purchase the property with the $500,000 from the sale of his apartment building. As a result, Paul has "exchanged" his New Jersey investment property for one that he'll be able to manage once he retires in North Carolina.

Deferral defined

Like-kind exchanges can take many forms, in addition to the one in the previous example. Regardless of the exchange's form, you must follow many rules in order to defer the full amount of tax due on the sale of your original property. In a deferred like-kind exchange, certain deadlines regarding the identification and receipt of the replacement property must be met (see the Trusted Advice column "Deferred Like-Kind Details" for further explanation).

Assuming that you follow all the rules, here are the requirements for a full tax deferral:

- You must pay at least as much for the new property as you received for the original property that you relinquished.
- You must reinvest any cash that you receive from the original sale into the new property.
- If you are relieved of any debt on your old property, you must replace that debt with a combination of new debt or cash, or both, that you add to complete the purchase of the new property.

If you implement an exchange and wind up with cash in your pocket or a smaller mortgage than you had before, the amount by which you benefit will be considered "boot" and subject to income tax. Like-kind exchanges are complex, but they may result in substantial savings; if you're interested, our office can help you meet all the requirements. ■

Did You Know?

From spring 2007 to spring 2011, "doubled-up" households in the United States increased from 19.7 million to 21.8 million. "Doubled-up" households include at least one adult who is not enrolled in school and is not the householder, spouse, or co-habiting partner of the householder.

Source: census.gov

Check the Numbers on 529 Plans

If you are saving for a child's college education or planning to help a grandchild pay for higher education, you should consider a 529 college savings plan, also known as a qualified tuition program (QTP). Every state and the District of Columbia offer 529 plans, which can deliver ample federal tax benefits (see the Trusted Advice column, "529 Basics" for further explanation). Residents who contribute to their home state's plan often receive state tax breaks, as well, such as deductions for the contributions.

Once you put money into a 529 plan, you must decide how to invest your funds. Typically, you can choose from a menu of investment options. Many parents and grandparents pick the age-based option and turn over the investment decisions to professional money managers.

From stocks to bonds

Age-based options shift the asset allocation as the plan beneficiary (a precollege student) grows older. For very young children, the allocation emphasizes stock funds. As the beneficiary grows older, the investment account evolves from stocks to bonds and cash equivalents.

Example: Doug and Laura Grant live in Missouri. When their daughter Ava is born, they set up an account in Missouri's 529 plan. The Grants choose the age-based option and select the moderate rather than the conservative or the aggressive portfolio.

Initially, Ava's 529 account is invested 80% in stock funds and 20% in bond funds. The stock fund allocation drops to 60% at age 6, 40%

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at age 11, and 20% at age 16. Money shifted from stocks goes to bond funds. When Ava reaches age 19, any money left in her 529 account will be 75% invested in bond funds and 25% in short-term investments, including money market funds. Going forward, this age-based option will hold no stocks.

History lessons

Other states' age-based options are generally similar to those offered by Missouri. This strategy stems from past performance in the investment markets. For investments of 12–18 years, stocks usually have done better than bonds or cash equivalents.

Recently, the U.S. stock market has been battered by severe bear markets in 2000–02 and 2008–09. Even so, Morningstar's Ibbotson subsidiary reports that returns on large-company U.S. stocks were 2% per year for the 12 years through 2010, 6.8% per year for the last 15 years, and 8.1% per year for the last 18 years. In most of the 12- to 18-year periods since records became available, stocks have been strong performers.

However, as the past decade has shown, stocks can fall sharply in a short time period. Therefore, it's risky to have a college fund for a teenager that's too heavily invested in stocks. When a child reaches age 18 or 19, he or she may be ready to go to college. A 529 account that shrinks in a bear market just before high school graduation might offer less financial support than the family has anticipated. Moreover, there is no guarantee of a market rebound and a 529 plan recovery during the four years or so that the student attends college.

Determining the differences

Age-based investment options vary from state to state. As noted, there may be different choices within the age-based plan in a given state. Missouri's aggressive option, for instance, keeps a 40% allocation to stocks through age 18, whereas the conservative option has only 20% stocks at age 11 and no stocks at all from age 16 on. Therefore, you should drill down to see exactly what you'll be getting if you choose an age-based 529 plan option. ■

Trusted Advice

529 Basics

- Contributions to 529 college savings plans are not tax deductible.
- Inside a 529 plan, any investment income is tax free.
- Withdrawals from a 529 plan are tax free to the extent that they are used to pay the beneficiary's higher education expenses in the same calendar year.
- Qualified higher education expenses include tuition, fees, books, supplies, and equipment. Room and board expenses also can be qualified higher education expenses if the youngster is enrolled at least part time.
- Withdrawals from a 529 plan that are not used for qualified higher education expenses are subject to income tax plus a 10% penalty.

Coverdell Accounts Can Cover Precollege Costs

Qualified tuition programs, known as 529 plans, can help you build a college fund with ample tax benefits, as explained in the previous article "Check the Numbers on 529 Plans." Most 529 plans allow you to contribute tens of thousands, even hundreds of thousands of dollars. It's true that gift tax rules apply, but a special provision of the tax code encourages gifts of up to five times the annual gift tax exclusion amount in a single year. The annual exclusion for 2011 is $13,000, so you can give up to $65,000 to a 529 plan for a specific beneficiary. As long as you file gift tax returns each year for five years, no gift tax will be due because the special provision allows givers to spread the exclusion amount over five years. Grandparents might consider such a strategy to move assets from their taxable estate.

By comparison, contributions to Coverdell Education Savings Accounts (ESAs) seem paltry. Contributions for each student are capped at $2,000 per year. Nevertheless, parents and grandparents may want to fully fund a Coverdell ESA for precollege children each year before putting any money into a 529 plan.

Assessing the advantages

Two main reasons for starting your college funding each year with a $2,000 Coverdell ESA contribution are as follows:

1. **Investment flexibility.** With a 529 plan, you're limited to the investment options on the menu. A Coverdell ESA, on the other hand, is like an IRA, so you

can pick your own investments. Many banks, brokerage firms, mutual fund families, and insurance companies offer Coverdell ESAs. You can choose among a broad range of funds and individual securities for your money.

2. **Distribution alternatives.** Like 529 plans, Coverdell ESAs are funded with aftertax dollars, and investment income is untaxed. Distributions may be tax free. Distributions from a 529 plan, however, are tax free only if you use the money for post-high school education. Coverdell distributions are tax free if used to pay for higher education expenses, but they also can be tax free if you use the money for education-related expenses while the beneficiary is in kindergarten through high school.

Example 1: Paul and Jennifer Wilson set up a Coverdell ESA for their newborn son, Ethan, and contribute $2,000 each year. They decide to send Ethan to private school, starting in first grade. If needed, the Wilsons can tap Ethan's Coverdell account to pay for his private school tuition.

Clearing the hurdles

Some drawbacks exist to Coverdell accounts. Married couples with modified adjusted gross income (MAGI) over $190,000 cannot contribute the full $2,000 to Coverdell accounts; for single taxpayers, that MAGI limit is $95,000. With MAGI up to $220,000 or $110,000, respectively, your ability to make partial Coverdell ESA contributions phases out altogether. Even if your income is over those limits, however, you can give $2,000 per student to a lower income relative, including the child who will be the Coverdell beneficiary. Then, the recipient of that gift can use the money to open a Coverdell account and make a full Coverdell ESA contribution with MAGI below $190,000 (joint returns) or $95,000 (single).

Also, Coverdell ESAs must be liquidated within 30 days after the beneficiary turns age 30 (unless the beneficiary is a special needs beneficiary). Distributions not used for qualified higher education expenses by then will be subject to income tax plus a 10% penalty. To avoid this, you can roll over the amount in one beneficiary's Coverdell ESA to a younger relative's Coverdell ESA, tax free.

Example 2: Ron and Jan Hansen set up a Coverdell ESA for their son, Craig. When Craig finishes his education at age 29, he has $5,000 left in the account. Craig withdraws the $5,000 and contributes to a Coverdell ESA established for his

younger sister Lucille. No tax is due on these transactions.

In reality, you should be able to spend down all the amounts in a Coverdell ESA before the original beneficiary reaches age 30.

Coverdell ESA tax benefits are scheduled to be reduced in 2013. However, Congress has extended those tax benefits in the past, so there may be a further extension in the future. If Congress does not act, and Coverdell ESA tax breaks are trimmed to the point where you're dissatisfied, you can roll over the amount in a Coverdell ESA to a 529 plan of your choice. ■

Taking Credits for Higher Education

In 2009, Congress replaced the Hope Scholarship tax credit with the more valuable American Opportunity tax credit. The latter credit was scheduled to expire after 2010 but was extended at year-end, along with many other tax benefits. Therefore, the American Opportunity credit remains the primary tax credit available for higher education in 2011 and 2012.

The maximum American Opportunity tax credit is $2,500 per student. To qualify for the maximum credit, you must spend at least $4,000 per student in 2012. You must spend this money for a student in his or her first four years of post-high school education. The money you pay for tuition and related fees counts for calculating the tax credit, along with outlays for necessary books, supplies, and equipment. Room and board costs do not count.

Example 1: Carl and Diane Hunter have a son who is a sophomore in college this year and a daughter who is a college senior.

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They spend $12,000 on each student's qualifying expenses in 2012. Thus, they can claim two American Opportunity credits of $2,500 each, for a total of $5,000. For most taxpayers, the American Opportunity credit is 40% refundable.

Credit constraints

High income taxpayers can't use the American Opportunity tax credit. To get the full credit, your MAGI must be no more than $80,000 if you are a single taxpayer or $160,000 if you are married and file a joint tax return. The American Opportunity tax credit phases out with MAGI up to $90,000 (single) or $180,000 (joint returns).

In addition, any money that you withdraw from a Coverdell Education Savings Account or a 529 plan won't count for calculating the credit.

Example 2: Jennifer Thomas pays $10,000 for her son Nick's college bills in 2012. Jennifer's MAGI is $75,000, so she qualifies for a full American Opportunity tax credit. However, Jennifer withdraws $8,500 from a 529 plan in 2012. If Jennifer counts that as a tax-free withdrawal, she will have only $1,500 of expenses that can be offset by the American Opportunity tax credit. If Jennifer counts $4,000 of expenses to be offset by a full American Opportunity tax credit, she will have only $6,000 of expenses that can count as a qualified 529 withdrawal.

As you can see, the interplay between a 529 plan, Coverdell account withdrawals, and the American Opportunity tax credit might not be simple. Our office can help you calculate the most tax-efficient amounts to withdraw and the most tax-efficient way to claim education-related benefits on your tax return.

Later learning

You may be able to use a Lifetime Learning tax credit instead of the American Opportunity tax credit; however, the Lifetime Learning credit is less valuable. The American Opportunity tax credit can save as much as $2,500 *per student*, but the Lifetime Learning credit saves no more than $2,000 *per tax return*. Moreover, the income limits for the Lifetime Learning credit are stricter.

Why bother with the Lifetime Learning credit? It may be the only education-related tax credit that you can use. The American Opportunity tax credit can be used only during a student's first four years of post-high school education, and only if that student is pursuing an undergraduate degree or a similar credential. The Lifetime Learning credit can be used if you incur other expenses at any time, such as outlays for graduate school or career advancement courses. A taxpayer cannot take an American Opportunity credit and a Lifetime Learning credit for the same child in the same year; however, it's possible to take an American Opportunity credit for one child and a Lifetime Learning credit for another child on the same tax return.

As mentioned, the Lifetime Learning credit also has income requirements. For 2012, the maximum $2,000 credit phases out with MAGI of $52,000–$62,000 (single) or $104,000–$124,000 (joint returns). ■

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