CPA

Client Tax Letter

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

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Renting Versus Buying a Home

Should you buy or rent your home? This decision can include financial as well as nonfinancial factors. Even if the nonfinancial aspects are extremely important, you should not overlook the financial side.

Crucial ratio

One key to choosing between buying or renting is to determine the annual rent-to-purchase price ratio in the housing market you're considering. The higher this ratio, the greater the advantage of buying a home.

Example 1: Art Smith is considering buying a home that is priced at $200,000. He can rent a comparable home in the same neighborhood for $800 a month, which is $9,600 a year. The rent-to-purchase ratio is $9,600 to $200,000, or 4.8%.

Example 2: In a different area of the U.S., Beth Jones also is eyeing a $200,000 home. A comparable home would rent for $1,200 a month. Thus, the rent-to-price ratio for Beth is $14,400 to $200,000, or 7.2% a month.

A recent study from Morningstar's HelloWallet unit indicates that renting might be a better choice when the rent-to-price ratio is below 5%, while buying may be preferable if that ratio is over 7%. That is, the more you'll have to pay to rent a desirable home, relative to home prices, the greater the chance that the numbers will favor a purchase.

Assuming the rent-to-purchase price ratio is favorable, young taxpayers with relatively low early career incomes might do well to rent rather than buy a home. The same may be true for relocating retirees who have modest incomes after they stop working.

Conversely, high-income taxpayers might enjoy considerable tax savings from home ownership, assuming they are comfortable with the purchase price. Today's low interest rates make financing a home purchase appealing, and the leverage can add to any profits from home price appreciation.

Thinking about taxes

Homeowners may enjoy multiple tax benefits that are not available to renters. Mortgage interest and property tax payments generally are tax-deductible. Moreover, profits on a sale of a home

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Home Trend

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

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often enjoy an exemption from capital gains tax. Assuming the home was owned and occupied at least two of the preceding five years, up to $250,000 of gains are untaxed ($500,000 for married couples filing a joint tax return).

Of course, there is no way for a home buyer to know if a home eventually will be sold at a profit. What's more, the deductions for mortgage interest may not generate any actual tax savings. That's because those savings are available only to taxpayers who itemize deductions. Homeowners who take the standard deduction get no tax benefit from their mortgage interest or property tax deductions.

Example 3: Craig and Diane Emerson bought a house for $200,000, taking out a $160,000 mortgage. At a 4% mortgage rate, their interest payments this year are $6,400 (4% of $160,000). The Emersons also pay $4,000 in state and local taxes and make $2,000 in charitable donations, for a total of $12,400 in possible itemized deductions.

In 2015, the standard deduction is $6,300 for single filers and $12,600 for married couples filing jointly. (Taxpayers who are blind or at least age 65 have higher standard deductions.) Thus, the Emersons will choose the standard deduction and get no tax benefit from paying mortgage interest or property taxes.

Tax bracket truths

Now, what happens if the Emersons had $14,200 in itemized deductions instead of $12,400? If so, they would itemize and deduct their mortgage interest and property tax payments. In this scenario, $14,200 of itemized deductions is $1,600 greater than the standard deduction for couples, so the Emersons' net tax deduction from home ownership would be $1,600. Assuming an effective marginal income tax rate of 20%, that $1,600 in net deductions would save them $320 in tax this year.

Example 4: Assume the same financial information as in example 3, but assume the Emersons have a higher income and, thus, have an effective marginal tax rate of 40%. Then that same $1,600 in net tax deductions from home ownership would save the Emersons $640 in tax. With a higher income, owning a home saves more tax.

Other issues

The decision about whether to rent or buy a home involves more than the purchase price, rental rates, and tax savings. Buying a house means saving up a great deal of cash for a down payment and putting that cash into an illiquid asset. Renting may leave you with more easily accessible cash, but will that cash be invested wisely or spent imprudently? It's also important to decide if the responsibility of home ownership is for you.

Nevertheless, financial concerns are vital to residential decisions. Our office can show you how money matters compare, pretax and aftertax. ■

Tax-Free Roth IRA Conversions

Moving money from a tax deferred retirement account to a potentially tax-free Roth IRA usually will trigger income tax. That won't always be the case, though, thanks to recent IRS announcements. Some examples show how this can work.

Example 1: Nancy Martin has participated in her company's 401(k) plan for many years. She typically has made maximum pretax contributions to the plan. Nancy's company allows employees to make additional aftertax contributions (many employers do), which she has done. Nancy decides to leave the company at a time when she has $600,000 in the 401(k), including $100,000 from aftertax contributions.

Thanks to an IRS notice published in September (IRS Notice 2014-54), Nancy can have her plan administrator transfer $100,000 of aftertax money to a Roth IRA. Because this is aftertax money, Nancy won't owe tax on the transfer. Inside her Roth IRA, untaxed growth can continue.

Once Nancy has met the five year and age 59½ requirements, she can withdraw as much or as little from the Roth IRA as she wishes without owing any tax.

In order to qualify for this tax treatment, Nancy's Roth IRA transfer must be part of a distribution to two or more retirement accounts. Thus, she can send $100,000 to a Roth IRA and the other $500,000 to a traditional IRA. Nancy won't owe any tax on these transfers. However, her $500,000 traditional IRA (and any future earnings) will remain pretax. Nancy will owe tax on any withdrawals from that traditional IRA or any future conversion to a Roth IRA.

Beyond 401(k)s, this strategy can be executed by taxpayers with aftertax money in other types of employer sponsored qualified plans.

IRA implications

What if Nancy already had rolled her $600,000 to a traditional IRA? In that case, any distributions from that account—including those for a Roth IRA conversion—would be considered a mix of aftertax and pretax money. If Nancy had $600,000 in a traditional IRA, with $100,000 of aftertax money, for instance, a $150,000 Roth IRA conversion would be considered $125,000 (5/6) taxable and $25,000 (1/6) untaxed.

Nevertheless, there can be a way to execute a tax-free Roth conversion in that situation.

Example 2: Assume that Nancy leaves the company and rolls her $600,000 401(k) balance to a traditional IRA. Currently, that IRA has the same balance, including $100,000 of aftertax money. Nancy has just accepted a new job with a company that sponsors a 401(k) plan for its employees.

In this situation, Nancy can roll her $500,000 of pretax money into the new company's 401(k) plan and then convert the aftertax $100,000 to a Roth IRA. Again, she'll owe no tax on either move and she'll have $100,000 in a potentially tax-free Roth IRA.

That tactic has been possible in the past but not always practical: many employer plan administrators were reluctant to accept such rollovers from IRAs into a company retirement plan because the IRS had not explained how such transactions should be handled.

That changed last year when the IRS published Revenue Ruling 2014-9, setting out the ground rules. Now, Nancy can have the custodian of her traditional IRA transfer up to $500,000 of her pretax money to the new company's plan. Nancy also has to submit a statement to the administrator of the new plan, certifying that this rollover is all pretax money. Following Rev. Rul. 2014-9, company plans are likely to accept such rollovers from traditional IRAs. ■

Final Regulations Bolster Longevity Annuities

Deferred income annuities (DIAs) recently have become popular. Final regulations from the U.S. Treasury Department, issued in 2014, may increase their appeal, opening the way for so-called "longevity" annuities inside IRAs and employer retirement plans.

Later rather than sooner

With a DIA, you pay an insurance company now in return for a predetermined amount of cash flow in the future.

Example 1: Grace Palmer is age 55, planning to retire at 65. She buys an income annuity now for $100,000. Depending on the specific features Grace requests, if she starts to receive payments immediately, she might get around $400 a month ($4,800 a year) as long as she lives.

Instead, Grace agrees to wait until she retires at 65 to start payments. In return for giving up her money for 10 years, with no return, Grace might get lifelong annual payouts of $800 a month. (Exact amounts will depend on the contract terms and the annuity issuer.)

Even later

Certain DIAs are known as longevity annuities. They begin paying out late in life, so they appeal to people who are concerned about running short of money if they live into their late 80s or 90s or beyond.

Example 2: Instead of starting her DIA payouts at 65, Grace asks for them to begin at 75 or later. Such a delay could increase her payouts to $2,000 a month or more, as her remaining life expectancy would be limited. Grace enters into this arrangement to assure herself that she'll have substantial cash flow if she lives until an advanced age.

Solving the distribution dilemma

Until recently, such longevity annuities were impractical for retirement accounts because required minimum distributions (RMDs) typically start after age 70½. Seniors would have to take RMDs on the annuity value even though no cash would be coming from the annuity.

Example 3: Suppose Henry Adams had bought a longevity annuity inside his IRA to begin

Trusted Advice

Rules for QLACs

- No more than 25% of an individual's total IRA money can be invested in qualified longevity contracts (QLACs).
- For this purpose, SEP IRAs and SIMPLE IRAs are included. Roth IRAs don't count because there is no reason to hold a QLAC in a Roth IRA, where the owner never has required minimum distributions.
- The 25% limit also applies to each employer plan.
- Counting all QLACs in all plans, an investor cannot invest more than $125,000. That ceiling will increase with inflation.
- QLAC payouts must begin no later than age 85, although they can begin earlier.

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payments at age 80. At age 70½, when Henry has $500,000 in his IRA, the annuity issuer values the contract at $100,000. Under prior rules, Henry would have had to take RMDs based on a $500,000 value even though he had only $400,000 currently available. Henry would have been required to withdraw (and pay tax on) a relatively large amount, even if he doesn't need all the money he'll withdraw.

This unfavorable tax treatment would continue, year after year, as long as Henry waited for his longevity annuity. Thus, longevity annuities were not attractive for retirement accounts and few people bought them in their IRA.

This situation has changed. In July 2014, the Treasury Department issued final regulations on qualified longevity annuity contracts (QLACs). If annuities meet certain conditions, they will be considered QLACs. (See the Trusted Advice column "Rules for QLACs.") That way, the account value won't count for RMD calculations.

Pros and cons

Some insurance companies have begun to introduce QLACs, which might appeal to seniors who are likely to live well beyond normal life expectancy and who are concerned about running short of money. In addition, individuals who would like to trim their RMDs and, thus, leave more to heirs, may consider buying QLACs. The regulations permit QLACs to have a return of premium feature, which would pay beneficiaries the amount invested yet not paid out in annuity payments by the time the annuity purchaser dies.

On the downside, QLACs will not be permitted to have any liquidity features for the buyer. If a taxpayer invests $100,000 in a QLAC, all she can get in return will be her annuity payments. ■

As Collectibles Boom, Selling Can Be Taxing

In the past few years, at least five paintings have been sold at auction for more than $100 million apiece, while another (by Cezanne) reportedly brought more than $250 million in a private sale. In addition, a pink diamond was auctioned for a record $83 million.

As you can see, the collectibles market has been booming. You might not own a multimillion dollar item, but the chances are that the coins, stamps, or paperweights that you collect have grown in value. If you decide to cash in by selling one or more pieces from your collection, you may have to deal with unpleasant tax surprises.

Raising the rates

The tax code has special treatment for collectibles, which can include artwork, rugs, antiques, gems, stamps, metals, coins, and alcoholic beverages, according to the IRS. When you sell collectibles, the special 0%, 15%, and 20% tax rates on long-term capital gains don't apply. Instead, you'll owe tax at your ordinary tax rate, with a cap of 28%.

As is the case with all assets, short-term capital gains on the sale of collectibles are taxed at ordinary rates.

Example 1: Dan King bought a rare U.S. coin for $1,000 and sold it 11 months later for $1,300. Dan's $300gain was short-term, so he owes tax at his ordinary rate, 15% in this example.

Dan bought another coin at the same price at the same time; he sold that coin for a $300 gain as well. This coin, though, was sold 13 months after Dan's purchase. Because the holding period was over one year, Dan reports the $300 as a long-term capital gain.

Normally, a long-term capital gain is taxed at a 0% rate by taxpayers in the 15% tax bracket, such as Dan. That would be the case, for example, if Dan had a $300 long-term gain on a stock sale. A long-term collectibles gain, though, doesn't qualify for the 0% rate. Thus, Dan will owe 15% in tax on this $300 gain ($45) from the second coin sale, just as he does on the first (short-term) coin sale.

Similarly, taxpayers in the next higher tax brackets (25% and 28%) also owe tax at their ordinary rate on long-term gains from collectibles. Taxpayers in higher brackets (33%, 35% and 39.6%) do get some tax break from long-term gains on collectibles because the rate does not exceed 28%.

Example 2: Emily Larsen has taxable income over $500,000, so she is in the top 39.6% tax bracket this year. She sells a painting for a $20,000 gain after holding the artwork for several years. On long-term gains from a stock, Emily would owe tax at the special 20% rate. However, Emily doesn't qualify for the 20% tax rate on the sale of the painting because it is a collectible. Emily's tax rate is higher than 28%, so she will owe the maximum 28% rate on her $20,000 long-term collectibles gain: $5,600 in tax.

Personal use

If you plan to sell collectibles at a loss, be aware that the tax code still works against you. If you sell collectibles for which you had "personal use," you can't claim a capital loss, and selling collectibles for which you had personal use at a profit will still result in a taxable capital gain.

Personal use will depend upon specific circumstances. Hanging a painting on the wall of your home might be considered personal use, depriving you of any tax benefit from a loss on a subsequent sale. However, if you regularly buy a specific type of painting, keep some in careful storage when not on display, and maintain careful records of your collection, you might be able to make the case that the artworks were held for investment purposes. Such efforts could result in a capital loss that provides tax benefits. Our office can help you determine if your collectibles may be treated as investment property. ■

S Corporation or LLC?

Many business owners structure their companies as S corporations or limited liability companies (LLCs). On the surface there are several similarities. Both types of entities avoid corporate income tax. Instead, business income is taxed only once, on the tax return of the S corporation shareholder or the LLC member. Moreover, both S corporation shareholders and LLC members have limited liability: their financial exposure from the company's operation generally is no greater than the amount they invest and any notes they personally sign. (In exceptional circumstances, creditors may gain access to additional personal assets of the business owner.)

Nevertheless, there are differences between the two structures, which you should consider when choosing between them.

Looking into LLCs

In some ways, an LLC resembles a sole proprietorship or a partnership, but with the advantage of limited liability. Usually, you can form an LLC with relatively little paperwork. Once an LLC is operating, there may be few tax returns to file and other recordkeeping and reporting requirements for LLCs are generally less burdensome than for corporations. If an LLC has multiple members, the business has a great deal of flexibility in how any profits are distributed among them.

A downside is that an LLC may have a limited life. Depending on state law and the operating agreement, the death of a member may dissolve the LLC, for instance. In addition, taxes might be relatively high for LLC members. That's because all net income of the LLC is passed through to members as earned income on their personal tax returns, per the LLC agreement. The members are treated as if they were self-employed; they owe the employer and employee shares of items such as Social Security and Medicare tax, with a relatively small deduction as an offset.

Considering S Corps

Even after making an election to be taxed under Subchapter S of the Internal Revenue Code, an S corporation is still a corporation. There are meetings that must be held, minutes that must be kept, and extensive paperwork to process. Such efforts can be time consuming and expensive.

In addition, S corporations must meet certain requirements. A business with more than one class of stock or a shareholder who is not a U.S. citizen or resident can't be an S corporation, for example. Similarly, an S corporation can't make disproportionate distributions of dividends or losses.

On the plus side, S corporation shareholders can receive a salary, on which they owe payroll tax, and dividends, on which they don't. Although artificially low-balling a salary will draw the ire of the IRS (see the January/February/March 2015 issue of the ***CPA Client Tax Letter***), S corporation owners may pay thousands of dollars less per year in payroll taxes than LLC members pay on similar company related income. What's more, S corporations can be long-lived, and this permanent nature may make them more attractive to lenders and investors than potentially short-lived LLCs.

Choosing or combining

Your choice of business structure may come down to whether you prefer the simplicity and flexibility of an LLC or the potential tax savings and lender and investor appeal of an S corporation. State laws vary, so a tilt in one direction or another may influence your decision.

Yet another possibility is to set up your business as an LLC and then request S corporation taxation by filing IRS Form 2553, "Election By A Small Business Corporation." Our office can go over your specific circumstances to help you decide how to structure your company. ■

Be Wary of Accumulated Assets

Owners of regular C corporations face double taxation. The company's profits are subject to the corporate income tax. If some of those profits are paid to the owner and other shareholders, as nondeductible dividends, the same dollars will be taxed again, on the recipients' personal tax returns.

Double taxation might not have been a major concern when the highest tax rate on qualified dividends was only 15%, as it had been for most of this century. However, recent legislation boosted the dividend tax rate to 20% for some taxpayers; high-income taxpayers also may owe the 3.8% Medicare surtax as well as some indirect taxes on dividends they receive. Therefore, business owners may prefer to retain earnings in the company, rather than pay out double taxed dividends.

Example 1: Craig Taylor owns 100% of CT Corp. The company's profits this year are $400,000, on which CT Corp. pays income tax. Rather than pay himself a dividend, which would be taxed at an effective rate of 25% in this scenario, counting all the various taxes that would be triggered, Craig decides to keep the money inside CT Corp.

Cash crunch

However, CT Corp. might run into a tax problem: the accumulated earnings tax (AET). Retained earnings over $250,000 are subject to this tax ($150,000 for personal service corporations, such as professional practices). Thus, if CT Corp. had $200,000 in retained earnings from prior years, this year's $400,000 makes the total $600,000, which is $350,000 over the $250,000 limit. CT Corp. would owe tax on the $350,000 overage: $70,000, at the current 20% AET rate.

In practice, the AET is not a certainty. The IRS might investigate when CT Corp. reports retained earnings over $250,000 on its corporate income tax return, but it's possible that it won't owe the AET, if the company has a good reason for the large accumulation.

Forward thinking

Earnings in excess of $250,000 will be permitted if the company can show that it had a reasonable need for holding onto cash and other liquid assets. That need could be to provide funding for a specific plan related to the company's business, such as buying expensive equipment or expanding into a new territory.

Solid proof

In order to retain earnings over $250,000, yet avoid the AET, a corporation must be able to show that there really was a plan in place to use the money, and that the reasons for the retention go beyond tax avoidance. Ideally, corporate minutes or other documentation, such as emails, will include a discussion of, for example, the company's intent to upgrade its information technology with an expensive new system.

No matter how well you can show that a plan was in place as a reason for accumulating excess assets, you'll also need to show that the plan has since been executed, or is in some stage of progress.

What's more, court decisions have approved the concept that C corporations can cite working capital as a reason for accumulating earnings over $250,000. Our office can help you determine an acceptable level of working capital for your company, which might raise its permissible level of accumulated earnings.

Simple solution

Regardless of your needs for working capital, there are basic steps you can take to avoid or limit the AET. For instance, you can pay some dividends to shareholders each year, even if that generates double taxation. A company that retains excess earnings while never paying out dividends may be especially vulnerable to IRS scrutiny and assessment of the AET. ■

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