CPA

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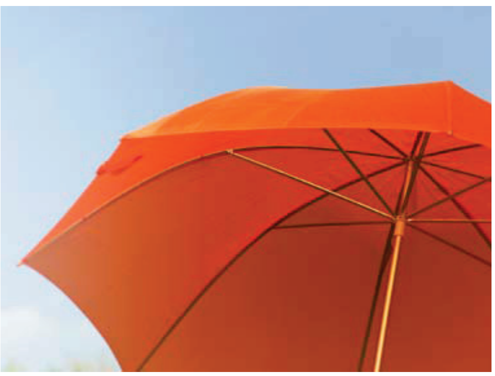
Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

January 2012

What's Inside

Make Disability Insurance Less Taxing



Disability insurance can be a valuable part of your risk management plan. If you cannot work because of an illness or injury, you might lose income. Disability insurance benefits can make up the difference.

Few insurers will offer to replace 100% of your income. As a rule, disability policies will replace no more than 60% or 70% of your income.

Example 1: Kevin Connors earns $60,000 per year ($5,000 per month). He has disability coverage that will pay up to 60% of his income: $3,000 per month. If Kevin should suffer a stroke, for example, and lose the ability to work, he'd receive a maximum of $3,000 per month.

If Kevin were able spend the full $3,000 each month, he might be able to maintain a comparable lifestyle. However, if Kevin owes, say, 20% in federal and state income tax, he would only have $2,400 per month ($28,800 per year) and face more financial challenges.

Tax treatment

A basic rule governs the taxation of disability benefits. If you pay for disability insurance with your own after-tax dollars, your benefits will be tax free. However, if your employer pays the premiums, you will owe income tax on any disability benefits that you receive. That's the federal income tax treatment, which typically is followed by states, as well.

Many people have some form of disability coverage at work. If you have group coverage there, and you pay for it, you'll receive tax-free benefits in case you're disabled. Even if you pay for your coverage through payroll withholding, as long as you pay income tax on the money that's withheld, you'll qualify for tax-free disability benefits.

Some employers have a cost-sharing arrangement. If so, employees will receive partially tax-free income pro rata.

Example 2: Michael Dobbs has group disability that costs $40 per month. His employer pays $20 per month, and Michael has $20 withheld from his paycheck each month. Because Michael pays for half the cost of the insurance, any disability benefits that he receives from the policy will be 50% taxable and 50% tax free.

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A New Advantage

Beginning in 2012, top-ranked Medicare Advantage and Medicare Part D prescription plans can engage in marketing and enroll beneficiaries throughout the year.

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If Michael's employer pays half or even all of the disability insurance premiums, and Michael wants totally tax-free benefits, he can see if his company will enter into an arrangement with him. Michael can ask his employer to treat the disability premiums that it pays as additional taxable compensation.

Example 3: As in example 2, Michael pays $20 per month for disability insurance, and his company pays the other $20 per month. In this scenario, Michael's company adds $20 to his taxable compensation, even though the money goes to the insurance company. Michael might pay an additional $5–$7 per month in tax, depending on his bracket, but any disability benefits will be tax free.

Going solo

You might not be able to convince your employer to treat its disability insurance premiums as taxable compensation. Even if you can arrive at such an arrangement, you might feel that your group coverage is inadequate. In either situation, you may want to purchase individual disability insurance, in addition to your group coverage.

As long as you pay for individual disability insurance with your own after-tax dollars, which typically will be the case, you'll owe no tax on any benefits that you'll receive. Individual policies can have other advantages: they might offer additional benefit amounts and longer payout periods than group policies. Also, you can take your individual insurance with you if you change jobs. Individual disability policies may be expensive, though, so shop carefully and work with a well-recommended agent. ■

Trusted Advice

Multiple Choice

- If you have multiple IRAs, you must calculate the annual RMD for each one, and then add them all together for your total RMD.
- Say your RMD for IRA A is $1,000 this year; your RMD for IRA B is $3,000; and your RMD for IRA C is $2,500. Your total RMD for the year is $6,500.
- You can withdraw that $6,500 from any or all of your IRAs in any manner that you choose.
- This flexibility allows you to manage how much you keep in different IRAs if you designate different beneficiaries for the various accounts.

Dealing With Required Distributions

Many people save for retirement in a traditional IRA in which income taxes are deferred. At some point, however, you must take money out of traditional IRAs and pay income tax. That's true regardless of whether you need the cash flow.

Required minimum distributions (RMDs) begin after you reach age 70½.

Example 1: Grace Turner was born in the first half of 1941, so she turned 70½ in 2011. Her cousin Stan Davis, was born a few months later in the second half of 1941. Stan will be 70½ in 2012.

Your official required beginning date (RBD) is April 1 of the year after you reach 70½. Therefore, Grace's RBD is April 1, 2012. Stan, who is just a few months younger, won't reach his RBD until one year later: April 1, 2013.

First impressions

In our example, Grace will have to take her first RMD in a few months, by April 1. Remember, this is the *minimum* amount and the required *latest* starting date. You can withdraw money from your IRA before then and you can take out more, if you need funds. However, if you withdraw less than your RMD, you will owe a 50% penalty on the shortfall.

Assume that Grace has not needed, and will not need, to take money from her IRA and, therefore, plans to take only her RMD. To determine how much she must withdraw, Grace begins by checking her IRA balance on December 31, 2010. Assume that it was $200,000. (In practice, your IRA custodian probably will make the calculation for you. This illustration explains the process, to help you with your planning.)

Grace's next step is to check the Uniform Distribution Table, which is found in IRS Publication 590 and

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

covers IRAs. Most IRA owners will use this table; if your IRA beneficiary is your spouse, who is more than 10 years younger than you are, you can use the joint life expectancy tables in Publication 590, which provide smaller RMDs.

The RMD that Grace must take by April 1, 2012, is her 2011 RMD. Grace had her 70th birthday in 2011, so she goes to age 70 in the Uniform Distribution Table and sees that her distribution period is 27.4 years. Therefore, Grace takes the relevant IRA balance ($200,000 on December 31, 2010) and divides it by 27.4 to calculate her first RMD: $7,299. Grace must withdraw this amount from her traditional IRA by April 1, 2012. (If Grace also has a Roth IRA, she can ignore that account because Roth IRA owners don't have RMDs from their Roth IRAs.)

Sooner or later

Grace has another RMD this year, which must be taken by December 31, 2012. This RMD will be based on her December 31, 2011, IRA balance.

Example 2: Suppose that Grace's December 31, 2011, IRA balance is $205,000. Grace sees that the distribution period at age 71 is 26.5 years. Dividing $205,000 by 26.5, Grace determines that her next RMD will be $7,736. This process will continue as long as Grace has money in her traditional IRA.

Note that Grace must withdraw over $15,000 from her IRA this year, with two RMDs. This might push her into a higher tax bracket for the year. As you approach age 70½, you might consider taking your first RMD by December 31 of the year you reach 70½, rather than waiting until the following April 1. Taking one RMD per year could help keep you from moving into a higher tax bracket. ■

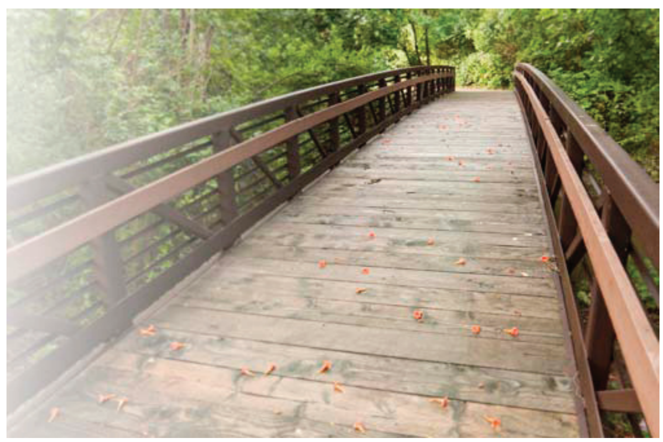
Weighing the Benefits of Medicare Advantage

At age 65, workers and their spouses generally become eligible for Medicare, the federal health insurance program for seniors. You may find that Medicare offers better coverage at a lower cost than the coverage you had previously. However, the standard (original) Medicare program has several shortcomings.

As an enrollee in original Medicare, you'll typically be responsible for 20% of the Medicare-approved amount for expenses such as doctors' charges and outpatient procedures. You'll also be responsible for the costs of prescription drugs. Such costs might run into thousands of dollars.

Covering the gaps

To reduce your exposure to steep outlays, you can buy insurance. Medicare supplement (Medigap) policies can help pay your medical bills, and Medicare Part D plans can cover your drug outlays. Both types of coverage are available from private companies, which must follow guidelines set by federal legislation.



Such coverage can be costly, though. Charges for Medigap policies and Part D plans vary widely, depending on the benefits they offer, but the combined cost can be thousands of dollars per year. Married couples with both spouses on Medicare might face extremely high premium payments.

Taking advantage

About 12 million seniors (approximately one-fourth of all Medicare enrollees) choose another way to obtain Medicare coverage. They opt out of original Medicare and enroll in a Medicare Advantage plan. Such plans, which are offered by private companies, may be attractive, but you should know the details before signing up.

Most Medicare Advantage plans have networks of doctors and labs and hospitals, so they resemble health maintenance organizations (HMOs) and preferred provider organizations (PPOs). As long as members stay in the network, they usually have modest costs. You might owe a $30 copay for a visit to a doctor, for instance, instead of the 20% coinsurance patients owe with original Medicare. If members go outside the network for care, though, they probably face higher costs.

Many Medicare Advantage plans offer prescription drugs to enrollees at discount prices. Therefore, seniors who sign up for a Medicare Advantage plan don't need a Medigap

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policy and, often, don't need to buy a Part D plan, either. What's more, some Medicare Advantage plans offer health benefits not offered by Medicare; these might include dental care, vision care, and even health club memberships.

Paying the price

What costs will you incur if you choose a Medicare Advantage plan? They vary, from plan to plan. You will continue to pay your Medicare Part B premium, which might be as low as $99.90 per month or much more, depending on your income. You may pay an additional monthly charge to your Medicare Advantage plan, but that's not always the case; some plans charge nothing at all to members except the copays for the care they receive.

In general, as long as you stay within the network, Medicare Advantage plans typically cost less than original Medicare plus a Medigap policy plus a Part D drug plan. That may be a good choice, if you are willing to give up the freedom to choose from a broader universe of health care providers. If you think that this would be a worthwhile strategy, check to see whether a plan includes your preferred physicians in its network.

At www.medicare.gov/find-a-plan, a Medicare Plan Finder provides costs, lists of covered drugs, and a quality rating system that goes up to five stars. If you do choose a Medicare Advantage plan and are not pleased with your choice, don't fret. You can leave a Medicare Advantage plan and move to original Medicare until February 14, 2012; you can switch into a five-star Medicare Advantage plan at any time. Also, from October 15 to December 7, 2012, you can join, switch, or drop a Medicare Advantage plan for 2013. ■

TAX CALENDAR

JANUARY 2012

January 17

Individuals. Make a payment of your estimated tax for 2011 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2011 estimated tax. However, you don't have to make this payment if you file your 2011 return and pay any tax due by January 31, 2012.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December if the monthly rule applies.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2011. Payments that are covered include (1) compensation for workers who are not considered employees, (2) dividends and other corporate distributions, (3) interest, (4) amounts paid in real estate transactions, (5) rents, (6) royalties, (7) amounts paid in broker and barter exchange transactions, (8) payments to attorneys, (9) profit-sharing distributions, (10) retirement plan distributions, (11) original issue discounts, (12) prizes and awards, (13) medical and health care payments, (14) debt cancellations (treated as payment to debtor), (15) payments of Indian gaming profits to tribal members, and (16) cash payments over $10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2011.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2011 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs. If your tax liability is less than $2,500, you can pay it with the return. If you deposited the tax for the year in full and on time, you have until February 10 to file the return.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2011. Deposit or pay any undeposited tax. If your tax liability is less than $2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2011. If your undeposited tax is $500 or less, you can either pay it with your return or deposit it. If it is more than $500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

FEBRUARY 2012

February 15

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 that you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2011, but did not give you a new Form W-4 to continue the exemption for 2012.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

February 29

All businesses. File information returns (Form 1099) for certain payments you made during 2011. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is April 2.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2011. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is April 2.

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