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Client Bulletin

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

Social Security: The 8% Solution

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In today's low yield world, you'll earn little interest by keeping your money in a bank account, a money market fund, or a high quality bond. Nevertheless, certain individuals can earn 8% a year, guaranteed by the federal government. If you are between age 62 and age 70, deferring the start of Social Security retirement benefits provides that return, which, for many people in that age group, makes waiting a savvy move.

Basic math

You can start to receive Social Security benefits as early as age 62. Before your full retirement age (FRA), though, you'll receive reduced benefits for the rest of your life. Say your full retirement age is 66, as it is for people born from 1943 to 1954 (age 59 to 70 this year). By starting your Social Security benefits at 62, you'll receive only 75% of your FRA benefit.

Example 1: Mark Jones has a work history that entitles him to $2,000 a month from Social Security at 66, his FRA. Instead, Mark starts his benefits at age 62. Mark will get $1,500 a month (75% of $2,000) for the rest of his life, plus any cost of living adjustments (COLAs).

Example 2: If Mark decides to wait until age 66, his FRA, he will get his basic $2,000 a month for the rest of his life, plus COLAs. Thus, by waiting 4 years, Mark increases his monthly benefit by $500—a 33.3% increase from $1,500 a month in example 1—which is about 8% a year for the 4 years he waited.

Patience is prudent

Beyond your FRA, deferring the start of Social Security will increase your benefits by 8% a year (actually, by ⅔ of 1% for each month beyond your FRA). This goes on until age 70; deferring benefits beyond 70 provides no additional cash flow.

Example 3: Mark Jones waits until age 70 to begin his Social Security benefits. This 4-year delay beyond his FRA increases Mark's check by 32%, from $2,000 to $2,640 a month, plus all the COLAs that took effect while he waited.

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Healthy Increase

The percentage of Americans under age 65 with health insurance coverage increased to 82% in 2011 from 81.5% in 2010, which was only the fifth annual increase since 1994.

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Altogether, waiting to start benefits increased Mark's monthly income from $1,500 at age 62 to $2,640 at age 70: a 76% increase in 8 years. That's a 76% return, guaranteed by the federal government.

Later than sooner

Waiting for Social Security has an obvious cost. If Mark Jones had started at age 62, with a reduced $1,500 monthly benefit, he would have collected $18,000 that year; by age 70, he would have collected $144,000 in benefits, plus COLAs. If Mark had started at age 66, receiving $2,000 a month, he would have received $96,000 plus COLAs in the 4 years before age 70.

When does it pay to take the money as soon as possible? When does it make sense to wait? Here are some guidelines:

Do you need the money? If Social Security benefits are necessary to maintain your lifestyle in retirement, you probably should take them.

How is your health? The shorter your life expectancy, the more likely you and your loved ones will be well served by taking the benefits while you can.

Assume, though, that Mark Jones is in good health with no pressing need for extra cash flow from Social Security. If he takes his benefits before age 70, he will pay tax and spend, save, or give away the aftertax amount. If he decides to reinvest, he'll either have to settle for a low yield or take investment risk in the hope of receiving a superior return.

For Mark, waiting in this example provides certain benefits. He'll earn an annual return of around 8%, plus COLAs, on his full (untaxed) Social Security benefit. The return from waiting will be longevity insurance: a reduced risk of running short of money if Mark lives into his 80s and beyond.

In addition, assume that Mark Jones is married and that his wife had lower lifetime earnings than Mark. In this case, Mark is entitled to a larger Social Security benefit than his wife. If Mark dies first, his widow will be entitled to his full Social Security benefit for the rest of her life, rather than her smaller benefit. Therefore, an older and higher earning spouse who waits to receive Social Security is essentially obtaining more life insurance for a surviving spouse. ■

Did You Know?

Assets in exchange-traded funds (ETFs) reached a record high of $8.8 trillion in August 2012. The three largest ETF sponsors (BlackRock iShares, State Street Global Advisors, and Vanguard) had over $1 trillion in assets: about 85% of the total.

Source: Cerulli Associates

Buying Stocks Through Dividend Reinvestment Plans

Dividend-paying stocks offer many potential advantages to investors. The dividends they pay provide welcome cash flow. Those dividends can grow over time, if the company's profits increase. Moreover, rising dividends may lead to higher stock prices, and, therefore, to profits for investors who sell shares.

Hundreds of dividend-paying companies offer yet another benefit: the opportunity to invest in a dividend reinvestment plan, known as a DRIP. Such plans make it easy to invest regularly and, thus, build wealth over the long term. DRIP participants generally cut out brokers' commissions, reducing their costs to acquire shares.

Partial purchases

As the name suggests, the basic purpose of a dividend reinvestment plan is to enable participants to reinvest a company's dividend payout in that company's stock. Suppose you own 100 shares of Pfizer, trading at $25 a share. If Pfizer's next quarterly dividend is 22 cents per share, you'd get $22. Assuming you had enrolled in the Pfizer DRIP, that $22 would automatically be reinvested in 0.88 shares of Pfizer, bringing your holdings to 100.88 shares. Your next dividend would be based on owning 100.88 shares, and so on.

Direct investing

Obviously, you'll have a difficult time building wealth at such a pace. For DRIP participants, the greatest advantage is the ability to make optional cash purchases, which most DRIPs offer. You can select the amount you'd like to invest and an investment schedule. Then you

buy the shares directly from the company.

Example: Laura Roberts enrolls in the Pfizer DRIP and decides to invest $200 every three months. In January 2013, with Pfizer trading at $25 a share, Laura's $200 buys 8 shares. In April 2013, if Pfizer is trading at $27 a share, Laura's $200 will purchase another 7.407 shares; if Pfizer is trading at $23 in July, her $200 will buy 8.696 shares.

Over time, Laura can steadily build up her stake in Pfizer. If she wishes, Laura might participate in DRIPs offered by, say, ExxonMobil, Procter & Gamble, Microsoft, and others, accumulating a diversified portfolio. Investors in DRIPs buy stock directly from the issuing company, so there are no brokerage commissions. Some DRIPs impose small fees, but even in those cases investors usually pay less than they would pay a broker.

If you are interested in becoming a DRIP investor, select the company or companies you believe will be superior long-term holdings. Go to each company's website and click on "Investors" or "Shareholder Services" or something similar for directions on how to enroll. Typically, you'll be able to arrange for automatic transfers from your bank account to the DRIP with your choice of scheduled payments and the amount to invest.

Cons and pros

DRIPs have their drawbacks. You won't know exactly how much you'll pay for each batch of shares you acquire, and selling through a DRIP might take more time than would be the case with a standard brokerage sale. Recordkeeping also may be an issue: for example, if you participate in three different DRIPs, you'll get statements and annual 1099 tax forms from each one. You won't get the consolidated statements that you'd get if you worked with a broker to buy and hold all your shares. Fortunately, our office can help with the necessary accounting and tax requirements.

For long-term investors, DRIPs can be valuable. They encourage the discipline to keep investing, in bad times as well as good ones. By regular investments of fixed amounts, you'll buy more shares when stock prices dip and, thus, benefit from a lower cost per share. Your transaction costs will be low with a DRIP, and you can acquire sizable holdings over time with modest outlays, as long as you stick with the program. ■

Tax Planning for S Corporation Owners

Small business owners may choose S corporation status. As long as certain criteria are met (see the Trusted Advice column in this issue on "S Corp Criteria" for further information), the S corporation election will be recognized, and corporate income tax will be avoided. Instead, all corporate income will flow through to the shareholders, who will report that income on individual tax returns.

Savvy planning can enhance S corporation tax benefits. For instance, owners may reduce self-employment tax.

Example 1: Nate Sawyer and his wife, Vicki, own all the shares of an S corporation that Nate runs. In 2013, that company has net income of $300,000, which Nate receives as compensation. Nate will report that $300,000 as taxable income. In addition, Nate will owe Social Security tax, on wages up to the 2013 limit ($113,700), a 2.9% Medicare tax on the first $250,000, and a 3.8% Medicare tax on the last $50,000 of those earnings because a new 0.9% Medicare surtax applies starting in 2013.

Suppose, though, that Nate determines that owners of comparable companies generally are paid around $140,000. He restructures his compensation, so he takes $140,000 in salary, leaving $160,000 as corporate profits not subject to Medicare tax. This will save Nate $5,090 in Medicare tax: 2.9% times $110,000 + 3.8% times $50,000.

Note that the IRS insists that the salary S corporation shareholders take be reasonable. Our office can help S corporation owners set a fair

Trusted Advice

S Corp Criteria

- To qualify as an S corporation, your company must be a domestic corporation with only individuals, certain trusts, and estates as shareholders.
- Partnerships, corporations, or nonresident aliens can't be S corporation shareholders.
- An S corporation can have no more than 100 shareholders and only one class of stock.
- Certain financial institutions, insurance companies, and domestic international sales corporations can't be S corporations.
- The company must file Form 2553, Election by a Small Business Corporation, signed by all shareholders, for the tax year the S corporation election is to take effect.

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compensation level and reduce the threat of adverse tax consequences.

Shifting shares

Family tax planning may provide additional tax savings.

Example 2: Nate Sawyer's S corporation is appraised at $2 million. The company has 2 million shares outstanding, so each share might be valued at $1. Nate can give 14,000 shares to his son, Tim, and 14,000 shares to his daughter, Alexa, this year. His wife, Vicki, makes identical gifts. The senior Sawyers will face no gift tax consequences because the annual gift tax exclusion is $14,000 in 2013. (Nate and Vicki can give away more shares, covered by the exclusion, because of valuation discounts, but this simplified example illustrates the concept.)

By giving away a total of 56,000 shares this year, Nate and Vicki transfer 2.8% of the company to their children. With repeated gifts of this magnitude, the senior Sawyers can transfer 14% of their company in 5 years and 28% in 10 years and still retain control of the S corporation. If the children own 14% of the company, they'll report 14% of corporate income on their income tax returns; as long as they are in lower tax brackets than their parents, the family will owe less income tax. Shifting ownership of shares also may result in lower estate tax in the future.

S corporation earnings are considered unearned income, which means that the so-called "kiddie tax" can limit tax savings on transfers to children. Therefore, this income-shifting strategy might have its greatest payoff after children leave school or reach age 24, when the kiddie tax won't apply. ■

TAX CALENDAR

JANUARY 2013

January 15

Individuals. Make a payment of your estimated tax for 2012 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 2012 estimated tax. However, you don't have to make this payment if you file your 2012 return and pay any tax due by January 31, 2013.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2012 if the monthly rule applies.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2012. 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 2012.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2012 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2012. 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 11 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2012. 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 11 to file the return.

FEBRUARY 2013

February 15

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

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

February 18

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2012 but did not give you a new Form W-4 to continue the exemption for 2013.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2012. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is April 1.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2012. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is April 1.

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