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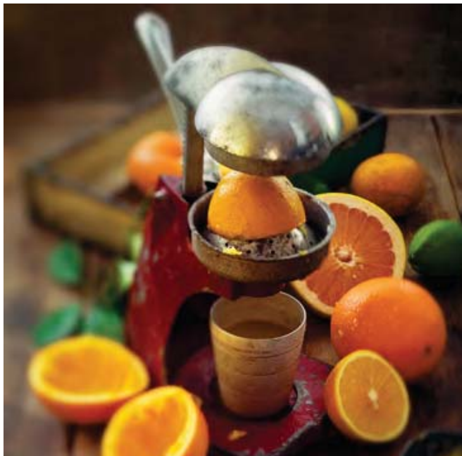
Client Bulletin

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

June 2013

Diversify 529 Accounts



Total college savings assets in 529 accounts reached $168.5 billion by the end of 2012, up 16.7% for the year, reports Financial Research Corp. (FRC), Boston. Parents increasingly use these plans to fund future college costs because of the tax advantages. Any investment earnings inside the plan are untaxed, and withdrawals also are untaxed if the money is spent on higher education.

Most 529 assets are held in so-called "age-based" accounts. Generally, these accounts emphasize stocks for young beneficiaries. As the student grows older, closer to college age, age-based plans reduce their allocation to stocks and increase holdings of bonds. This method decreases the chance of a steep loss when the 529 beneficiary goes to college and payments are due.

Action plans

Age-based 529 accounts offer benefits, especially for parents who prefer to let professionals handle the asset mix in their college fund. However, if you are willing to take a more active role, you might be able to squeeze more tax savings juice out of the 529 orange.

One way to do this is to invest in multiple 529 plans. You can choose among the plans offered by nearly every state. With each plan you choose, use a different investment strategy.

Example 1: Ron and Sarah Parker want to invest $10,000 a year in their son Kevin's college fund. They invest $6,000 a year in state A's 529 plan, putting the money into a stock fund; the Parkers also invest $4,000 a year in state B's 529 plan, using a bond fund there.

After doing this for 12 years, the Parkers have $110,000 in state A's stock fund and $60,000 in state B's bond fund. Kevin will go to college this year, and the Parkers want to take $15,000 from his 529 plans. For tax efficiency, all $15,000 should come from Kevin's state A 529 account, which has the stock market gain. That account has more growth, so taking withdrawals from that account turns paper profits into untaxed earnings used for college costs.

Example 2: Assume the same facts as example 1, except that Kevin is still too

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No Longer Lost

According to Morningstar, the average domestic stock fund returned 14.5% in 2012, bringing the annualized 10-year return up to 7.9%.

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Trusted Advice

Countable Costs

- No tax is due on a distribution from a qualified tuition program, also called a "529 plan," unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses, which are the beneficiary's qualified education expenses less any tax-free educational assistance.
- To be qualified education expenses, expenses for tuition, fees, books, supplies, and equipment must be required for enrollment or attendance at an eligible educational institution.
- Virtually all accredited public, nonprofit, and proprietary postsecondary educational institutions will qualify.
- For room and board expenses to be qualified education expenses, the student must be enrolled for at least half the full-time academic workload for the course of study he or she is pursuing.

young for college. Instead, suppose that the Parkers need $15,000 in cash to meet a medical emergency. They decide that the best available source is Kevin's 529 money. In this situation, they should tap the lower-growth state B bond fund.

With a total value of $60,000 that includes $12,000 of earnings, the earnings ratio is only 12/60, or 20%. On a $15,000 distribution, for expenses other than higher education, only 20% ($3,000) will be a taxable distribution. When you withdraw 529 funds for purposes other than higher education, you'll owe ordinary income tax plus a 10% penalty for nonqualified withdrawals. If the Parkers are in a 25% tax bracket, they'll owe a total of 35% (including the 10% penalty) on the $3,000 taxable distribution. Thus, they can withdraw $15,000 from Kevin's 529 bond account, in this example, and owe only $1,050 in tax.

Fine points

Regardless of how many 529 plans you use, you should begin by evaluating your own state's plan. Many states offer residents a tax break for contributing to their plan; contributions may be deductible for state income tax, although annual ceilings might apply.

In addition, when you withdraw money from a 529 plan to pay for college, be sure the distributions and outlays match up within a calendar year. Otherwise, you may owe tax and a 10% penalty.

Example 3: Assume again that Kevin Parker goes to college this year. His parents withdraw $15,000 from a 529 plan in 2013 but spend only $10,000 on Kevin's higher education this year.

In such a situation, the IRS will treat $5,000 of the Parkers' 2013 distribution as a nonqualified withdrawal and tax the withdrawn earnings at the Parkers' ordinary income tax rate, plus a 10% penalty. Even if the Parkers spend another $5,000 on Kevin's college costs in 2014 without taking a further withdrawal, the $5,000 nonqualified withdrawal from 2013 will still be taxed. ■

Maximizing Medical Deductions

Under federal health insurance legislation, you'll probably find it more difficult to claim medical expenses as itemized deductions on Schedule A of your tax return, beginning in 2013. (See the October 2012 ***CPA Client Bulletin.***) You'll get deductions only for expenses that exceed 10% of your adjusted gross income (AGI), up from 7.5% in prior years. (Through 2016, the threshold will remain at 7.5% of AGI if you or your spouse is age 65 or older at the close of the tax year.)

You cannot include medical expenses that were paid by insurance companies or other sources. This is true whether the payments were made directly to you, the person receiving the medical services (that is, your spouse or dependent), or to the provider of the medical services.

Example 1: Joel Gordon, age 45, has AGI of $100,000 in 2013 and $12,000 of unreimbursed medical expenses. The 10% threshold for Joel is $10,000, so he can deduct $2,000 of his medical bills. Under prior law, his 7.5% threshold would have been $7,500, and Joel could have claimed $4,500 in medical deductions.

The 10% solution

Even with a higher threshold, you shouldn't give up on deducting medical expenses. Good recordkeeping and a knowledge of the rules can help you go over the 10% level in some years. In particular,

Did You Know?

Head of the Class: Among 529 college savings plans, Virginia's CollegeAmerica Plan is by far the largest, with over $35 billion in assets and a 21% market share. New York's 529 College Savings Program, Direct Plan, is in second place with a 7.1% share.

Source: Financial Research Corp. (FRC)

you should be sure to track items, such as the following:

Health insurance premiums. Even if you're covered by an employer plan at work, you probably are contributing to the cost of your insurance. Many employers require some form of cost sharing, and employees' share of the total has been increasing. If your contributions are withheld from your paychecks and are paid with your own after-tax dollars, don't forget to include those amounts in your total outlays. (Note that many people have pre-tax dollars withheld, in which case they are not deductible.)

Seniors are likely to be in a similar situation regarding Medicare, the federal government's health insurance program that mainly covers individuals 65 and older. You can include the premiums you pay for Medicare Part B (medical costs) and Part D (prescription drugs). Often, the government takes those costs from your Social Security checks, so you might not realize you've paid them. Medicare Part B costs over $1,200 a year, so you should be sure to count the money withheld from Social Security for such premiums.

In addition to ordinary health insurance, you also can include premiums you pay for long-term care insurance (subject to age-based limits), dental insurance, and contact lens coverage in the medical outlays you report as itemized deductions on Schedule A.

Instead of deducting health insurance premiums as itemized deductions on Schedule A, if you are self-employed, a partner in a partnership, or a more than 2% shareholder of an S corporation, you not only can deduct your health insurance premiums, you can take the deduction "above the line" on page 1 of your tax return. There is no AGI threshold for these deductions; in fact, your self-employed health insurance deductions reduce your AGI, which may help you deduct other medical expenses.

Dependents' costs. You can include medical costs you pay for yourself and your spouse. You also can count the medical costs you incur for someone who was your dependent either at the time the medical services were provided or at the time you paid the bill. The person must be either a "qualifying child" or a "qualifying relative," generally someone who depends on you for the necessities of life. The specific definitions are complex; our office can help you determine whether someone is a dependent for purposes of the medical expense deduction.

Transportation. You can include in your medical expenses outlays for transportation that was primarily for, and essential to, medical care. Such travel can be by bus, taxi, train, or plane. When you're taking a child for needed medical care, count those costs as well.

In addition, you can include your actual out-of-pocket for medical trips by car, such as gas and oil. As an alternative, you can calculate the deductible transportation expense amount by adding up the number of miles you travel for medical reasons and multiplying the total miles by the standard medical mileage rate, which is 24 cents a mile in 2013. You can add parking fees and tolls to your medical expenses, whether you use actual expenses or the standard mileage rate. Medical travel doesn't include commuting to and from work or travel for the general improvement of your health.

On the house

Amounts you pay for special equipment installed in your home, or for home improvements, can be included if the main purpose is medical care for you, your spouse, or a dependent. To justify the deduction, you should have a written recommendation from a

doctor, prescribing the equipment or home improvement to treat a specific medical condition. IRS examples include access ramps, wider doorways, and elevators, but it's also possible to get deductions for a swimming pool or central air conditioning, if you proceed correctly. The cost of permanent improvements may be included as a medical expense, but you must reduce the deduction by any increase in the home's value. If the improvement does not increase the value of your home, the entire cost of the improvement can be deducted as a medical expense.

Example 2: Lynn Johnson has a severe form of arthritis, and her doctor tells her to swim regularly to regain her range of motion. Lynn decides to install a pool in her home.

Lynn begins by having her house appraised. After her home pool has been installed, Lynn gets another appraisal. She can claim the difference between the amount she has spent and the increase in her home's value as a medical deduction.

Say Lynn spends $40,000 installing her pool. The before-and-after appraisals indicate her home's value went from $350,000 to $375,000 as a result of the improvement. Thus, Lynn spent $40,000, and her house appreciated by $25,000. She can claim the $15,000 difference as a medical expense, which may allow her to take an itemized medical deduction. ■

Getting Started on a Succession Plan

As a successful business owner, you still may reach a point where life's realities are at odds with your career. Your health might decline, making it more difficult to keep up the pace, or you may just be tired of working so hard and decide to step aside.

Whatever the reason, you probably plan to sell your business and use the proceeds to help finance your retirement. However, waiting until the last minute can be a trap. If you are eager to sell and move on with your life, you'll be in a poor position to negotiate terms with prospective buyers.

Realize reality

Your chances of selling your company for its full value will increase if you develop a succession plan, and such a plan will be more effective if you begin years before an anticipated sale. A viable succession plan has many moving parts, but one way to start is to get a reasonable idea of what your company is worth.

You may have heard that another company in your industry was sold for a certain price or that businesses in your industry sell for X times net operating income. Thus, you have an idea of what a buyer would pay for your company. Your expectations, though, may prove to be inaccurate. In most cases, buyers will look at your company as a unique collection of products, services, customers, and employees, and they will make an offer based on their estimate of future profitability.

Consequently, you should have your company valued by a knowledgeable appraiser, ideally a few years before putting it up for sale. Look for someone experienced in appraising companies in your industry. You'll probably have to pay several thousands of dollars for such a valuation, but you'll know what you reasonably can expect to receive, and you might get ideas about how you can make your company more attractive to bidders.

Select a successor

When you're ready to sell, you can just put your company on the market or contact a business broker. With this approach, though, you may not know who'll be taking over your company. Will the new owner antagonize long-term employees or customers? If the deal calls for a buyout over time, will the new owner keep the company healthy enough to make the ongoing payments to you?

Such considerations may lead you to choose your successor as part of your succession plan. Your first thought might be a relative, assuming that person is capable and enthusiastic about taking over. Keeping your business in the family may not be possible, though.

You may consider a current employee. Promoting from within can ensure that your successor already is familiar with your company's staff, customers, and suppliers.

If you don't already have a relative or current employee in mind, you can hire someone to groom for an eventual buyout. Whatever path you choose, it is best to start planning early. ■

TAX CALENDAR

JUNE 2013

June 17

Individuals. If you are not paying your 2013 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2013 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2012. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2013.

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

JULY 2013

July 15

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

July 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2013. Deposit or pay any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 12 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan, such as a pension, profit sharing, or stock bonus plan, with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2012.

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