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

March 2015

Above-The-Line Tax Deductions

At this time of the year, chances are that you're getting together information for preparing your 2014 income tax return or reviewing a return that's already prepared. When you are doing so, it can pay to take a close look at the adjustments to income you can take on the bottom of page 1 of your Form 1040 or Form 1040A. These adjustments, which reduce the taxable income you'll declare, are known as *above-the-line* deductions—you enter them just above the last line on the page, where you report your adjusted gross income (AGI).

Above-the-line deductions offer two key advantages. First, you are allowed to take the page 1 deductions regardless of whether you itemize deductions on Schedule A of your tax return.

Second, above-the-line deductions reduce your AGI and, in many situations, also reduce your modified adjusted gross income (MAGI). A lower AGI or MAGI, in turn, can provide tax savings on various tax return items. For instance, most taxpayers now can deduct medical expenses only to the extent they exceed 10% of AGI. With a lower AGI, you may qualify for a larger itemized medical deduction.

Looking at the lineup

There are more than a dozen categories of above-the-line deductions. They include:

IRAs. You can make contributions for 2014 until April 15 of 2015. Although many taxpayers won't be able to deduct IRA contributions because of income and participation in an employer plan, some people might qualify for deductions.

Example: Alice Baker is a home-maker with no earned income in 2014; her husband, Carl, is employed and participates in his company's retirement plan. The couple's MAGI for 2014 is over $116,000, so Carl cannot make a deductible IRA contribution for that year. However, if the couple's 2014 MAGI is less than $181,000, Alice can make a fully tax deductible contribution of up to $5,500 ($6,500 if she is 50 or older).

Other retirement accounts. Contributions to such accounts also

continued on page 2

What's Inside

Hitting the Ceiling

The maximum Social Security benefit for a worker starting to collect at full retirement age (66) in 2015 is $2,663 a month, or $31,956 a year.

continued from page 1

Trusted Advice

Self-Employment Health Insurance

You may be able to deduct the premiums you paid if

- you had a net profit from self-employment, reported on a Schedule C or a Schedule F;
- you had self-employment earnings as a partner;
- you used an optional method to figure your net earnings from self-employment on Schedule SE; or
- you were paid wages as a shareholder who owns more than 2% of an S corporation.

reduce your AGI. Moreover, if you had self-employment income in 2014, you can contribute to a simplified employee pension (SEP) plan until the due date of your 2014 tax return. Thus, with a filing extension, the SEP deadline can be October 15, 2015. You generally can contribute nearly 20% of your self-employment income, with a SEP contribution cap of $52,000 for 2014.

Health Savings Accounts (HSAs). With certain high deductible health insurance plans, you can make tax-deductible contributions to an HSA; you can tap these accounts for health care costs without owing income tax. Again, if you qualify for a 2014 HSA contribution, the deadline is April 15, 2015. Contribution limits go up to $7,550 for someone age 55 or older with family coverage.

Self-employed health insurance. Self-employed individuals can deduct the premiums paid for any medical insurance, dental and long-term care insurance. Policies also can cover the worker's spouse, dependents, and non-dependent children who were under age 27 at the end of last year. What's more, the IRS has said that Medicare premiums paid by self-employed individuals can be taken as an above-the-line adjustment to income. There are some conditions that must be met to claim this deduction; our office can help you report the appropriate amount.

Alimony. Amounts you paid to your spouse or a former spouse under a divorce or separation decree that qualify as alimony for tax purposes are deductible here.

Other above-the-line deductions include job-related moving expenses and interest payments on student loans. Our office can help you make the most of the various above-the-line adjustments to income on your 2014 tax return. ■

Dealing With Sequence Risk

Sequence risk, sometimes known as sequence of returns risk, is the peril that might be faced by retirees when they start drawing down their savings for living expenses. If you happen to retire at the wrong time—just before a severe bear market—you might run short of money in a relatively short time.

Some financial advisors are especially concerned about sequence risk for retirees who are following a schedule of drawing down their savings. Such plans typically begin with a specific percentage withdrawal in year one of retirement, followed by inflation-based adjustments.

Example 1: Molly Larson retires in 2015 with $1 million in savings. Molly's plan calls for her to withdraw $40,000 (4% of $1 million) for living expenses this year. If inflation in 2015 is 5%, Molly would increase her 2016 withdrawal by 5%, to $42,000. If inflation in 2016 is 3%, Molly would increase her 2017 withdrawal by 3%, from $42,000 to $43,260. And so on.

Research indicates that such a plan has a very high likelihood of avoiding portfolio depletion over a 30-year retirement, assuming historic investment returns and inflation levels. Some advisors suggest another initial withdrawal rate, often in the 3%–5% range. Regardless, this strategy increases retirement withdrawals and decreases savings over time.

Enter sequence risk

If a retiree's portfolio earns 7% or 8% every year, it probably can pay out the projected cash flow for 30 years or longer. However, investment returns fluctuate, and the sequence of those returns can be vital.

Did You Know?

In 2014, offerings of consumer-directed health plans (CDHPs) jumped from 39% to 48% among employers with 500 or more employees. The average cost of coverage in a CDHP paired with a tax-advantaged health savings account is $8,789 per employee, compared to $10,664 for PPOs and $11,052 for HMOs.

Source: Mercer

Example 2: Assume the same facts as in example 1. Molly's portfolio grows by 15% in 2015, from $1 million to $1.15 million. Her $40,000 withdrawal reduces the balance to $1.11 million. If inflation is 5% this year, and Molly withdraws $42,000 in 2016, as planned, her withdrawal rate ($42,000 withdrawal from a $1.11 million portfolio) is around 3.8%. Molly's withdrawal schedule seems to be on track.

A down year, however, won't be so welcome.

Example 3: Assume instead that Molly's portfolio falls by 15% in 2015, to $850,000. Now Molly's planned $42,000 withdrawal would be over 4.9% of her savings. The higher withdrawal rate increases the risk of running out of money in her portfolio.

Serious for seniors

Sequence risk may not be a major risk for younger investors because initial setbacks can be recovered by later gains. That may not be true for retirees in the distribution mode, especially if their plan calls for increasing withdrawals to keep pace with inflation.

Early portfolio losses mixed with larger distributions result in a smaller asset base, so that the subsequent recovery won't be as powerful. The effect of sequence risk is especially potent during the first five years of retirement distributions.

Safer solutions

How can recent retirees and people approaching retirement reduce their exposure to sequence risk? You can discuss the issue with your financial or investment advisor. Get suggestions and decide whether they're likely to be effective.

In general terms, sequence risk may be addressed by reducing portfolio volatility. The less chance you face a large portfolio loss, the less chance of seeing your savings depleted rapidly. Reducing portfolio risk usually means more asset diversification and less exposure to stocks, but this approach may reduce upside potential.

Reduced portfolio risk might be combined with increased distribution flexibility. After a down year, you may decide to hold portfolio distributions steady, or even decrease them. In any case, you should be aware of sequence risk and start your retirement with a strategy that won't expose your life's savings to rapid depletion. ■

Turn Relatives Into Employees to Reduce Taxes

High-income business owners may be realizing the impact of new tax laws as they prepare their 2014 tax returns. Those laws can be especially painful if your company is structured as an S corporation or a limited liability company (LLC), with all income reported on your personal return. Besides the recently added 39.6% top income tax bracket, your income may be subject to the 3.8% Medicare surtax as well as the phaseout of itemized deductions and personal exemptions. Including state taxes, you might be in a marginal tax bracket in excess of 50%.

Savvy shifting

You may receive some tax relief by hiring relatives. The money you pay will reduce business profits, so you might have less taxable income to report. That compensation will be taxable to the relatives you hire—or it might not. The standard deduction is $6,300 in 2015, so your children can each receive up to that much, tax-free.

Example: Jennifer Boyd has a mail order clothing business that makes enough money to put her into a high tax bracket. She hires her two children and pays them $3,500 and $5,000 this year. Jennifer reduces her reported income by $8,500, saving her thousands of dollars a year in tax, while her children owe no income tax.

Jennifer also hires her widowed mother, who is in the 15% tax bracket. (That rate goes up to $37,450 of taxable income in 2015.) Again, Jennifer saves tax by reducing

continued on page 4

continued from page 3

her income, while her mother owes relatively little in tax.

To justify the tax savings, family members on the payroll must be paid fairly for work they actually perform. Thus, tasks should be suited for each individual's capabilities. Jennifer's teenage son, for instance, might help with her company's website and its IT operations; her daughter, who goes away to college, could generate market research reports that relate to Jennifer's business and play a role in keeping the company's social media activities up to date. Jennifer's mother, a retired fashion designer, could provide advice on product trends and selection.

No matter what kind of work relatives perform, business owners should keep records showing their production. Compensation should be in line with the amounts paid to other employees.

Weighing the tradeoff

If your business is a partnership between spouses or a sole proprietorship or a certain type of LLC, you won't be required to pay Social Security and Medicare taxes on the wages you pay to your children if they are under age 18. Similarly, with an unincorporated business, you won't need to pay federal unemployment tax on wages paid to a son or daughter under age 21.

Except for those situations, the wages you pay relatives will be subject to payroll taxes. Those payments may reduce the family's tax savings. Our office can help you calculate the net tax benefit of hiring family members and assist in setting up the required paperwork.

Beyond tax savings, hiring relatives can be rewarding. Your children may gain valuable life lessons, and your retired parents can continue to perform worthwhile tasks. Tax savings, while undoubtedly welcome, might turn out to be the icing on the cake. ■

TAX CALENDAR

MARCH 2015

March 16

Corporations. File a 2014 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2014 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2015. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2016.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

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

APRIL 2015

April 15

Individuals. File a 2014 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2015 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2015 estimated tax. Use Form 1040-ES.

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

Household employers. If you paid cash wages of $1,900 or more in 2014 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2013 or 2014 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2014 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2014 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2015.

The *CPA Client Bulletin* (ISSN 1942-7271) is prepared by AICPA staff for the clients of its members and other practitioners. The *Bulletin* carries no official authority, and its contents should not be acted upon without professional advice. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service, call 888.777.7077 or visit *www.cpa2biz.com*.