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Online ::: www.ReaganandCompany.com
98 Adams St., Suite 101 | Leominster, MA 01453 | (978) 534-4095



# Client Bulletin

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

February 2017


## After-Tax Dollars in Traditional IRAs

Workers under age 70½ can deduct contributions to a traditional IRA, as long as they are *not* covered by an employer's retirement plan. The same is true for those workers' spouses.

If these taxpayers *are* covered by an employer plan, they may or may not be able to deduct IRA contributions, depending on the taxpayer's income. (See Trusted Advice, "Deducting IRA Contributions.") However, all eligible workers and spouses can make nondeductible contributions to a traditional IRA, regardless of income. Inside a traditional IRA, any investment earnings will be untaxed.

### Dealing with distributions

Problems can arise for people who hold nondeductible dollars in their IRAs when they take distributions. Unless they're careful, they may pay tax twice on the same dollars.

**Example 1:** Marge Barnes has $100,000 in her traditional IRA on February 15, 2017. Over the years, she has made deductible and nondeductible contributions. Assume that $25,000 came from nondeductible contributions, $45,000 came from deductible contributions, and $30,000 came from investment earnings inside Marge's IRA.

Now Marge wants to take a $20,000 distribution from her IRA. She might report $20,000 of taxable income from that distribution; indeed, Marge's IRA custodian may report a $20,000 distribution to the IRS. However, Marge would be making a mistake, resulting in a tax overpayment.

### Cream in the coffee

To the IRS, a taxpayer's IRA money must be stirred together to include pre-tax and after-tax dollars. Any distribution is considered to be proportionate. If Marge were to pay tax on a full $20,000 distribution, she would effectively be paying tax twice on the after-tax dollars included in this distribution.

Example 2: After hearing about this rule, Marge calculates that her $25,000 of after-tax money (her nondeductible

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### Costly care

*In 2016, the national median daily rate for a private room in a nursing home was $253 a day; that's $92,345 a year.*

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## Trusted Advice

### *Deducting IRA Contributions*

- Single filers who are covered by a retirement plan at work cannot deduct traditional IRA contributions for 2016 with modified adjusted gross income (MAGI) of $71,000 or more in 2016 ($72,000 for 2017 IRAs).
- On joint tax returns, covered workers are shut out from deductible IRA contributions with MAGI of $118,000 or more for 2016 ($119,000 for 2017).
- A spouse who is not covered by a retirement plan at work and files jointly with a covered worker can deduct IRA contributions as long as joint MAGI is less than $194,000 for 2016 ($196,000 for 2017).
- Other income limits apply to contributions to Roth IRAs in which contributions are never deductible, but future distributions may be tax-free.

contributions) was 25% of her $100,000 IRA on the date of the distribution. Thus, 25% of the $20,000 ($5,000) represented after-tax dollars, so Marge reports the $15,000 remainder of the distribution as a taxable withdrawal of pre-tax dollars. Again, this would be incorrect.

### Year-end calculation

Tax rules require an IRA's after-tax contributions to be compared with the year-end IRA balance, plus distributions during the year, to calculate the ratio of pre-tax and after-tax dollars involved in a distribution.

Example 3: Assume that Marge's IRA holds $90,000 on December 31, 2017. Her $100,000 IRA was reduced by the $20,000 distribution in February, but increased by subsequent contributions and investment earnings. Therefore, Marge's IRA balance for this calculation is $110,000 (the $90,000 at year-end plus the $20,000 distribution). This assumes no other distributions in 2017.

Accordingly, Marge divides her $110,000 IRA balance into the $25,000 of after-tax money used in this example. The result—22.7%—is the portion of her distribution representing after-tax dollars. Of Marge's $20,000 distribution, $4,540 (22.7%) is a tax-free return of after-tax dollars, and the balance ($15,460) is reported as taxable income. Marge reduces the after-tax dollars in her IRA by that $4,540, from $25,000 to $20,460, so the tax on future IRA distributions can be computed.

### Form 8606

As you can see, paying the correct amount of tax on distributions from IRAs with after-tax dollars can be complicated. Without knowledge of the rules, an IRA owner may overpay tax by reporting already-taxed dollars as income. However, keeping track of after-tax and pre-tax dollars may not be simple, especially for taxpayers with multiple IRAs and multiple transactions during that year.

The best way to deal with this issue is to track pre-tax and after-tax IRA money by filing IRS Form 8606 with your federal income tax return each year that your IRA holds after-tax dollars. Our office can help prepare Form 8606 for you, when it's indicated, and, thus, prevent this type of double taxation. ■

# "Combo" Products for Long-Term Care Coverage

If you or a loved one ever need help with daily living activities, you will discover that custodial care can be expensive. That's true whether the care is provided at home, in an assisted living facility, or in a nursing home, and it's especially true if care is needed for many years.

Long-term care (LTC) insurance is available, but insurance companies have learned that these costs can be steep. Premium increases for LTC insurance are in the news (for example, some press reports tell of cases where premiums have tripled in the last three years), and some insurance companies have dropped out of this business. Consumers face the prospect of paying thousands of dollars a year, every year, and never getting any benefit at all if it turns out that custodial care is not needed.

### Sure things

Some people might prefer another path to LTC coverage, such as a hybrid or "combo" product. These come in two varieties: a combination with a life insurance policy or with a deferred annuity. Here, a consumer buys a product that will deliver a death benefit (life insurance) or future cash flow

## Did You Know?

Online sales are driving in-store traffic. Half of shoppers who buy online will ship their purchase to a physical store. Of these, 46% make additional purchases while picking up their items. A majority of shoppers (60%) also prefer to return items to a store, at which time 70% of them make additional purchases.

*Source:* ups.com

(deferred annuity). With a combo product, the consumer can obtain a rider that will offer a payout if the covered individual needs LTC.

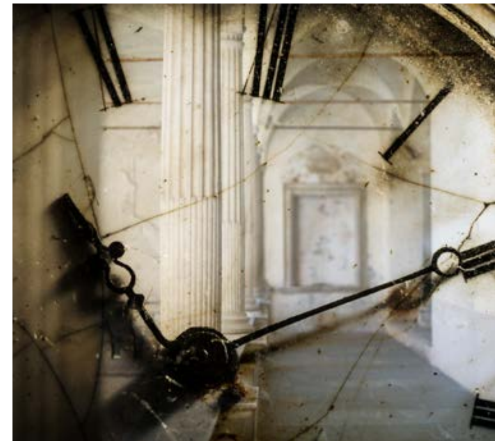
**Example 1:** Ted Moore has an insurance policy on his life, payable to his son Paul. Ted's policy has an LTC rider. So, if Ted needs LTC, that insurance policy will provide a benefit to help pay those bills. Regardless if Ted needs care and collects an LTC benefit, his life insurance policy will pay a death benefit to Paul at the time of Ted's death.

Generally, in this situation, Ted would receive an "accelerated death benefit" to pay for care. When someone receives such a payout, the amount of the lifetime benefit is subtracted from the death benefit that eventually will be paid to beneficiaries. Typically, a combo life insurance product would be some form of whole life or universal life, rather than term life insurance.

**Example 2:** Rita Smith decides to invest in a deferred annuity, attracted by that particular product's features, which include guaranteed withdrawals. Like Ted in the previous example, she has an LTC rider for this annuity. In retirement, Rita can receive cash flow from the deferred annuity, and the LTC rider will provide money to pay for care, if needed. Depending on how Rita handles the annuity, there also may be a payout to beneficiaries she has named at the time of her death.

The common aspect of those two tactics is the absence of a "use it or lose it" drawback. With standalone LTC insurance, the money spent could wind up generating no return. With either life insurance or a deferred annuity, there will be a payout to someone at some point. The extra LTC coverage is another benefit that possibly will come in handy.

Acquiring LTC coverage in this manner usually avoids the threat of future premium increases. As another attraction, existing life insurance policies or annuities might be exchanged, tax-free, for a new contract that includes an LTC rider.



## Added expense

The attractions of LTC combo products, however, come with negatives as well. The underlying problem here includes the potentially disastrous costs of LTC, and this problem can't be escaped by switching from one type of insurance to another. There often is a cost to adding an LTC rider to an insurance policy or a deferred annuity. These combo products may require a substantial outlay, which must be paid upfront or within relatively few years.

In addition, tax advantages may be lost with combo products. With most standalone LTC insurance policies, certain amounts of your premium count as a medical expense, which can potentially be deducted. That's not the case with a rider to a life insurance policy or to a deferred annuity.

As of 2017, people age 40 and younger can include LTC premiums up to $410 as a medical expense; that amount scales up as premium payers age, maxing out at $5,110 for those 70 and older. Those outlays are added to other medical expenses, and the amount that exceeds 10% of adjusted gross income can be taken as an itemized deduction.

## Putting needs first

Combo products vary widely, and so do individuals' concerns on this issue. However, generally, people who only want LTC insurance might be best-served with standalone coverage, working with an insurance professional to hold down premiums. That said, if you are interested in life insurance such as whole life or universal life, it may be worth exploring the idea of adding LTC coverage, perhaps for an added fee. The same may be true if you are seriously considering a deferred annuity. ■

# Defined Benefit Plans for (Very) Small Companies

Traditional defined benefit plans, structured to provide a lifelong pension, have become rare in the private sector. They're still the norm for public sector employers; some large companies continue to offer plans.

Ironically, these plans might be a good fit for extremely small companies. A possible prospect could be a business or professional practice with one or two principals who are perhaps 5–10 years from retirement, with a few employees who are younger and modestly compensated.

## Key difference

Most private sector retirement plans today are defined *contribution* plans.

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That is, the amounts that can be contributed to the plan are set by law, with a maximum of $60,000 (counting employee and employer inputs) in 2017, or $54,000 for those under age 50. The amount of the eventual retirement fund will depend on how much is contributed and how well the selected investments perform.

Defined *benefit* plans, as the name indicates, operate by setting a target benefit: the amount of a pension a given employee will receive in retirement. That benefit is determined by an employee's age, compensation, and years of service with the company. Such plans might permit annual contributions well over $120,000 to the principal's account, in certain circumstances. With few years to retirement, it will be necessary to build an adequate fund quickly, with large annual cash flows into the plan.

Those contributions can be tax-deductible for the employer and not taxable to the employee until money is received in retirement. Much smaller amounts might have to be contributed to the accounts of younger employees, who have many years to build up a retirement fund. What's more, the money in the principal's account eventually may be rolled over into an IRA, tax-free, for ongoing control over investment decisions and distributions. *Note:* Even if your company already has a defined contribution plan such as a 401(k), it may be able to establish a defined benefit plan as well.

## Proceed with care

Before jumping into a defined benefit plan, business owners should consider the drawbacks. These plans can be extremely expensive to administer. You must hire an actuary or a third-party administrator to calculate how much to contribute annually. What's more, your company must continue to make the required payments to the plan, even in a down year, and underfunding might trigger IRS penalties. Other rules and regulations apply to defined benefit plans.

In addition, some defined benefit plans may be structured so that employees who don't work for a specified number of years forfeit their benefits. This can create incentives for the company's principals to hire short-term workers. Hiring individuals who become long-term employees probably will be better for the firm, in terms of business results, but these workers eventually may be entitled to large payouts from the plan.

Overall, there is more to a small-company defined benefit plan than large tax-deductible contributions for business owners. If you think such a plan could work for you, our office can go over the numbers with you and explain the requirements that your company would face. ■

# TAX CALENDAR

### FEBRUARY 2017

#### February 15

**All businesses.** Give annual information statements (Forms 1099) to recipients of certain payments you made during 2016. Payments that are covered include (1) amounts paid in real estate transactions, (2) amounts paid in broker and barter exchange transactions, and (3) payments to attorneys.

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

**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.

#### February 16

**Employers.** Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2016, but did not give you a new Form W-4 to continue the exemption for 2017.

### MARCH 2017

#### March 15

**Partnerships.** File a 2016 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, and so on, or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. File Form 1065 by September 15.

**S corporations.** File a 2016 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, and so on, 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 2017. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2018.

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

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# Citation and Resource Guide

Sidney Kess, CPA, JD, Editor

## After-Tax Dollars in Traditional IRAs

- For the income limits on deducting contributions to traditional IRAs for 2016 and 2017, go to **www.irs.gov/retirement-plans/ira-deduction-limits.**

## "Combo" Products for Long-Term Care Coverage

- The U.S. Department of Health and Human Services explains the pros and cons of using life insurance to pay for long-term care at **http://longtermcare.gov/costs-how-to-pay/using-life-insurance-to-pay-for-long-term-care/**.

## Defined Benefit Plans for (Very) Small Companies

- The IRS spells out points to consider when thinking about a defined benefit plan at **www.irs.gov/retirement-plans/choosing-a-retirement-plan-defined-benefit-plan.**

# Practice Development Tip

## Turn Tax Prep Into College Prep

When you meet with clients during tax preparation season, you'll probably meet with some who have teenaged and pre-teen children. Other clients will have grandchildren in that age group. During those meetings, you can combine traditional tax planning with some new wrinkles in planning for college financial aid.

For starters, urge parents to have their students fill out the Free Application for Federal Student Aid (FAFSA) when he or she is in his or her senior year of high school. That's true even for parents who are "sure" that their child won't qualify for need-based aid from the FAFSA formula. Some colleges will require a FAFSA submission as a condition for merit-based (academic) grants, even if there is no need-based aid forthcoming. Besides, with costs at some colleges so high now, even relatively affluent families may qualify for some need-based aid.

Remind parents that the FAFSA can be filed as early as October 1 of the preceding year, for the next school year, and that the numbers to be reported will be on the just-filed income tax return. In October 2017, for example, students can submit a FAFSA for the 2018–2019 school year, with the family's expected contribution to college costs based on income reported for 2016.

FAFSA and tax planning should begin early, ideally, no later than when a student is in the ninth or tenth grade. If a student will be starting college in, say, 2020, and the FAFSA will report income from 2018, it may be advisable to avoid additions to income next year. Instead, some parents might want to implement transactions such as capital gains, retirement plan distributions, and Roth IRA conversions in 2017, rather than waiting.

How will grandparents be affected? If they want to help, they might put money into a 529 college savings plan for their grandson or granddaughter, for tax-free investment income and possibly tax-free distributions. Grandparent-owned 529 accounts aren't reported on a FAFSA as family assets. Distributions from grandparent-owned 529s *will* reduce potential financial aid, but that may not be an issue once the student files the final FAFSA. Assuming that occurs in, say, October 2021, based on 2020 income, a grandparent could begin to distribute funds from a 529 account in 2021, and possibly avoid any decrease in financial aid.

If you can help clients obtain more financial aid for their families, the results can be just as meaningful as income tax reduction.

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# Practice Development and Management Resources

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**[Item no. PPM1307HI—AICPA Member $119.00, Nonmember $149.00]**

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**[Item no. MAPTKD—AICPA Member $229.00, Nonmember $289.00]**

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