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Client Bulletin

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

August 2017

College Costs Really Are Increasing Again

The College Board reports that the average published charges for tuition, fees, room, and board at private, nonprofit, four-year schools were over $45,000 in the 2016–17 academic year. At public universities, the average charge was around $20,000 for state residents. Both numbers are the highest on record.

Such expenses for higher education are daunting, but the reality may be less onerous. Many collegians receive some form of financial aid that brings down the actual cost. The College Board also reports "net" prices, estimating the true cost of a year in college after recognizing financial aid and the savings from certain education-related tax benefits.

For the 2006–07 academic year to 2010–11, net prices declined in constant 2016 dollars. Even as published prices continued to rise, the average net price at private colleges fell from $24,580 to $23,620.

Since then, however, net prices have begun to move up. In 2016–17, the average figure at four-year private colleges reached $26,080. In-state students at public universities saw average net prices hold steady in the $11,000–$12,000 range from 2006–07 to 2010–11, but shoot up to $14,210 in 2016–17. In recent years, increases in grants have not kept up with rising published prices, creating more expensive net prices for higher education.

For parents of collegians and younger students, the message is that they may have to put more effort into competing for college grants. Some strategies for dealing with the Free Application for Federal Student Aid (FAFSA) can be found on page 2 of this issue of the *CPA Client Bulletin*. Savvy investing of college funds can also help; on page 3, you'll find suggestions on how to manage 529 college savings accounts. ■

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Vacation Destinations

Among recent vacation home buyers, 36% purchased in a beach location, 21% bought lakefront property, and 20% bought elsewhere in the country.

Start FAFSA Planning Earlier <Back

The "new" FAFSA schedule (introduced in 2016) makes summer the time for FAFSA prep. On October 1, 2017, financial aid applications for the 2018-19 school year can be filed. In prior years, students had to wait until January 1 to request financial aid for the coming academic year.

Why is this important? Some observers believe that financial aid may be granted on a first come, first served basis, so the early filer may have more of a chance to receive aid. Also, filing a FAFSA early may increase the chance for merit (not need-based) aid because some colleges require the FAFSA for such grants.

In addition, FAFSA will now have real family income numbers from federal income tax returns, rather than estimates.

Example 1: Mark Thompson will start college in the fall of 2020. In October 2019, Mark can file the FAFSA. He'll use his family's income from 2018 based on the tax return filed in 2019. (Even if Mark's family gets a filing extension from April 15, 2019, the return must still be filed by October 15 of that year, so the 2018 income numbers will be available for a FAFSA filing in October 2019.)

Under the previous FAFSA schedule, Mark would have filed the FAFSA in early 2020, using estimated income numbers for 2019. Then, he would have amended the FAFSA, if necessary, to conform with the actual 2019 numbers. That won't be necessary now that the Thompsons' 2018 income will help determine Mark's need-based aid in the 2020-21 school year.

Planning far ahead

Under the new FAFSA schedule, planning for college funding should begin much earlier, probably in the ninth or tenth grade. Income from the calendar year that includes the student's sophomore and junior years of high school will be the income that shows up on the first annual FAFSA filing.

Example 2: Mark Thompson, who will start college in the second half of 2020, will be a tenth grader in the first half of 2018, and a high school junior in the second half of the year. The family's income from that year will be the income reported on Mark's first annual FAFSA and, thus, will determine financial aid when Mark goes to college.

Therefore, if Mark's parents are planning actions that would increase income, they might want to do so in 2017, when Mark goes from the ninth to the tenth grade. Such actions could include taking capital gains, taking retirement plan distributions, or converting traditional IRA dollars to a Roth IRA. Acting before January 1 of the sophomore year of high school will keep the resulting income from the FAFSA. Alternatively, such actions might be postponed until January of the student's sophomore year of college, or later, when the income may no longer show up on a FAFSA filing.

Reducing the assets reported on a FAFSA also may increase aid. Parents might fund an IRA in the current year, moving cash into retirement accounts that are not counted in determining the expected family contribution to college costs. IRA contributions for 2018 can be made until April 15, 2019, but contributing in early 2018 can reduce reported assets on a subsequent filing.

In some cases, a business owner might want to consider changing the choice of entity during the FAFSA years. Many small businesses are S corporations, which avoid the corporate income tax. However, an S corporation passes through all income to the company's owner, and a high income could reduce financial aid. With a regular C corporation, the company's income doesn't pass through to the owner. Our office can help you weigh all the pros and cons of C corporation versus S corporation status, including the impact on college aid.

Grandparent strategy

The new FAFSA schedule also affects planning for 529 college savings plans that are owned by grandparents, with a grandson or granddaughter as the beneficiary. The assets of such a 529 plan are not reported on a FAFSA, so they don't reduce possible financial aid. However, when grandparent-owned 529 plans distribute funds

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Trusted Advice

FAFSA Facts

- There is no upper limit on family income to qualify for federal student aid.
- Eligibility for aid is determined by a mathematical formula, not by family income alone. Besides income, many factors (such as family size and parents' age) are taken into account.
- The higher the cost of attendance at the chosen college, the more aid that may be offered.
- Having more than one child in college at the same time will increase the chance for financial aid.
- A student who fills out the FAFSA automatically applies for funds from his or her state as well as from the federal government, and possibly from the school as well.
- Some schools won't consider students for any of their scholarships (including academic scholarships) until they have submitted a FAFSA.

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to cover college costs, the payouts count as untaxed income to the student on a FAFSA, which can reduce aid eligibility substantially.

Now, grandparent-owned 529 plans can hold onto their assets until January of the student's sophomore year. Tax-free distributions for educational expenses may be able to begin then without showing up on a FAFSA to affect financial aid.■

Asset Allocation in 529 Plans <Back

Parents with young children have two broad choices when investing for higher education. One is to invest as you did before you had children, with assets in taxable and tax deferred accounts, under your own names. This will give you maximum flexibility in terms of investment choices and tax planning. When the time comes, you can peel off assets to pay college bills. (Financial advisers may advise against tapping retirement accounts to pay for college.)

The other approach is to have a dedicated college fund, or one college fund for each student. One advantage of this method is psychological; you may be reluctant to use higher education money for a cruise or a luxury car lease.

In addition, a dedicated college fund has a compressed time horizon. When the child is in his or her late teens and early twenties, the money will be needed. If the portfolio value has dropped sharply before and during those years, there may not be enough time to recover losses, let alone continue to grow.

Why 529 is the magic number

For parents and grandparents who prefer a dedicated college fund, 529 plans—named after a section of the tax code—are increasingly appealing. Over $275 billion is invested in these plans, mainly in college savings plans that are similar to 401(k) retirement plans in that account holders choose from a menu and enjoy untaxed investment income. (Some 529 plans are prepaid tuition plans, which operate differently.)

Unlike 401(k)s, 529 plans are largely funded with after-tax dollars. As an offset, all 529 withdrawals can be tax-free, whereas 401(k) distributions are taxable. To qualify for tax exclusion, 529 withdrawals must not exceed the amount spent on qualified higher education costs, which generally include tuition, fees, room, and board.

Age-old question

The holders of 529 accounts face a dilemma when it comes to investing. To make the most of the benefit of tax-free distributions, 529 plans should be invested for growth. The tax savings from an account that has gained, say, 2% a year will be much less than the tax savings from a 529 account in which growth has been 7% or 8% a year.

On the other hand, for a 529 account to grow rapidly, investors must put money into volatile assets, such as stock funds. That brings the risk of poor timing; your student might enter college after a bear market has depleted the 529 account, which could leave your student with a smaller college fund.

Investment professionals may suggest a "glide path" strategy to address such concerns. For a young child who is 10, 15, or even 18 years away from high school graduation, 529 money might be invested mostly in equities with a hope for strong growth. As college nears, the asset allocation can shift from stocks to bonds and cash. Some observers assert that a 529 account should be very light (perhaps less than 10%) in equities by the time of college admission, minimizing risk, whereas others suggest a somewhat larger position in stocks for continuing growth potential.

Packaged portfolios

Parents who like the idea of a glide path can choose from a 529 plan's menu. Every year or so, move money from aggressive to more conservative investment options.

If you don't feel up to such maneuvers, or just prefer not to be bothered, don't fret. "Age-based" portfolios usually are offered to 529 investors. Essentially, these portfolios are on autopilot so that your child's 529 account will become more conservative over time.

Nevertheless, an age-based portfolio in one state's 529 plan may be much different from another state's. Before signing up, look at the details carefully. Are you comfortable with the underlying asset allocation and the way that allocation will shift? There may be multiple options to consider within one state's plan, as well as from different states. Make sure you know just how your college fund will be managed.■

Outlining the Trump Tax Plan <Back

As a candidate in 2016, Donald Trump promised significant tax reform. A few months after becoming President, Trump released a one-page outline of his goals in that area. As the year goes on, we may see details added to his plan and eventually learn whether major tax legislation is enacted. Here are the major areas that will be addressed.

Taxes on business

Trump wants to cap the corporate income tax rate at 15%. Currently, the top rate is 35%. Such a reduction, he asserts, would make American companies more competitive worldwide.

The outline also includes a one-time tax on "trillions of dollars" held overseas. Previously, Trump indicated that he favors a 10% tax on corporate offshore profits brought into the United States.

In addition, the plan would eliminate tax breaks for unspecified "special interests" and implement a "territorial tax system" to level the playing field for American companies. Generally, in a territorial tax system, domestic profits are taxed at the full rate, whereas profits from abroad are not subject to domestic income tax.

Taxes on individuals

The Trump plan calls for reducing the number of tax brackets from seven to three. Today, individual taxpayers start with a 10% income tax rate and move into the 15%, 25%, 28%, 33%, 35%, and 39.6% brackets, as their taxable income increases. The three proposed tax rates would be 10%, 25%, and 35%.

Depending on the cut-off points for these tax rates, it's possible that taxpayers now in the 15% bracket would have a 10% marginal tax rate under this plan. Those in the 28%, 33%, and perhaps the 35% bracket could be in the 25% bracket, whereas the top rate would fall from 39.6% to 35%.

The tax plan also calls for doubling the standard deduction, which is available to individual taxpayers. That standard deduction is now $6,350 for single taxpayers, $9,350 for heads of households, and $12,700 for couples filing joint returns. Doubling those numbers would produce standard deductions of $12,700 for single filers, $18,700 for household heads, and $25,400 for married couples filing jointly.

In addition, the outline calls for tax relief for families with child and dependent care expenses without giving details. Press reports hint that one approach could be an increase in the child and dependent care tax credit, which now allows people with care-related outlays to reduce their tax bill by up to $2,100.

Tax simplification

Under this heading, the outline would "protect" the home ownership and charitable gift tax deductions. In other words, many itemized deductions, such as medical expenses as well as state and local taxes paid, would be eliminated, but the deductions for home mortgage interest and charitable contributions would be spared.

Assuming the preceding proposals are enacted, more taxpayers would take the larger standard deduction rather than itemizing deductions. The only ones still itemizing would be taxpayers with mortgage interest and charitable deductions that exceed the standard deduction amounts.

The next item on the list—repeal the alternative minimum tax (AMT)—would possibly make the interaction between the standard deduction and itemized deductions more thought-provoking. As mentioned, state and local income and property tax no longer would be deductible. However, some people who now pay large amounts of those taxes owe the AMT and don't get the benefit of deducting such taxes. Would the repeal of the AMT make up for the loss of deducting state and local tax payments? Our office can go over the numbers for you in your specific circumstances.

The Trump outline also calls for repeal of the 3.8% surtax on net investment income, a tax that applies to taxpayers with high incomes. Currently high-income taxpayers can be subjected to a 43.4% marginal tax rate on some income, if they are in the 39.6% bracket and have ordinary investment income subject to the 3.8% tax. Long-term capital gains can be taxed at a rate as high as 23.8%, with the surtax included.

Also on the outline's "to repeal" list is the federal estate tax. This tax now has an exemption of $5.49 million, which can be $10.98 million for married couples, so relatively few estates owe this tax anyway. Still, owners of valuable small companies and investment property might get some relief when those assets pass to younger generations, if the estate tax is repealed.

Another bullet point in this section calls for eliminating targeted tax breaks that mainly benefit the wealthiest taxpayers.

From outline to legislation

Such an outline must be fleshed out before it's presented to Congress for approval or rejection. Observers predicted that the process probably would last beyond the lawmakers' August recess. Therefore, it's likely that taxpayers won't know until the fall whether any of these changes will become law this year.■

How Small Business Retirement Plans Compare <Back

In recent issues of the *CPA Client Bulletin*, various small business retirement plans were described. If your company does not have a retirement plan, or if you're not pleased with the one you have, this summary can help you see how these choices stack up.

Safe harbor 401(k)s

As 401(k) plans have gained popularity, many employees or prospective employees expect to have such a plan at the company where they work. Therefore, offering a 401(k) may help your business attract and retain talented people. Employers commonly like the fact that 401(k) plans are largely self-funded from employees' tax deferred contributions from their earnings.

However, 401(k)s have drawbacks, too. One key issue is the requirement that they don't discriminate in favor of highly-compensated employees. Testing is required, and failing such tests may result in limiting the retirement contributions of owner-employees.

With the safe harbor versions of a 401(k), employers make certain contributions to employees' accounts. Anti-discrimination testing isn't required, and owner-employees can maximize contributions to their own retirement funds if they wish. The downside to such plans is that the required employer contributions can be expensive.

Bottom line: These plans can appeal to business owners who want to offer a 401(k) retirement plan yet avoid nondiscrimination testing.

Solo 401(k)s

Yet another variety of a 401(k) is available to companies without any common-law employees. If the only people working at the firm are owners, business partners, shareholders, and their spouses, a solo 401(k) can be used. (Independent contractors hired by the company, as well as part-time workers who are paid for less than 1,000 hours a year, can be excluded.)

Solo 401(k)s allow business owners and their employed spouses to make relatively large contributions. With a standard 401(k), the 2017 maximum is $18,000 a year, or $24,000 for those 50 or older. Solo 401(k)s permit both employee and employer contributions, so the maximums this year can be $54,000 or $60,000.

Bottom line: If your company qualifies, these plans can allow you (and your employed spouse) to make substantial retirement plan contributions.

SIMPLE IRAs

Compared with other retirement plans, savings incentive match plan for employees (SIMPLE) IRAs allow relatively low contributions: no more than $31,000 a year. That number is for participants 50 or older receiving both employer and employee contributions, so the maximum is much lower for many participants.

On the other hand, SIMPLE IRAs are designed to be easy on the paperwork. Companies fill out a short form to establish the plan and ensure that IRAs are set up for each employee. To be eligible, your company must have no more than 100 employees and must not sponsor another retirement plan.

Going forward, there is no annual filing requirement and nondiscrimination testing is not necessary. Administrative costs usually are low. However, certain contributions to employees' SIMPLE IRAs are required.

Bottom line: If you want to offer a retirement plan that requires little administration and you are content with the contribution limits to your own account, a SIMPLE IRA can be a viable choice.

Profit-sharing plans

The name of these plans might help motivate employees. They may believe that if they help the company do well (make significant profits), the company will make a meaningful contribution to their retirement accounts.

Actually, your company has no obligation to give a certain percentage of any profits to its employees. As an employer, you can raise or lower annual contributions as you wish or even skip them altogether. Still, companies with profit-sharing plans may peg their contributions to the firm's results, so employees will learn that their successful efforts will produce tangible rewards.

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In addition, profit-sharing plans come in different forms. Some will contribute a certain percentage of compensation to all participants, and other plan designs may skew contributions to certain individuals, according to various formulas. Such sophisticated profit-sharing plans can be expensive to create and administer.

Bottom line: If your company can afford substantial tax-deductible contributions to employees' retirement accounts, a well-publicized profit-sharing plan can be a potent motivator.

ESOPs

As the name indicates, employee stock ownership plans (ESOPs) are designed to transfer some, or sometimes all, of company ownership to employees. Shares are transferred to the ESOP, valuations are implemented, and departing participants receive a cash payout equal to the value of the shares allocated to their accounts.

Again, employees are motivated to perform well. Higher profits generally equal higher share values and a larger buyback when they retire or change jobs. For business owners, ESOPs may offer tax advantages that go beyond deductible contributions as well as an appealing exit strategy.

That said, it can be expensive to comply with regulatory requirements for ESOPs. Some companies offer an additional retirement plan because a reliance on an ESOP means a lack of investment diversification.

Bottom line: Adopting an ESOP should not be taken lightly because these plans can be complex, but they may offer an attractive mix of employee appeal, unique tax benefits, and company continuity.

Defined benefit plans

Traditional pension plans are defined benefit plans. They commit employers to certain contributions each year and to certain payouts to retirees. They may be too costly to administer and too inflexible for most small companies.

Nevertheless, they can appeal to companies whose owners want the largest possible contributions to their retirement funds. In some circumstances, annual contributions to the principal's account can reach well into six figures and are tax deductible. Large contributions must be made to the plan to provide a sizable pension to participants.

Bottom line: Defined benefit plans may work well for companies when the owner or owners are planning to retire in 5–10 years. Assuming that there are other employees who are younger and modestly paid, the owners might build up a large pension fund in a few years while relatively few dollars go to fund other employees' retirements.

Final thought

The preceding list is not exhaustive, as other retirement plans may be adopted by small businesses and professional practices. Our office can go over your goals for an employer-sponsored plan and suggest options that will help you meet them. ■

TAX CALENDAR

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AUGUST 2017

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2017. This due date applies only if you deposited the tax for the quarter in full and on time.

August 15

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

SEPTEMBER 2017

September 15

Individuals. If you are not paying your 2017 income tax through withholding (or will not pay enough tax during the year), pay the third installment of your 2017 estimated tax. Use Form 1040-ES.

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

Corporations. Deposit the third installment of estimated income tax for 2017. Use the worksheet Form 1120-W to help estimate tax for the year.

Partnerships. File a 2016 calendar year return (Form 1065). This due date applies only if you timely requested an automatic six-month extension. Provide each partner with a copy of his or her final or amended Schedule K-1 (Form 1065) or substitute Schedule K-1 (Form 1065).

S corporations. File a 2016 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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