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Client Bulletin

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

SEP Plans Go Separate Ways

Simplified employee pension (SEP) plans are commonly used by self-employed individuals and others with part-time self-employment income. In addition, SEPs can offer many benefits to small companies, so business owners may want to consider using a SEP for themselves and the firm's workers.

On your own

Self-employed individuals choose SEPs for several reasons. There are virtually no costs or paperwork to setting up and maintaining a SEP. Many financial firms offer them, and the investment options are broad. Contribution limits are generous, with a $52,000 maximum for 2014. (SEP contributions may be as high as 25% of compensation, but special rules effectively limit contributions to around 20% of your net self-employment income.)

In addition, SEPs offer a rare opportunity to make

retroactive tax deductions. Each year, you can deduct SEP contributions made until the filing date of your tax return, including extensions.

Example 1: Beth Carson, a freelance graphic artist, qualifies for a $15,000 SEP contribution based on her 2013 earnings. On April 1, 2014, Beth contacts a mutual fund company and creates a SEP, funded with a check for $15,000. As long as Beth makes the contribution by the time she files her 2013 tax return on April 15, she can take a $15,000 tax deduction on that return. If Beth can't make that deadline, she can request an automatic filing

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Biggest Benefit
In 2014, the maximum Social Security benefit for a worker retiring at full retirement age (now 66) is $2,642 a month, or $31,704 a year.

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extension until October 15, giving her an extra six months to make a deductible SEP contribution.

Strictly business

Small companies also can use SEPs. Again, the simplicity of such plans, the flexibility, and the high ceiling for contributions may make SEPs appealing to business owners. Employers must fill out and retain IRS Form 5305-SEP to establish the plan, but there are no subsequent required filings with the IRS. The downside is that a SEP is funded entirely by employer contributions; SEPs are different from 401(k)s and similar plans, which are funded largely by employees' salary deferrals.

To set up a SEP for your company, you merely have to sign a document with the financial firm you have chosen. Then you must notify each eligible employee about the plan and create an account (a SEP-IRA) for each qualified employee at the financial firm.

Once the plan is established, your company must make equivalent contributions for each eligible employee, as a percentage of compensation.

Example 2: ABC Corp. has two co-owners and four employees. If the owners want maximum SEP contributions of 25% of their pay, the company also must contribute 25% of pay to the SEP-IRAs of the other four employees. (See the Trusted Advice box for guidelines for which employees must be included in a SEP.)

Fortunately, SEP-IRAs are flexible. Even if ABC makes a 25% contribution in a given year, it can make a contribution of any percentage of pay in the following year. The company also can skip contributions altogether, if cash is tight.

With a SEP, business owners have plenty of time to decide about contribution levels. You can set up and make deductible contributions to a SEP plan as late as the due date (including extensions) of your company's income tax return for that year. Therefore, your company still has time to set up a SEP plan and make deductible contributions for 2013.

SEP Requirements

When a company has a SEP plan, it must include all employees who have done all of the following:

- Reached age 21
- Worked for the company in at least 3 of the last 5 years
- Received at least $550 in compensation from your business for the year, subject to annual cost-of-living adjustments in later years

Your company can impose less restrictive requirements, such as reaching age 18 or working there for 3 months.

Certain union members and nonresident aliens may be excluded.

Did You Know?

The average cost of tuition and fees at private nonprofit four-year colleges rose by $1,105 (3.8%), from $28,989 in 2012–13 to $30,094 in 2013–14. The average total charges, including room and board, are $40,917.

Source: The College Board

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Mixing IRA Distributions With Social Security

Many workers save for the future in a 401(k) or another employer sponsored retirement plan. Contributions avoid income tax, and the same is true for investment earnings inside the plan. Often, 401(k) participants roll over the money to a traditional IRA after they retire, which extends the tax deferral. Many people try to keep their IRAs intact as long as possible, continuing tax free buildup inside the plan.

Example 1: Alice Wells retired at age 62. To make up for her lost earnings, Alice draws down her taxable accounts, so her IRA can keep growing untaxed. Alice's plan is to wait as long as possible before taking distributions from her IRA. (She'll have to take at least the required minimum distributions from her

minimum distributions from her traditional IRA after age 70½.)

However, once she retires, Alice finds that she is still short of cash flow. She can start to receive Social Security retirement benefits as early as age 62, so Alice puts in her claim to get the additional monthly income.

Lower brackets are likely

Alice's strategy, as described, is followed by many seniors. That is, they take Social Security early and eventually tap their IRA. That may not always be the best approach.

What might indicate taking a different route? Taxes, for one thing. The value of tax deferral depends on your tax bracket. The higher your bracket, the more putting off the IRS makes sense.

Suppose Alice typically was in a 28% or 33% tax bracket during her working years. In 2014, those brackets cover single taxpayers with about $90,000 to $400,000 of taxable income after deductions. Deferring income tax while she worked saved Alice 28 cents or 33 cents on the dollar.

Now that she's retired, Alice's taxable income is sharply reduced. In our example, Alice can tap her IRA for cash flow and keep taxable income below $90,000, which would put her in the 25% bracket. At 25 cents on the dollar, tax deferral isn't as valuable as it was during her working years. On the other hand, taking IRA distributions and paying 25% tax isn't as painful as it would be in a higher bracket.

Indeed, many retired couples are in the 15% bracket now, which goes up to nearly $75,000 of taxable income, after deductions. Such couples will owe even less tax on IRA distributions.

A plumper pension

There's another reason to consider reversing the plan to take Social Security early and IRA distributions late. The longer you wait to start Social Security, the larger your monthly benefits will be.

Example 2: Suppose that Alice Wells has an earnings history that would qualify her to receive $2,000 a month at 66, which Social Security considers the "full retirement age" for people now in their 60s. If Alice starts Social Security at age 62, she'll get only 75% of that benefit: $1,500 a month, plus cost-of-living adjustments (COLAs), for the rest of her life.

On the other hand, Alice can wait as late as age 70 to start Social Security. That would increase the monthly payment from her full retirement age by 32%, from $2,000 to $2,640 a month, plus all the COLAs along the way. Not counting COLAs, waiting from 62 to 70 will increase Alice's annual benefit from $18,000 a year to $31,680 a year, which she'll receive for the rest of her life.

Once Alice starts to receive Social Security, those much larger payments may reduce the amounts she'll need from her IRA. If that's the case, Alice will be substituting Social Security dollars, which are partially taxed under current law, for traditional IRA distributions, which usually are fully taxable.

Building up Social Security benefits might have another appeal for married couples. When the first spouse dies, the survivor will receive the decedent's Social Security payments, if they are larger than the benefits the survivor had been receiving. Thus, waiting to start Social Security may provide extra cash flow for a surviving spouse.

This plan to tap your IRA early and wait to start Social Security will help some people but not others. Calculations involve each individual's health and work history as well as some complicated navigation through the tax code. When you are ready to make your decision, our office can help you determine a course of action likely to maximize cash flow and income security as you grow older. ■

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The "Other" April 15 Deadlines

As you are probably aware, April 15, 2014, is the deadline for filing your 2013 federal income tax return. If you are not ready to file by then, you can obtain an automatic six-month extension until October 15 by filing IRS Form 4868 by April 15. Keep in mind that this is a filing extension, not a payment extension. On the form, you will be asked to estimate any tax due and make a payment; a shortfall may generate interest and penalties.

Also keep in mind that a filing extension doesn't extend everything. Certain April 15 deadlines remain in place, no matter when you legitimately file your return.

Traditional IRAs

You can contribute to a traditional IRA for 2013 until April 15, 2014. Anyone who had taxable compensation last year can contribute, as long as they were younger than 70½ on December 31. You can contribute an amount equal to your taxable compensation in 2013 to your IRA, up to $5,500, or up to $6,500 if you were 50 or older at year-end. Both spouses can make maximum IRA contributions, if they file a joint return and their total combined compensation is at least the amount of those contributions.

Just because most workers can contribute to a traditional IRA, it doesn't follow that they can deduct their IRA contributions. To automatically qualify for a deduction, you can't be covered by an employer's retirement plan.

If you are covered by an employer's plan, your ability to take a deduction is determined by your modified adjusted gross income (MAGI). To get a full $5,500 or $6,500 deduction, your 2013 MAGI must be no higher than $59,000 (single filer) or $95,000 (joint return). With slightly higher MAGI, you can deduct part of your IRA contribution.

The 2013 phaseout range for deducting traditional IRA contributions is $178,000–$188,000 of MAGI, for a noncovered spouse filing jointly with someone who is covered by an employer's plan.

Roth IRAs

The earned income and contribution limits for traditional IRAs apply to Roth IRAs as well, along with an April 15, 2014, deadline for making 2013 contributions. (You can fund both types, but the $5,500 and $6,500 annual ceilings apply to combined contributions to Roth and traditional IRAs.) Both types of IRAs shelter investment earnings inside the account from income tax. From there, these vehicles take different paths.

With Roth IRAs, there is no age limit for making annual contributions, as there is for traditional IRAs. Roth IRAs are always funded with aftertax dollars; you never can deduct any contributions. However, all Roth IRA money qualifies for tax-free distributions after age 59½, as long as the distribution is made after the 5-year period beginning with the first tax year you made a contribution to a Roth IRA set up for your benefit. Traditional IRA distributions typically are fully or mainly taxable.

What's more, you can't contribute to a 2013 Roth IRA if your income last year was too high. The phaseout range runs from MAGI of $112,000–$127,000 for singles and from $178,000–$188,000 for married couples filing joint returns.

Health savings accounts

April 15, 2014, is also the deadline for contributing to a health savings account (HSA) for 2013. To contribute to an HSA, you must have had a qualifying health insurance policy last year; such policies follow federal guidelines for high out-of-pocket costs, before the coverage takes effect, and for caps on out-of-pocket expenses.

If you have the right health insurance coverage, you can contribute to an HSA offered by many banks and other financial firms. HSA contributions are tax deductible; those deductible contributions for 2013 can be as much as $6,450, or $7,450 if you were at least age 55.

As is the case with IRAs, investment income inside an HSA avoids income tax. HSA distributions are tax-free also, if the money is used for qualified medical expenses. There is no annual "use it or lose it" requirement, so you can let the money build up inside your HSA and eventually take tax-free distributions to pay uninsured medical costs in retirement. ■

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TAX CALENDAR

FEBRUARY 2014

February 18
All businesses. Give annual information statements to recipients of certain payments you made during 2013. This due date applies only to the following

MARCH 2014

March 17
Corporations. File a 2013 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

due date applies only to the following types of payments: (1) amounts paid in broker and barter exchange transactions, (2) amounts paid in real estate transactions, (3) amounts paid to an attorney and (4) substitute payments in lieu of dividends or interest.

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.

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All businesses. File information returns (for example, Forms 1099) for certain payments you made during 2013. If you file the forms electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2013. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is March 31.

month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2013 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 2014. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2015.

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.

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