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CPA

Client Bulletin

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

Renting Versus Buying a Home

Should you buy or rent your home? This decision can include financial as well as nonfinancial factors. Even if the nonfinancial aspects are extremely important, you should not overlook the financial side.

Crucial ratio

One key to choosing between buying or renting is to determine the annual rent-topurchase price ratio in the housing market you're considering. The higher this ratio, the greater the advantage of buying a home.

Example 1: Art Smith is considering buying a home that is priced at $200,000. He can rent a comparable home in the same neighborhood for $800 a month, which is $9,600 a year. The rent-to-purchase ratio is $9,600 to $200,000, or 4.8%.

Example 2: In a different area of the U.S., Beth Jones also is eyeing a $200,000 home. A comparable home would rent for $1,200 a month. Thus, the rent-to-price ratio for Beth is $14,400 to $200,000, or 7.2% a month.

A recent study from Morningstar's HelloWallet unit indicates that renting might be a better choice when the rentto- price ratio is below 5%, while buying may be preferable if that ratio is over 7%. That is, the more you'll have to pay to rent a desirable home, relative to home prices, the greater the chance that the numbers will favor a purchase.

Assuming the rent-to-purchase price ratio is favorable, young taxpayers with relatively low early career incomes might do well to rent rather than buy a home. The same may be true for relocating retirees who have modest incomes after they stop working.

Conversely, high-income taxpayers might enjoy considerable tax savings from home ownership, assuming they are comfortable with the purchase price. Today's low interest rates make financing a home purchase appealing, and the leverage can add to any profits from home price appreciation.

Thinking about taxes

What's Inside
February 2015

Home Trend
U.S. home ownership has declined from 69.1% in 2005 to 64.8% in 2014.

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MainStreet Tax Advisors

Trusted Advice

Withdrawal Rules

- It's possible for target date funds

Homeowners may enjoy multiple tax benefits that are not available to renters. Mortgage interest and property tax payments generally are tax-deductible. Moreover, profits on a sale of a home often enjoy an exemption from capital gains tax. Assuming the home was owned and occupied at least two of the preceding five years, up to $250,000 of gains are untaxed ($500,000 for married couples filing a joint tax return).

Of course, there is no way for a home buyer to know if a home eventually will be sold at a profit. What's more, the deductions for mortgage interest may not generate any actual tax savings. That's because those savings are available only to taxpayers who itemize deductions. Homeowners who take the standard deduction get no tax benefit from their mortgage interest or property tax deductions.

Example 3: Craig and Diane Emerson bought a house for $200,000, taking out a $160,000 mortgage. At a 4% mortgage rate, their interest payments this year are $6,400 (4% of $160,000). The Emersons also pay $4,000 in state and local taxes and make $2,000 in charitable donations, for a total of $12,400 in possible itemized deductions.

In 2015, the standard deduction is $6,300 for single filers and $12,600 for married couples filing jointly. (Taxpayers who are blind or at least age 65 have higher standard deductions.) Thus, the Emersons will choose the standard deduction and get no tax benefit from paying mortgage interest or property taxes.

Tax bracket truths

Now, what happens if the Emersons had $14,200 in itemized deductions instead of $12,400? If so, they would itemize and deduct their mortgage interest and property tax payments. In this scenario, $14,200 of itemized deductions is $1,600 greater than the standard deduction for couples, so the Emersons' net tax deduction from home ownership would be $1,600. Assuming an effective marginal income tax rate of 20%, that $1,600 in net deductions would save them $320 in tax this year.

Example 4: Assume the same financial information as in **example 3**, but assume the Emersons have a higher income and, thus, have an effective marginal tax rate of 40%. Then that same $1,600 in net tax deductions from home ownership would save the Emersons $640 in tax. With a higher income, owning a home saves more tax.

Other issues

The decision about whether to rent or buy a home involves more than the purchase price, rental rates, and tax savings. Buying a house means saving up a great deal of cash for a down payment and putting that cash into an illiquid asset. Renting may leave you with more easily accessible cash, but will that cash be invested wisely or spent imprudently? It's also important to decide if the responsibility of home ownership is for you.

Nevertheless, financial concerns are vital to residential decisions. Our office can show you how money matters compare, pretax and aftertax. ■

in defined contribution plans to hold deferred income annuities and satisfy nondiscrimination requirements.

- Among other conditions, the deferred annuities cannot provide a guaranteed lifetime withdrawal benefit (GLWB) or a guaranteed minimum withdrawal benefit (GMWB).
- With a GLWB, the participant is guaranteed to receive a specified lifetime stream of income, regardless of the investment performance of the account, while still retaining access to the funds in the account.
- A GMWB is similar to a GLWB, but a stream of income is guaranteed for a specified period rather than for the lifetime of the contract owner or annuitant.
- The Treasury Dept. and the IRS are considering whether to provide guidance relating to GLWB and GMWB features in defined contribution plans.

Did You Know ?

Among people who buy individual life insurance policies at their workplace, 75% belong to either Generation X or Generation Y (now ages 20-48). Of those buying life insurance through an offer from work, 36% apply for the coverage online or via email, more than any other application method.

*Source:*LIMRA

Income Annuities in Employer Retirement Plans

In the private sector, employers have been moving away from traditional pensions, known as defined benefit plans. These plans, funded by employer contributions, often pay long-time employees (and usually those employees' spouses) lifelong regular cash flow.

Instead, many companies now provide defined contribution plans, such as 401(k)s, which are funded largely by workers' salary deferrals. The actual retirement benefit will vary, depending on how the chosen investments perform.

National security

Last year, the Treasury Department and the IRS took steps to encourage the use of substitute traditional pensions by retirees. Deferred income annuities (DIAs), which are mainly held in IRAs, were given favorable tax treatment, if certain requirements are met (**see the *CPA Client Bulletin*, December 2014 issue**). Later in 2014, the Treasury and IRS issued Notice 2014-66, which made it more likely that target date funds, mainly held in 401(k) plans, will purchase DIAs, which can offer pension-like cash flow to retirees.

Setting the date

Target date funds offer a predetermined asset allocation that gradually becomes less aggressive and more conservative, as its target date approaches.

Example 1: Fawn Grant, age 50, plans to retire in her mid-60s. She invests her 401(k) contribution in a 2030 target date fund. Now, that fund has a balanced mix of equities, for appreciation potential, and fixed income, for stability and cash flow.

As this fund approaches its 2030 target date, its asset mix will shift to fewer equities and more fixed income. Many plan participants like the idea of having professional investment strategists automatically make these asset allocation decisions.

Enter deferred annuities

Notice 2014-66 clarifies that target date funds in employer sponsored retirement plans can hold DIAs. A DIA is purchased today; the resulting income stream will not begin until years later. The longer the time between the investment and the start of annuity payments, the greater the amount of periodic cash flow an annuitant will receive.

Example 2: Hugh Jordan purchases a DIA at age 55. If Hugh defers lifelong income payments until age 65, he will get more monthly income than he would get by starting immediately. Hugh will get even larger annuity payments by waiting until age 70, or age 75.

The recent federal notice explains that target date funds offered through employer plans will be able to include DIAs among their fixed-income holdings for participants who are nearing retirement age. If those DIAs meet certain criteria, some technical issues won't arise.

Similarly, target date funds are considered qualified default investment alternatives (QDIAs), which helps to explain their popularity in 401(k) plans. Employers who make the proper explanation can use QDIAs for the contributions of employees who neglect to make investment choices, while the employers generally avoid liability for any investment losses.

How 401(k) pensions might work

Here is an example of how DIAs could provide lifetime income from a target date fund offered by an employer-sponsored retirement plan. Such funds might be limited to participants of similar ages. A 2033 target date fund, for instance, might be available only to employees born in 1967, 1968, or 1969. In 2033, those employees will be 66, 65, or 64.

Beginning in 2023, when the fund participants are 56, 55, or 54, the target date fund can begin to purchase DIAs as part of its fixed income allocation. For the next 10 years, the fund will purchase more and more DIAs, increasing the allocation to such annuities. In 2033, the fund's target date, the fund will dissolve.

At this point, the participants will learn what their DIA options are. They can start to receive lifetime income right away, or they can wait until a later time to start, in order to increase the annuity payments. Other assets of the now-dissolved target date fund, besides the DIAs, can be reinvested elsewhere in the company retirement plan.

The federal notice provides one example, so not all target date funds holding DIAs inside company plans will look exactly like that. However they're structured, the idea is to provide employees with predictable cash flow after retirement through income annuities. ■

When Workers Are Independent Contractors

As business owners know all too well, hiring an employee costs more than just paying a salary. Employers generally provide benefits to employees, which can be expensive. Moreover, employers must pay a share of Medicare, Social Security, and state unemployment taxes.

None of the above applies when your company hires an independent contractor—a publicist to get your company's name in the news, for example, or a freelance website designer. You pay these people the agreedupon amount and let them worry about funding their retirement or handling payroll tax. If that's the case, why not just use a group of independent contractors to work for your company and do with few or even no employees?

Defining the difference

The answer is that the IRS is well aware of the advantages of using contractors. Therefore, the IRS has established rules governing how independent contractors are classified, as opposed to employees. Drilling down, the major difference is a matter of control.

Hiring an independent contractor to do a specific task is fine. You tell the contractor what you want done, and you pay for results. However, if you tell the worker how and when and where the work is to be done, you risk having that worker re-cast as an employee by the IRS.

In some cases, common sense will apply. If that freelancer works on your website while doing other paying jobs for other companies, chances are the IRS will go along with independent contractor classification. On the other hand, if you have a person who works from home as a freelancer but works only on your website, does it more or less full time, and takes direction from your IT people, you may have a difficult time treating him or her as a contractor.

If you have been misclassifying employees as contractors, the penalties can be steep. Our office can discuss your workers with you, letting you know how to proceed in order to legitimately treat them as independent contractors. ■

TAX CALENDAR

FEBRUARY 2015

February 2

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2014. Payments that are covered include: (1) compensation for workers who are not considered employees; (2) dividends and other corporate distributions; (3) interest; (4) rents; (5) royalties; (6) profit-sharing distributions; (7) retirement plan distributions; (8) original issue discounts; (9) prizes and awards; (10) medical and health care payments; (11) debt cancellations (treated as payment to debtor); (12) payments of Indian gaming profits to tribal members; and (13) cash payments over $10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2014.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2014 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income

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

February 18

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2014, but did not give you a new Form W-4 to continue the exemption for 2015.

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 tax, file Form 941 for the fourth quarter of 2014. Deposit or pay any undeposited tax. If your tax liability is less than $2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2014. If your undeposited tax is $500 or less, you can either pay it with your return or deposit it. If it is more than $500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

February 17

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2014. 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.

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.

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.

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