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Client Bulletin

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

August 2014

Financial Aid Starts With the FAFSA

College-bound students and their families have more work to complete beyond submitting applications and (hopefully) deciding which school to attend. Students should file the Free Application for Federal Student Aid (FAFSA) before starting college and in succeeding years. As the cost of higher education soars, filing the FAFSA may provide some valuable relief.

Why it's important

Using the FAFSA to apply for aid opens the door to various forms of assistance, including need-based grants, merit-based scholarships, education loans, and work opportunities. Funds may come from federal or state governments or from individual colleges.

Essentially, aid applicants use the FAFSA to report the student's assets, student's income, parents' assets, and parents' income. These data are placed into a formula to determine the expected family contribution (EFC) for the coming academic year. If the cost of attending a given college exceeds the EFC, the student may be offered some form of financial aid.

Example 1: Arlene Walker fills out the FAFSA, which determines that her EFC for the coming school year is $22,000. If Arlene will be attending a college where the published total cost is $36,000, she might receive a $14,000 aid package to fill the gap.

Some parents may choose not to have their youngsters file the FAFSA, either because they doubt they'll receive need-based aid or because they don't want to deprive more deserving applicants of limited aid dollars. That's for each family to decide, but not filing the FAFSA may have repercussions. Some merit scholarships require the FAFSA, as do federal education loans. What's more, some colleges are so expensive that relatively affluent parents can qualify for aid, especially if more than one child will be attending college.

A matter of time

Filling out the FAFSA presents some challenges. The forms can be filled out as early as January for the following

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What's Inside

Large Loans

Outstanding U.S. student loan debt is $870 billion, topping the balances of auto loans ($730 billion) and credit-card debt ($693 billion).

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school year. Indeed, some observers recommend filing as early as possible because late filers may be competing for a depleted pool of funds. Some universities have early deadlines for submitting the FAFSA. However, families filing in January may not yet have all the relevant information, such as adjusted gross income (AGI) for the previous calendar year.

Example 2: Brad Taylor is a high school senior in 2014–15 who will start college in August 2015. In January 2015, Brad fills out the FAFSA with help from his parents. They include their best estimates for 2014 financial information, including AGI. In March 2015, after the Taylors' tax returns for 2014 are completed, they update the data on the FAFSA that was previously submitted.

Going forward, the Taylors keep submitting a new FAFSA every year, until Brad no longer will be in undergraduate or graduate school.

Application assistance

You and your student can fill out the FAFSA online at www.fafsa.ed.gov. Some colleges require still other financial aid forms, and the entire process can be time-consuming. Our office can help college students and their families to organize the required documents and submit the necessary materials on time. ■

Did You Know?

Bond bear markets are much tamer than stock bear markets. In the past half-century, the worst performance of a diversified bond portfolio was -7.6%, in 1979–80. In three different stock slumps (1973–74, 2000–02, 2007–09), the benchmark S&P 500 Index fell more than 40% each time.

Source: Savant Capital Management

Grandparent Aid for College Costs

Many grandparents would like to help their grandchildren with the steep costs of higher education. That's often a laudable goal, but some methods of providing this assistance might be more effective than other tactics.

Grand gifts

The simplest tactic is to give money to youngsters before or during their college years. In 2014, the annual gift tax exclusion is $14,000 per recipient.

Example 1: Cora Smith has three grandchildren. She can give each of them $14,000 this year for their college funds. Cora's husband, Rob, can make identical gifts to each of their grandchildren. Such gifts will have no adverse tax consequences. (Larger gifts may reduce this couple's gift tax exemption and, ultimately, their estate tax exemption.)

In addition to all of these $14,000 gifts, the Smiths can pay the college tuition for any of their grandchildren. No matter how large these outlays might be, Cora and Rob will not owe any tax or suffer any reduction in their transfer tax breaks.

Axing aid

Such grandparent gifts may have their disadvantages, though. They could result in reduced financial aid.

Example 2: Over the years, Rob and Cora have made gifts to their grandson Doug. Counting investment buildup, Doug has $50,000 worth of assets when he fills out the FAFSA (see the article "Financial Aid Starts With the FAFSA" in this issue) for his first year of college. The FAFSA assesses Doug's assets by 20%, when calculating the expected family contribution (EFC), so the $50,000 could reduce his financial aid by $10,000: the 20% assessment times $50,000 of Doug's assets. Tuition payments by Rob and Cora for Doug's schooling could result in even larger aid cutbacks.

For some grandparents, this won't be a major concern. The student's immediate family might have such extensive assets and such substantial income that need-based financial aid won't be possible. However, today's college costs are so high that aid might be available, even to well-off families. The possible impact on financial aid should be discussed with the student's parents.

In addition, it should be considered that assets given to grandchildren will come under the youngsters' control once they come of age, usually on or before age 21. Grandparents need to be comfortable with the idea that money in a grandchild's account may or may not be used for education or other worthwhile purposes.

Grandparents to parents

Instead of making gifts directly to grandchildren, grandparents can give assets to their own children who are the student's parents. This plan will have less impact on financial aid.

Example 3: Assume that Cora and Rob have made gifts to their daughter Elly, Doug's mother, rather than making gifts directly to Doug. Such gifts have increased Elly's assets by $50,000. A parent's assets are assessed at no more than 5.64%, on the FAFSA, so the additional assets held in Elly's name would reduce possible aid by $2,820: 5.64% of $50,000.

Therefore, giving money to the student's parent would be better

than giving money to the student, if financial aid is a concern, and, assuming the parents are more financially prudent, less chance exists of the transferred assets being squandered.

Focusing on 529 plans

If concerns about the security and intent of the gifted funds still exist, they may be addressed by contributing to a 529 college savings plan, instead. Such plans have many advantages.

Example 4: Cora Smith creates three 529 accounts, naming a different grandchild as the beneficiary for each one. Now Cora has control over how the money will be invested and how it will be spent. Any investment earnings will be tax-free and distributions also will be untaxed if the money is used for the beneficiary's college bills. Cora can even reclaim the funds in the 529 if she needs money, paying tax and (with some exceptions) a 10% penalty on any earnings.

What's more, a 529 account owned by a grandparent won't be reported on the grandchild's FAFSA, so it will not have any initial impact on financial aid. It's true that eventual distributions from a grandparent's 529 will be reported on a subsequent FAFSA and will substantially reduce financial aid. That won't be a concern for families who are not receiving need-based aid. If the student is receiving aid, distributions from the grandparent's 529 plan can be postponed until the last FAFSA has been filed.

Example 5: Doug Franklin will start college in the 2015-2016 school year, so he files his first FAFSA in January 2015. Doug receives some need-based aid, so his grandmother Cora lets the 529 account continue to grow, untaxed. Doug files a new FAFSA every year until January 2018, when he submits the form for his senior year. Subsequently, Cora can tap the 529 account to pay Doug's remaining college bills. Doug won't be filing any more FAFSAs for financial aid, so Cora's 529 distributions won't be reported. The bottom line is that grandparents have many tactics they can consider if they wish to give grandchildren a financial assist on the path towards a college degree. ■

Keeping Wealth in Your Family's Future

According to a new study by Merrill Lynch's Private Banking and Investment Group, family wealth fails to outlive the generation following the one that created that wealth in more than two out of three instances; 90% of the time, "assets are exhausted before the end of the third generation." This report focuses on investors with more than $5 million, but the principles apply just as well to those with $500,000 or even $50,000 to invest. If you are concerned about the financial security of your children and grandchildren, you should set a good example and discuss money matters regularly with your descendants.

Savvy spending

One reason that family wealth may not last very long is simple: people spend too much. In the Merrill Lynch study, more than half of the respondents either expressed confidence that a 6% distribution rate could sustain an investment portfolio indefinitely or did not have any idea of how much could be withdrawn prudently. To put this in perspective, research indicates that a sustainable distribution rate might be as low as 2% of portfolio value a year.

Obviously, the less you spend the more that can pass to a surviving spouse and to your descendants. Spending moderately will signal to your loved ones that this is how one builds and maintains net worth. In addition, you can make sure that your heirs know that your spending habits are designed to minimize the chance of depleting the family's coffers.

Continuing the conversation

Indeed, perhaps the most important thing you can do to preserve wealth in your family is to regularly talk to your children about finances. Remember to keep the discussions age appropriate. With very young children, you might talk about how money is earned by working, how some money goes to taxes to pay for schools and other services, and how what's left might be either saved or spent. Avoid getting into too much detail with youngsters, who probably will be overwhelmed and, therefore, intimidated rather than educated.

Once your children are ready for college, you can have practical conversations about their choice of study and eventual career path. A student who knows a substantial inheritance lies in the future, or who can play a possible role in a thriving family business, might be inclined to consider a course of study that relates to a personal passion; another student, one who understands that his or her lifestyle will depend on his or her earnings, could go in another direction.

Similar conversations might take place when children are about to become parents or are shopping for a home. The more they know about

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your finances, and about their own prospects for an inheritance, the greater the likelihood they'll make informed decisions.

On the flip side, holding these ongoing conversations with your children can educate you, too. You might discover a need for gifts or loans that you hadn't known about. Conversely, you might realize that your children are uninterested in financial matters and may make poor decisions if they inherit money outright. If so, you may have the opportunity to build safeguards into your estate plan, such as giving or leaving money to a trust for a child's benefit.

Hitting the highlights

Of course, some parents will not want to reveal all the details of their financial affairs to their children. In truth, that's not really necessary. You might give your children an overview, with enough information to impart what you are willing and able to provide during your life and a general idea of what they might inherit someday. In addition, you can tell your children where to find key documents and also provide contact information for your professional advisors.

Once you bring your advisors into the inheritance conversation, keep in mind that some studies show that both parents and children may be more comfortable discussing their circumstances with a financial professional (CPA, attorney, financial planner) than with each other. If that's the case in your situation, you might ask a professional with whom you work to suggest and even host a meeting of the generations. Our office would be pleased to help you get the conversation started. ■

Tougher Rules on Reverse Mortgages

The Federal Housing Administration (FHA) has imposed more stringent requirements on reverse mortgages, making them increasingly difficult to obtain. For qualified borrowers, though, continued low rates and the spread of so-called "purchase loans" can make it worthwhile to consider this type of debt.

Income instead of outflow

As the name suggests, a reverse mortgage is the opposite of a traditional home loan. With a reverse mortgage, you get cash instead of making payments to the lender. You can get a lump sum, a line of credit, or regular monthly income. The amount you borrow will be secured by your home, so reverse mortgages are for homeowners with little or no debt on their home. Most reverse mortgages are Home Equity Conversion Mortgages (HECMs), which are offered by private lenders and insured by the FHA; borrowers must be at least age 62.

The amount you'll receive will be determined by current interest rates, your age, and your home equity. Interest rates are relatively low now (around 5% for a fixed-rate loan and under 3% for a loan with a variable rate that adjusts monthly), but you'll pay an added 1.25% of the balance for mortgage insurance. The older you are and the greater your home equity, the more you'll be able to borrow on a reverse mortgage.

Many reverse mortgage calculators can be found online. Near mid-year 2014, the calculator at reversemortgage.org was asked what a married couple in Indianapolis, both aged 68, could borrow against a $320,000 debt-free home. A fixed-rate loan would permit an upfront payout of over $97,000, whereas a variable-rate loan would provide $971 in monthly cash flow. If that couple were both age 78, the numbers would be about $106,000 upfront and $1,236 a month, respectively. In any case, no tax would be due on the borrowed funds. (See the Trusted Advice column "Delayed Deduction" for more information.)

With a HECM, an owner occupant doesn't have to make any debt repayment while still living in the home. No matter how large the loan balance becomes, the outstanding loan balance won't be due until the borrower dies, sells the home, or is no longer using the home as a primary residence. Naturally, the loan balance will keep mounting: that $97,000 or $106,000 loan against a $320,000 house will approximately double in 11 years, at today's fixed interest rates.

Higher hurdles

A reverse mortgage borrower still owns the home, which means continuing to have ownership responsibility.

Example 1: Frank and Robin Grant receive a reverse mortgage that will pay them $1,000 a month. They still own their home, so they still must pay homeowners insurance premiums, local property taxes, and association dues.

Under new FHA rules, reverse mortgage applicants must undergo a financial assessment in order to qualify for a loan. Lenders have to check to see that borrowers can afford to pay the required taxes and insurance bills, based on their assets and cash flow. Borrowers with questionable resources may be asked to put money into escrow or may have their application rejected.

Borrowing to buy

Reverse mortgages are aimed at seniors who wish to stay in their home as they grow older. In effect, they can use their home equity for added cash in retirement so they won't have to move into an unfamiliar place, perhaps one that's away from friends and family.

That's not the case for all seniors. Some want to buy a different home that's easier to maintain or move to a less expensive region.

Example 2: Helen Parker is a widow living in a large house. She wants to buy a place in a seniors' community, but she lacks the income to qualify for a traditional mortgage, and she is having a difficult time selling the house where she now lives.

Fortunately, Helen has enough assets to qualify for a reverse mortgage purchase loan, which will enable her to buy into the seniors' community now. Helen still plans to sell her old home, but she can move right away and not have to make payments on the reverse mortgage purchase loan.

Reverse mortgages can be complicated, and they require various fees, but they may offer a practical way to tap home equity in specific circumstances. ■

Trusted Advice

Delayed Deduction

- Because reverse mortgages are considered loan advances and not income, the amount you receive is not taxable.
- Any interest accrued on a reverse mortgage is not deductible until the interest is actually paid, which is usually when the loan is paid off in full. Such a payment might be made by the borrower, by an heir, or by the borrower's estate.
- For the party repaying the loan, the deduction may be limited because a reverse mortgage loan generally is subject to the limit on home equity debt. That limit caps deductions to the interest on $100,000 of debt.

Reasonable Compensation for S Corporation Owners

For regular C corporations, "reasonable compensation" can be a troublesome tax issue. The IRS doesn't want shareholder executives to inflate their deductible salaries while minimizing the corporation's nondeductible dividend payouts.

For S corporation owners, the opposite is true. If owner employees take what the IRS considers "unreasonably low" compensation, the IRS may recast the earnings to reflect higher payroll taxes, along with interest and penalties.

One pocket to pick

Eligible corporations that elect S status avoid corporate income taxes. Instead, all income flows through to the shareholders' personal tax returns.

Example 1: Ivan Nelson owns a plumbing supply firm structured as an S corporation. Ivan's salary is $250,000 a year while the company's profits are $400,000. The $650,000 total is reported on Ivan's personal tax return.

In 2014, Ivan pays 12.4% as the employer and employee shares of Social Security tax on $117,000 of earnings. He also pays 2.9% Medicare tax on his $250,000 of salary. As a result of recent tax legislation, Ivan—who is not married—owes an additional 0.9% Medicare tax on $50,000, the amount over the $200,000 earnings threshold (the threshold is $250,000 on a joint tax return). Altogether, Ivan pays well over $20,000 in these payroll taxes.

Going low

Often, S corporation owners have a great deal of leeway in determining their salary and any bonus. Holding down these earnings may reduce payroll taxes.

Example 2: Jenny Maxwell owns an electrical supply firm across the street from Ivan's business. Jenny's company also is an S corporation. She reports the same $650,000 of income from the business but Jenny classes only $75,000 as salary

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and $575,000 as profits from the business. Thus, she pays thousands of dollars less than Ivan pays for Social Security and Medicare taxes.

Proving your payout

As mentioned, the IRS might target S corporation owners suspected of lowballing earned income. Therefore, all S corporation shareholders should take steps to justify the reasonableness of their compensation.

If you own an S corporation, consider spelling out your salary level in your corporate minutes. Where possible, give examples and quote industry statistics that show your compensation is in line with the amounts paid to executives at similar firms.

Other explanations also might help. Depending on the situation, you might say that business is slow, in the current economy, so the minutes will report that you are keeping your salary low to provide working capital for the company. If your business is young, the minutes could explain that you're holding fixed costs down, so the company can grow, but you expect to earn more in the future. In still another scenario, you might say that you are nearing retirement and making an effort to rely more on valued employees, so a modest level of earnings reflects the actual work you're now contributing.

As illustrated above, holding down S corporation compensation can result in sizable payroll tax savings. Our office can help you establish a reasonable, tax-efficient plan for your salary and bonus.

Calculating coverage

Beyond compensation, health insurance also may affect the payroll tax paid by an S corporation owner. Special rules apply to anyone owning more than 2% of the company's stock.

If the company has a health plan and pays some or all of the costs for coverage of such a so-called "2% shareholder," the payments will be reported to the IRS as taxable income. However, that amount will not be subject to payroll taxes, including those for Medicare and Social Security. The company can take a deduction for these payments, effectively reducing corporate profits passed through as taxable income for the shareholder.

In addition, the S corporation shareholder may be able to deduct the premiums paid by the company—this deduction can be taken on page 1 of his or her personal tax return, which may provide other tax benefits. However, such an "above-the-line" deduction cannot be taken in any month when the shareholder or spouse is eligible to participate in another employer-sponsored health plan. Also, this deduction can't exceed the amount of the shareholder's earned income for the year.

This can be a complicated issue, especially if your state law prevents a corporation from buying group health insurance for a single employee. If you own an S corporation, our office can help you decide the best way to hold down payroll tax as well as income tax from your health plan. ■

TAX CALENDAR

AUGUST 2014

August 11

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2014. 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 2014

September 15

Individuals. If you are not paying your 2014 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2014 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. File a 2013 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic 6-month extension.

Deposit the third installment of estimated income tax for 2014. Use the worksheet Form 1120-W to help estimate tax for the year.

Partnerships. File a 2013 calendar year return (Form 1065). This due date applies only if you were given an additional 5-month extension. Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.

S corporations. File a 2013 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic 6-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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