Client Bulletin

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

Planning for Retirement Income

October 2014

Save substantially. Invest your savings wisely. The conventional wisdom holds that this is the way to accumulate a nest egg for your retirement, and the conventional wisdom is right on the money.

However, you probably won't always have earnings to invest. At some point, your work income is likely to cease or drop sharply in retirement, and you'll need to draw down prior savings. Yet, studies have found that very few people have considered how they'll go from investing earned income to generating retirement income. The sooner you give this issue serious thought, the more likely you'll be prepared with a realistic spending plan when the paychecks stop. Here are a few options to consider.

Spend income, not principal

Most people can rely upon Social Security benefits for some retirement income. Beyond Social Security, you probably will have to tap your own savings. The question, then, is how to go about drawing down the money you'll spend. One method is to use only dividends and investment interest income for cash flow.

Example 1: Suppose Ed and Nancy Parker will each receive $20,000 a year from Social Security, so their joint annual benefits will be $40,000 per year, indexed for inflation. The Parkers have a $600,000 portfolio, in this example, invested in high-quality stocks and bonds. If their interest income and dividends average 2.5%, the Parkers will receive another $15,000 a year (2.5% of $600,000). By spending that $15,000 but leaving their stocks and bonds intact, the Parkers' retirement income will be $55,000 a year, including $40,000 from Social Security.

Cracking your nest egg

Dividends and investment interest yields are low today, and may remain a low in the future. The Parkers, in our previous example, may wish for greater retirement income than $55,000 a year. One alternate strategy is to follow the so-called 4% rule, which has been

continued on page 2

What's Inside

1 Planning for Retirement Income
2 As Collectibles Boom, Selling Can Be Taxing
3 S Corporation or LLC?
4 Tax Calendar

Preferred for Pensions

Among all employer sponsored retirement plans, 19% of total assets are invested in target date funds and another 14% are in index funds.

continued from page 1

developed by financial advisors and academic researchers.

Example 2: The Parkers withdraw 4% of their $600,000 investment portfolio ($24,000) in the first year after they stop working. Now they have $64,000 ($40,000 from Social Security plus $24,000 from their portfolio) to spend rather than $55,000.

The 4% rule assumes that the Parkers increase their withdrawals each year to keep up with inflation. Going by historic investment results, research indicates a high probability that the Parkers' portfolio will last at least 30 years, with this method.

To get that $24,000 in the first year of retirement, the Parkers might spend their $15,000 of investment income, as explained, and sell $9,000 of their investments to raise the rest of their cash. Over time, they would gradually deplete their portfolio in this manner.

The 4% rule likely will provide more retirement income than just spending interest and dividends. However, active management will be involved—deciding which assets will be sold each year to provide the cash flow. In addition, the Parkers run the risk that poor results in the stock or bond market will accelerate portfolio depletion.

Assessing annuities

Yet another approach is to put retirement funds in an immediate annuity, sometimes called an income or a payout annuity. You can give a lump sum to an insurance company and receive monthly income for the rest of your life. Joint annuities are available, so a married couple might get this payout as long as either spouse is alive.

Example 3: The Parkers, both age 65, weigh putting all of their $600,000 into a joint annuity. By using an online annuity calculator, they learn that such an annuity might pay them $3,000 a month, or $36,000 a year. If one spouse dies, the survivor will continue to get that $36,000 a year.

Now the Parkers will start retirement with $76,000 of income in the first year, with $36,000 from the annuity plus $40,000 from Social Security. The annuity will protect them from running short of money over a long retirement. They won't have to make decisions about selling securities, and they'll enjoy some tax benefits because most of their annuity payments will be treated as a tax-free return of principal for many years, if held in a taxable account.

On the other hand, annuities typically provide a fixed payment. The $36,000 the Parkers receive in 2015 won't buy as much in 2025 or 2035, assuming inflation drives prices higher. Depending on the terms of the contract, a joint annuity may not leave anything to their children, even if the Parkers both die in a few years. Buying an annuity today, while interest rates are at historic lows, also will lock in a relatively low return, which might be surpassed by stocks and bonds over the coming decades.

Mix and match

The bottom line is that no method is absolutely better than the others. Some advisors suggest putting some retirement funds into an immediate annuity, for dependable lifetime income, while continuing to manage other assets under a withdrawal plan, such as the 4% rule. Other sources of income also might be considered: an inheritance, selling your home, using a reverse mortgage, even doing some part-time work.

By planning ahead you will have a better idea of how much cash you reasonably can expect to receive and where it will come from, so you can set your retirement expectations realistically. ■

As Collectibles Boom, Selling Can Be Taxing

In the past two years, five paintings have been sold at auction for more than $100 million apiece, while another (by Cezanne) reportedly brought more than $250 million in a private sale. In the same time frame, a pink diamond was auctioned for a record $83 million.

As you can see, the collectibles market has been booming. You might not own a multimillion dollar item, but the chances are that the coins, stamps, or paperweights that you collect have grown in value. If you decide to cash in by selling one or more pieces from your collection, you may have to deal with unpleasant tax surprises.

Raising the rates

The tax code has special treatment for collectibles, which can include artwork, rugs, antiques, gems, stamps, metals, coins, and alcoholic beverages, according to the IRS. When you sell collectibles, the special 0%, 15%, and

20% tax rates on long-term capital gains don't apply. Instead, you'll owe tax at your ordinary tax rate, with a cap of 28%.

As is the case with all assets, short-term capital gains on the sale of collectibles are taxed at ordinary rates.

Example 1: Dan King bought a rare U.S. coin for $1,000 and sold it 11 months later for $1,300. Dan's $300gain was short-term, so he owes tax at his ordinary rate, 15% in this example.

Dan bought another coin at the same price at the same time; he sold that coin for a $300 gain as well. This coin, though, was sold 13 months after Dan's purchase. Because the holding period was over one year, Dan reports the $300 as a long-term capital gain.

Normally, a long-term capital gain is taxed at a 0% rate by taxpayers in the 15% tax bracket, such as Dan. That would be the case, for example, if Dan had a $300 long-term gain on a stock sale. A long-term collectibles gain, though, doesn't qualify for the 0% rate. Thus, Dan will owe 15% in tax on this $300 gain ($45) from the second coin sale, just as he does on the first (short-term) coin sale.

Similarly, taxpayers in the next higher tax brackets (25% and 28%) also owe tax at their ordinary rate on long-term gains from collectibles. Taxpayers in higher brackets (33%, 35% and 39.6%) do get some tax break from long-term gains on collectibles because the rate does not exceed 28%.

Example 2: Emily Larsen has taxable income over $500,000, so she is in the top 39.6% tax bracket this year. She sells a painting for a $20,000 gain after holding the artwork for several years. On long-term gains from a stock, Emily would owe tax at the special 20% rate. However, Emily doesn't qualify for the 20% tax rate on the sale of the painting because it is a collectible. Emily's tax rate is higher than 28%, so she will owe the maximum 28% rate on her $20,000 long-term collectibles gain: $5,600 in tax.

Personal use

If you plan to sell collectibles at a loss, be aware that the tax code still works against you. If you sell collectibles for which you had "personal use," you can't claim a capital loss, and selling collectibles for which you had personal use at a profit will still result in a taxable capital gain.

Personal use will depend upon specific circumstances. Hanging a painting on the wall of your home might be considered personal use, depriving you of any tax benefit from a loss on a subsequent sale. However, if you regularly buy a specific type of painting, keep some in careful storage when not on display, and maintain careful records of your collection, you might be able to make the case that the artworks were held for investment purposes. Such efforts could result in a capital loss that provides tax benefits. Our office can help you determine if your collectibles may be treated as investment property. ■

Trusted Advice

Collecting Net Investment Income Tax

- Some taxpayers owe a 3.8% surtax, commonly called the net investment income tax, to help finance Medicare.
- This net investment income tax may be imposed if you report modified adjusted gross income (MAGI) over $200,000, or over $250,000 on a joint tax return.
- Your net investment income tax amount will depend on your MAGI and your net investment income.
- If you owe the net investment income tax, that may effectively increase the tax you owe on sales of collectibles: the maximum tax on a long-term gain could rise from 28% to 31.8%.

S Corporation or LLC?

Many business owners structure their companies as S corporations or limited liability companies (LLCs). On the surface there are several similarities. Both types of entities avoid corporate income tax. Instead, business income is taxed only once, on the tax return of the S corporation shareholder or the LLC member. Moreover, both S corporation shareholders and LLC members have limited liability: their financial exposure from the company's operation generally is no greater than the amount they invest and any notes they personally sign. (In exceptional circumstances, creditors may gain access to additional personal assets of the business owner.)

Nevertheless, there are differences between the two structures, which you should consider when choosing between them.

Looking into LLCs

In some ways, an LLC resembles a sole proprietorship or a partnership, but with the advantage of limited liability. Usually, you can form an

continued on page 4

continued from page 3

LLC with relatively little paperwork. Once an LLC is operating, there may be few tax returns to file and other recordkeeping and reporting requirements for LLCs are generally less burdensome than for corporations. If an LLC has multiple members, the business has a great deal of flexibility in how any profits are distributed among them.

A downside is that an LLC may have a limited life. Depending on state law and the operating agreement, the death of a member may dissolve the LLC, for instance. In addition, taxes might be relatively high for LLC members. That's because all net income of the LLC is passed through to members as earned income on their personal tax returns, per the LLC agreement. The members are treated as if they were self-employed; they owe the employer and employee shares of items such as Social Security and Medicare tax, with a relatively small deduction as an offset.

Considering S Corps

Even after making an election to be taxed under Subchapter S of the Internal Revenue Code, an S corporation is still a corporation. There are meetings that must be held, minutes that must be kept, and extensive paperwork to process. Such efforts can be time consuming and expensive.

In addition, S corporations must meet certain requirements. A business with more than one class of stock or a shareholder who is not a U.S. citizen or resident can't be an S corporation, for example. Similarly, an S corporation can't make disproportionate distributions of dividends or losses.

On the plus side, S corporation shareholders can receive a salary, on which they owe payroll tax, and dividends, on which they don't. Although artificially low-balling a salary will draw the ire of the IRS (see the August 2014 issue of the *CPA Client Bulletin*), S corporation owners may pay thousands of dollars less per year in payroll taxes than LLC members pay on similar company related income. What's more, S corporations can be long-lived, and this permanent nature may make them more attractive to lenders and investors than potentially short-lived LLCs.

Choosing or combining

Your choice of business structure may come down to whether you prefer the simplicity and flexibility of an LLC or the potential tax savings and lender and investor appeal of an S corporation. State laws vary, so a tilt in one direction or another may influence your decision.

Yet another possibility is to set up your business as an LLC and then request S corporation taxation by filing IRS Form 2553, "Election By A Small Business Corporation." Our office can go over your specific circumstances to help you decide how to structure your company. ■

Did You Know?

Six of the 10 costliest hurricanes in U.S. history occurred in 2004-2005. Katrina ($108 billion in damages) is by far the record holder. Others on the list from those years are Wilma ($22 billion), Ivan ($18.8 billion), Charley ($15.1 billion), Rita ($12 billion), and Frances ($9 billion).

Source: weather.com

TAX CALENDAR

OCTOBER 2014

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2013, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

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

Electing large partnerships. If you are a calendar year filer and were given an additional six-month extension, file a 2013 tax return (Form 1065-B).

October 31

Employers. For Social Security, Medicare and withheld income tax, file Form 941 for the third quarter of 2014. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

NOVEMBER 2014

November 10

Employers. For Social Security, Medicare and withheld income tax, file Form 941 for the third quarter of 2014. This due date applies only if you deposited the tax for the quarter in full and on time.

November 17

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

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