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CERTIFIED PUBLIC ACCOUNTANTS | CONSULTANTS CLIENT PLANNING ADVISORY SUMMER 2015

ATKINSON & CO. CELEBRATES 45 YEARS!

Atkinson & Co. celebrated its 45th anniversary this year! We are pleased to have served individuals and businesses throughout the southwest and the nation for many years.

Throughout the years our mission has remained the same; to provide outstanding service and contribute to the growth, profitability, and success of our clients; to meet the highest professional and ethical standards in both service and conduct; to offer a challenging career to all the of staff of Atkinson & Co., and to give energy and time back to the community from which we derive our business.

We sincerely want to thank all of our clients. Your confidence in our firm and our staff is the main reason that we have been successful in completing 45 years in business.

We would also like to thank our employees; their knowledge, skills, and caring attitude have made a difference!

We look forward to serving you and our many friends for many years to come!

—Henry C. South, CPA, CVA
Managing Partner

Americans Counts on CPAs SM

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-to purchase 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 rent-to-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.

CONTINUED ON PAGE 3

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Tax Free Roth IRA Conversions

Moving money from a tax-deferred retirement account to a potentially tax-free Roth IRA usually will trigger income tax. That won't always be the case, though, thanks to recent IRS announcements. Some examples show how this can work.

Example 1: Nancy Martin has participated in her company's 401(k) plan for many years. She typically has made maximum pretax contributions to the plan. Nancy's company allows employees to make additional aftertax contributions (many employers do), which she has done. Nancy decides to leave the company at a time when she has $600,000 in the 401(k), including $100,000 from aftertax contributions.

Thanks to an IRS notice published in September (IRS Notice 2014-54), Nancy can have her plan administrator transfer $100,000 of aftertax money to a Roth IRA. Because this is aftertax money, Nancy won't owe tax on the transfer. Inside her Roth IRA, untaxed growth can continue.

Once Nancy has met the five year and age 59½ requirements, she can withdraw as much or as little from the Roth IRA as she wishes without owing any tax.

In order to qualify for this tax treatment, Nancy's Roth IRA transfer must be part of a distribution to two or more retirement accounts. Thus, she can send $100,000 to a Roth IRA and the other $500,000 to a traditional IRA. Nancy won't owe any tax on these transfers. However, her $500,000 traditional IRA (and any future earnings) will remain pretax. Nancy will owe tax on any withdrawals from that traditional IRA or any future conversion to a Roth IRA.

Beyond 401(k)s, this strategy can be executed by taxpayers with aftertax money in other types of employer sponsored qualified plans.

IRA IMPLICATIONS

What if Nancy already had rolled her $600,000 to a traditional IRA? In that case, any distributions from that account—including those for a Roth IRA conversion—would be considered a mix of aftertax and pretax money. If Nancy had $600,000 in a traditional IRA, with $100,000 of aftertax money, for instance, a $150,000 Roth IRA conversion would be considered $125,000 (5/6) taxable and $25,000 (1/6) untaxed.

Nevertheless, there can be a way to execute a tax-free Roth conversion in that situation.

Example 2: Assume that Nancy leaves the company and rolls her $600,000 401(k) balance to a traditional IRA. Currently, that IRA has the same balance, including $100,000 of aftertax money. Nancy has just accepted a new job with a company that sponsors a 401(k) plan for its employees.

In this situation, Nancy can roll her $500,000 of pre-tax money into the new company's 401(k) plan and then convert the aftertax $100,000 to a Roth IRA. Again, she'll owe no tax on either move and she'll have $100,000 in a potentially tax-free Roth IRA.

That tactic has been possible in the past but not always practical: many employer plan administrators were reluctant to accept such rollovers from IRAs into a company retirement plan because the IRS had not explained how such transactions should be handled.

That changed last year when the IRS published Revenue Ruling 2014-9, setting out the ground rules. Now, Nancy can have the custodian of her traditional IRA transfer up to $500,000 of her pretax money to the new company's plan. Nancy also has to submit a statement to the administrator of the new plan, certifying that this rollover is all pretax money. Following Rev. Rul. 2014-9, company plans are likely to accept such rollovers from traditional IRAs. ❍

TRUSTED ADVICE

ROTH IRA RULES

- Contributions to a Roth IRA are not tax-deductible.
- Qualified distributions are tax-free. Such distributions are made on or after the date you reach age 59½, if 5 years have passed since your first Roth IRA contribution.
- Workers and their spouses can make contributions to a Roth IRA even after reaching age 70½. There are income limits for Roth IRA contributions.
- Account owners can leave amounts in a Roth IRA as long as they live with no required distributions.

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 agreed upon 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. ❍

Turn Relatives Into Employees to Reduce Taxes

High-income business owners may be realizing the impact of new tax laws as they prepare their 2014 tax returns. Those laws can be especially painful if your company is structured as an S corporation or a limited liability company (LLC), with all income reported on your personal return. Besides the recently added 39.6% top income tax bracket, your income may be subject to the 3.8% Medicare surtax as well as the phaseout of itemized deductions and personal exemptions. Including state taxes, you might be in a marginal tax bracket in excess of 50%.

SAVVY SHIFTING

You may receive some tax relief by hiring relatives. The money you pay will reduce business profits, so you might have less taxable income to report. That compensation will be taxable to the relatives you hire—or it might not. The standard deduction is $6,300 in 2015, so your children can each receive up to that much, tax-free.

Example: Jennifer Boyd has a mail order clothing business that makes enough money to put her into a high tax bracket. She hires her two children and pays them $3,500 and $5,000 this year. Jennifer reduces her reported income by $8,500, saving her thousands of dollars a year in tax, while her children owe no income tax. Jennifer also hires her widowed mother, who is in the 15% tax bracket. (That rate goes up to $37,450 of taxable income in 2015.) Again, Jennifer saves tax by reducing her income, while her mother owes relatively little in tax.

To justify the tax savings, family members on the payroll must be paid fairly for work they actually perform. Thus, tasks should be suited for each individual's capabilities. Jennifer's teenage son, for instance, might help with her company's website and its IT operations; her daughter, who goes away to college, could generate market research reports that relate to Jennifer's business and play a role in keeping the company's social media activities up to date. Jennifer's mother, a retired fashion designer, could provide advice on product trends and selection.

No matter what kind of work relatives perform, business owners should keep records showing their production.

No matter what kind of work relatives perform, business owners should keep records showing their production. Compensation should be in line with the amounts paid to other employees.

WEIGHING THE TRADEOFF

If your business is a partnership between spouses or a sole proprietorship or a certain type of LLC, you won't be required to pay Social Security and Medicare taxes on the wages you pay to your children if they are under age 18. Similarly, with an unincorporated business, you won't need to pay federal unemployment tax on wages paid to a son or daughter under age 21.

Except for those situations, the wages you pay relatives will be subject to payroll taxes. Those payments may reduce the family's tax savings. Our office can help you calculate the net tax benefit of hiring family members and assist in setting up the required paperwork.

Beyond tax savings, hiring relatives can be rewarding. Your children may gain valuable life lessons, and your retired parents can continue to perform worthwhile tasks. Tax savings, while undoubtedly welcome, might turn out to be the icing on the cake. ❍

RENTING VERSUS BUYING A HOME *CONTINUED FROM PAGE 1*

THINKING ABOUT TAXES

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. ❍

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