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CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

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New In-Plan Conversions

Although traditional 401(k) plans have become widespread, many employers are adding Roth 401(k) s to their employee benefits. The relationship between these two types of plans is similar to the relationship between traditional and Roth IRAs:

- Traditional 401(k)s are funded largely with pretax dollars. Withdrawals are fully or mostly subject to income tax.
- Roth 401(k)s are funded with after-tax dollars. Withdrawals are completely tax-free after you have had the account for 5 years and reach age 59½.

New opportunity

Under the new tax law (see the *CPA Client Tax Letter* for April/May/June 2013), you can convert your traditional 401(k) balance to a Roth 401(k). You can do so at any time, as long as your employer offers a Roth 401(k) and the plan documents permit such conversions. The same rules apply for conversions to employer sponsored Roth accounts if you participate in 403(b) or 457(b) plans. Moreover, the federal government's Thrift Savings Plan for federal employees may decide to permit in-plan conversions to its Roth version.

The tax code has allowed such conversions since 2010, but only for people eligible for distributions. That meant conversions generally were available only when a participant left the company, reached 59½, became disabled, died, or when the plan terminated without a similar substitute in place. The new tax law permits current participants to convert without having to meet any of those requirements.

Example 1: Arlene Baxter, age 32, works for ABC Corp., where she participates in a traditional 401(k) plan. ABC also offers a Roth 401(k); in-plan conversions are allowed. Arlene, who has $80,000 in her 401(k), can convert any or all of that

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What's Inside

Ramped-up Retirement

Average retirement assets per U.S. household, in constant dollars, has grown from $27,300 in 1975 to $153,100 in 2012.

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Trusted Advice

Conversion Caveats

- In-plan conversions to Roth 401(k) accounts (unlike Roth IRAs) can't be recharacterized. This decision is irrevocable, and so is the tax obligation you incur.
- The owner of a Roth IRA never has to take required minimum distributions (RMDs), but owners of employer-sponsored Roth 401(k) accounts do not have this advantage. A retired owner of a Roth 401(k) account must take RMDs from the account after age 70½.
- To avoid RMDs, participants can roll their Roth 401(k) accounts to a Roth IRA. However, the period that the rolled-over funds were in the Roth 401(k) account does not count toward the 5-year period for determining qualified distributions from the Roth IRA.

$80,000 from her traditional 401(k) to a Roth 401(k).

As mentioned, Arlene creates an opportunity to receive tax-free cash flow in the future when she moves money into the Roth version. Once she reaches 59½, Arlene will be beyond the 5-year mark so she can withdraw as much as she'd like without owing tax.

Arlene will pay a price for this future income stream. She'll owe income tax on all the pretax money she moves from her traditional 401(k) to the Roth 401(k). Assuming Arlene's traditional 401(k) is all pretax, she'll add $80,000 to her taxable income for 2013, if she executes a full conversion this year.

Balancing the brackets

Perhaps most important, you should compare your present tax rate to your estimated future tax rate. Ideally, you'll pay tax now at a relatively low tax rate, then take tax-free withdrawals at a time when your tax rate would have been much higher.

The catch, of course, is that converting a traditional 401(k) to a Roth 401(k) will increase your income and may push you into a higher tax bracket in the year of the conversion.

Example 2: Suppose Arlene Baxter is single and expects her taxable income this year, after deductions, to be around $75,000. In 2013, such income puts Arlene in the 25% federal tax bracket, which goes up to $87,850 of taxable income. If Arlene implements a full $80,000 conversion, she'll move into the 28% bracket for the year and owe the higher rate on most of her conversion.

Arlene may not want to pay that much in tax, considering she has no idea of what her income or the tax rates will be when she's age 59½. Therefore, Arlene decides to convert only $10,000 of her traditional 401(k) to a Roth 401(k) in 2013. She will stay in the 25% bracket, so the conversion will increase her tax bill by only $2,500 for the year: 25% of $10,000. Arlene is confident that she will be able to pay that tax without having to borrow from her 401(k) or tap her IRA.

You may decide that taking a series of partial conversions each year is a prudent way to build a tax-free retirement fund. However, the rules on Roth 401(k) plans are complex. For instance, such conversions are irrevocable, so they lack the flexibility of a Roth IRA conversion, which can be reversed. Our office can go over the outlook for an in-plan Roth conversion in your particular circumstances. ■

Tax-Free Gains From Home Sales

The National Association of Realtors has reported that the median sales price of an existing single family home was around $175,000 in early 2013. That's down from the peak years of 2005–2007, when such prices were near $220,000 but still up from 2002, when the median price was $167,600. Therefore, if you sell a home you've owned for 10 years or more, you may well have a gain on the sale. (The same might be true if you sell a house bought in late 2009 or early 2010, the low point of the recent cycle.)

Thanks to some of the most generous breaks in the tax code, you may owe little or no tax on such a gain. In brief, you can exclude up to $250,000 of housing profits from capital gains tax, or up to $500,000 of gains if you are married and file a joint tax return. However, you must pass several tests in order to qualify for either tax exclusion.

Owned and occupied

The $250,000 and $500,000 tax breaks apply only to sales of your principal residence. You can't claim these exclusions for sale of a vacation home or an investment property. What's more, you must have owned and used the home as your primary residence for at least two of the five years before the sale. (Some exceptions apply in cases of poor health, job changes, and unforeseen circumstances.)

The two years do not have to be an unbroken time period.

Example 1: Pete Roberts bought a house for $200,000 in April 2008. He moved in right away and lived there until February 2009. At that point, Pete took a new job and relocated to a different state. He put his home on the market but was not able to sell it.

Pete's new job didn't work out, so he moved back into his home in January 2011. On June 15, 2012, he sold the home for $250,000. In this scenario, the five-year period before the sale stretched from June 16, 2007, to June 15, 2012. Pete had owned the home since April 2008, so he exceeded the two-year requirement.

During the five-year period, Pete lived in the house as his main home for 10 months (April 2008 to February 2009) and for 17 months (January 2011 to June 2012). Therefore, he passed the residency requirement as well. Pete is able to exclude the $50,000 gain from tax because it is less than the $250,000 maximum exclusion.

Regarding rentals

The tax rules are more complicated if you sell a house that has had some business use.

Example 2: Assume that Laura Martin has the same housing experience as Pete Roberts in example 1. However, when Laura moved out of her house for nearly two years, she rented it to a tenant. Then, Laura moved back into the house, sold it, and qualified under both two year tests.

Again, Laura can exclude up to $250,000 of gain on the house sale. However, Laura cannot exclude the part of the gain equal to the depreciation she claimed while her house was rental property. If you are in this type of situation, our office can help you calculate the taxable gain you will need to report.

Another two-year rule

You can claim the $250,000 or $500,000 tax exclusion multiple times, without limit. If you claim either of these exclusions, though, you generally cannot claim another one within two years. In the previous examples, both Laura Martin and Pete Roberts claim exclusions for a house sale on June 15, 2012. Therefore, if either of them sells a house before June 16, 2014, he or she cannot claim any exclusion on that sale.

Married couples

Married couples can exclude up to $500,000 of gain from the sale of their principal residence as long as either spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse is ineligible to take the exclusion because they had already excluded the gain on a different primary residence during the two-year period ending with the date of the current sale. ■

Diversify 529 Accounts

Total college savings assets in 529 accounts reached $168.5 billion by the end of 2012, up 16.7% for the year, reports Financial Research Corp. (FRC), Boston. Parents increasingly use these plans to fund future college costs because of the tax advantages. Any investment earnings inside the plan are untaxed, and withdrawals also are untaxed if the money is spent on higher education.

Most 529 assets are held in so-called "age-based" accounts. Generally, these accounts emphasize stocks for young beneficiaries. As the student grows older, closer to college age, age-based plans reduce their allocation to stocks and increase holdings of bonds. This method decreases the chance of a steep loss when the 529 beneficiary goes to college and payments are due.

Action plans

Age-based 529 accounts offer benefits, especially for parents who prefer to let professionals handle the asset mix in their college fund. However, if you are willing to take a more active role, you might be able to squeeze more tax savings juice out of the 529 orange.

One way to do this is to invest in multiple 529 plans. You can choose among the plans offered by nearly every state. With each plan you choose, use a different investment strategy.

Example 1: Ron and Sarah Parker want to invest $10,000 a year in their son Kevin's college fund. They invest $6,000 a year in state A's 529 plan, putting the money into a stock fund; the Parkers also invest $4,000 a year in state B's 529 plan, using a bond fund there.

After doing this for 12 years, the Parkers have $110,000 in state A's stock fund and $60,000 in state B's bond fund. Kevin will go to college this year, and the Parkers want to take $15,000 from his 529 plans. For tax efficiency, all $15,000 should come from Kevin's state A 529 account, which has the stock market gain. That account has more

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growth, so taking withdrawals from that account turns paper profits into untaxed earnings used for college costs.

Example 2: Assume the same facts as example 1, except that Kevin is still too young for college. Instead, suppose that the Parkers need $15,000 in cash to meet a medical emergency. They decide that the best available source is Kevin's 529 money. In this situation, they should tap the lower-growth state B bond fund.

With a total value of $60,000 that includes $12,000 of earnings, the earnings ratio is only 12/60, or 20%. On a $15,000 distribution, for expenses other than higher education, only 20% ($3,000) will be a taxable distribution. When you withdraw 529 funds for purposes other than higher education, you'll owe ordinary income tax plus a 10% penalty for nonqualified withdrawals. If the Parkers are in a 25% tax bracket, they'll owe a total of 35% (including the 10% penalty) on the $3,000 taxable distribution. Thus, they can withdraw $15,000 from Kevin's 529 bond account, in this example, and owe only $1,050 in tax.

Fine points

Regardless of how many 529 plans you use, you should begin by evaluating your own state's plan. Many states offer residents a tax break for contributing to their plan; contributions may be deductible for state income tax, although annual ceilings might apply.

In addition, when you withdraw money from a 529 plan to pay for college, be sure the distributions and outlays match up within a calendar year. Otherwise, you may owe tax and a 10% penalty.

Example 3: Assume again that Kevin Parker goes to college this year. His parents withdraw $15,000 from a 529 plan in 2013 but spend only $10,000 on Kevin's higher education this year.

In such a situation, the IRS will treat $5,000 of the Parkers' 2013 distribution as a nonqualified withdrawal and tax the withdrawn earnings at the Parkers' ordinary income tax rate, plus a 10% penalty. Even if the Parkers spend another $5,000 on Kevin's college costs in 2014 without taking a further withdrawal, the $5,000 nonqualified withdrawal from 2013 will still be taxed. ■

Maximizing Medical Deductions

Under federal health insurance legislation, you'll probably find it more difficult to claim medical expenses as itemized deductions on Schedule A of your tax return, beginning in 2013. (See the ***CPA Client Tax Letter*** for January/February/March 2013.) You'll get deductions only for expenses that exceed 10% of your adjusted gross income (AGI), up from 7.5% in prior years. (Through 2016, the threshold will remain at 7.5% of AGI if you or your spouse is age 65 or older at the close of the tax year.)

You cannot include medical expenses that were paid by insurance companies or other sources. This is true whether the payments were made directly to you, the person receiving the medical services (that is, your spouse or dependent), or to the provider of the medical services.

Example 1: Joel Gordon, age 45, has AGI of $100,000 in 2013 and $12,000 of unreimbursed medical expenses. The 10% threshold for Joel is $10,000, so he can deduct $2,000 of his medical bills. Under prior law, his 7.5% threshold would have been $7,500, and Joel could have claimed $4,500 in medical deductions.

The 10% solution

Even with a higher threshold, you shouldn't give up on deducting medical expenses. Good recordkeeping and a knowledge of the rules can help you go over the 10% level in some years. In particular, you should be sure to track items, such as the following:

Health insurance premiums. Even if you're covered by an employer plan at work, you probably are contributing to the cost of your insurance. Many employers require some form of cost sharing, and employees' share of the total has been increasing. If your contributions are withheld from your paychecks and are paid with your own after-tax dollars, don't forget to include those amounts in your total outlays. (Note that many people have pre-tax dollars withheld, in which case they are not deductible.)

Seniors are likely to be in a similar situation regarding Medicare, the federal government's health insurance program that mainly covers individuals 65 and older. You can include the premiums you pay for Medicare Part B (medical costs) and Part D (prescription drugs). Often, the government takes those costs from your Social Security checks, so you might not realize you've paid them. Medicare Part B costs over $1,200 a year, so you should be sure to count the money withheld from Social Security for such premiums.

In addition to ordinary health insurance, you also can include premiums you pay for long-term care insurance (subject to age-based limits), dental insurance, and contact lens coverage in the medical outlays you report as itemized deductions on Schedule A.

Instead of deducting health insurance premiums as itemized deductions on Schedule A, if you are self-employed, a partner in a partnership, or a more than 2% shareholder of an S corporation, you not only can deduct your health insurance premiums, you can take the deduction "above the line" on page 1 of your tax return. There is no AGI threshold for these deductions; in fact, your self-employed health insurance deductions reduce your AGI, which may help you deduct other medical expenses.

Dependents' costs. You can include medical costs you pay for yourself and your spouse. You also can count the medical costs you incur for someone who was your dependent either at the time the medical services were provided or at the time you paid the bill. The person must be either a "qualifying child" or a "qualifying relative," generally someone who depends on you for the necessities of life. The specific definitions are complex; our office can help you determine whether someone is a dependent for purposes of the medical expense deduction.

Transportation. You can include in your medical expenses outlays for transportation that was primarily for, and essential to, medical care. Such travel can be by bus, taxi, train, or plane. When you're taking a child for needed medical care, count those costs as well.

In addition, you can include your actual out-of-pocket for medical trips by car, such as gas and oil. As an alternative, you can calculate the deductible transportation expense amount by adding up the number of miles you travel for medical reasons and multiplying the total miles by the standard medical mileage rate, which is 24 cents a mile in 2013. You can add parking fees and tolls to your medical expenses, whether you use actual expenses or the standard mileage rate. Medical travel doesn't include commuting to and from work or travel for the general improvement of your health.

On the house

Amounts you pay for special equipment installed in your home, or for home improvements, can be included if the main purpose is medical care for you, your spouse, or a dependent. To justify the deduction, you should have a written recommendation from a doctor, prescribing the equipment or home improvement to treat a specific medical condition. IRS examples include access ramps, wider doorways, and elevators, but it's also possible to get deductions for a swimming pool or central air conditioning, if you proceed correctly. The cost of permanent improvements may be included as a medical expense, but you must reduce the deduction by any increase in the home's value. If the improvement does not increase the value of your home, the entire cost of the improvement can be deducted as a medical expense.

Example 2: Lynn Johnson has a severe form of arthritis, and her doctor tells her to swim regularly to regain her range of motion. Lynn decides to install a pool in her home.

Lynn begins by having her house appraised. After her home pool has been installed, Lynn gets another appraisal. She can claim the difference between the amount she has spent and the increase in her home's value as a medical deduction.

Say Lynn spends $40,000 installing her pool. The before-and-after appraisals indicate her home's value went from $350,000 to $375,000 as a result of the improvement. Thus, Lynn spent $40,000, and her house appreciated by $25,000. She can claim the $15,000 difference as a medical expense, which may allow her to take an itemized medical deduction. ■

Did You Know?

Head of the Class: Among 529 college savings plans, Virginia's CollegeAmerica Plan is by far the largest, with over $35 billion in assets and a 21% market share. New York's 529 College Savings Program, Direct Plan, is in second place with a 7.1% share.

Source: Financial Research Corp. (FRC)

Using the Work Opportunity Tax Credit

Among the business related provisions of the American Taxpayer Relief Act of 2013, the work opportunity tax credit (WOTC) was extended retroactively, for 2012, and also through 2013.

Under the WOTC, employers can receive federal tax credits for hiring and retaining workers from specific groups of individuals that have been designated as facing significant barriers to employment.

Taking credit

If your company hires a worker covered by the WOTC, the tax credit you can claim will depend on the target group of the individual,

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the amount you pay him or her for the first year of employment, and the number of hours that individual worked. Here are the basic rules. If an employee works

- at least 120 hours, you can claim a tax credit of 25% of the individual's first year wages.
- at least 400 hours, you can claim a tax credit of 40% of the individual's first year wages.

Generally, the maximum tax credit is $2,400. That ceiling applies if you hire food stamp recipients, certain residents of a federally designated Enterprise Community, Renewal Community, Rural Renewal County or Empowerment Zone, individuals in certain vocational rehab programs, ex-felons, or recipients of Supplemental Security Income benefits. If you hire a qualified summer youth employee (i.e., a 16 or 17-year-old who lives in an Empowerment Zone, an Enterprise Community, or a Renewal Community) to work for your company between May 1 and September 15, the maximum tax credit is $1,200.

As explained in the following paragraphs, two other categories of employees have higher maximum WOTC credits.

Hiring veterans

You may be able to claim the WOTC if your company hires a veteran who served on active duty (not including training) in the U.S. Armed Forces for more than 180 days or has been discharged or released from active duty because of a service related disability. That person must not have been on active duty (not including training) for more than 90 days within the 60-day period before being hired.

To get the tax credit, your company must hire a veteran who meets certain other criteria, such as being a member of a family receiving food stamps, having a service related disability, or having a lengthy period of unemployment. The maximum WOTC is $2,400 for hiring a qualified veteran unemployed for at least 4 weeks but less than 6 months during the 1-year period ending on the hiring date. The maximum credit is increased to $5,600 for hiring a qualified veteran unemployed for at least 6 months or more during the 1-year period ending on the hiring date. For hiring a veteran who has been on food stamps for at least a 3-month period ending during the 12-month period ending on the hiring date, the maximum credit is $2,400.

Veteran Target Group	Maximum Tax Credit
Receives food stamps	$2,400
Entitled to compensation for service-connected disability	
Hired one year from leaving service	$4,800
Unemployed at least 6 months	$9,600
Unemployed	
At least 4 weeks	$2,400
At least 6 months	$5,600
Source: U.S. Department Of Labor	

Special rules apply to veterans entitled to compensation for a service related disability. If such a veteran is hired by your company within 1 year of leaving the service, your company can receive a tax credit up to $4,800. If such a veteran was unemployed for at least 6 months during the 1-year period ending on the date of hiring, you can receive a credit up to $9,600.

Hiring members of needy families

Temporary Assistance to Needy Families (TANF) is a federal program. If you hire a short-term TANF recipient—any member of a family that received TANF benefits for 9 of the 18 months before being hired—the maximum WOTC is $2,400.

Your company also can hire a long-term TANF recipient. That's someone from a family meeting any of the following conditions:

- The family received TANF benefits during the 18-month period ending on the hiring date.
- The family received TANF benefits for at least 18 months after August 5, 1997. The employee's hiring date must be no more than 2 years after the earliest 18-month period.
- The family stopped being eligible for TANF payments during the past two years because a federal or state law limited the time those payments could be made.

If your company hires an employee from the long-term TANF group, it can take the WOTC over two years.

- If the individual works at least 120 hours in the first year, the employer may claim a tax credit equal to 40% of first-year wages.
- If the individual works at least 400 hours in the second year, the employer may claim a tax credit equal to 50% of second-year wages.

Companies that hire long-term TANF recipients can take a WOTC up to a total of $9,000, over those two years.

To apply for the WOTC, your company must fill out and submit several IRS and Labor Dept. forms. Our office can help you handle the paperwork and claim the tax credit. ■

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