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

August 2016

The True Cost of Higher Education

The College Board reports that full-time students at private institutions typically paid almost $44,000 for tuition, fees, room and board during the 2015-2016 academic year. That's the average, so costs at some private colleges and universities were well over $50,000 per year. Higher education at public schools was much less expensive, but in-state students still spent nearly $20,000 for tuition, fees, room and board, on average. All college costs continue to rise, so younger students probably will pay even more when they arrive on campus.

Now for the good news. The above numbers are all published costs, sometimes known as the "sticker price." The College Board also provides net prices, which may be more indicative of actual outlays by parents and students. The average net cost for public institutions falls from nearly $20,000 to just over $14,000; among private schools, the average net price drops from almost $44,000 to $26,400.

Discounts and taxes

What accounts for the huge differences between published and net prices? The College Board estimates grant aid and education tax benefits in determining the net price. Grant aid is mainly discounts from a college's published price; education tax benefits are the amounts a family saves from tax credits and deductions.

Example: Alan Burns attends a private college where the published tuition is $30,000. His room and board plan costs $10,000, so the total cost is listed at $40,000. Alan receives financial aid that reduces his tuition bill to $22,500. His parents also get $2,500 of higher education-related tax savings. Considering the $7,500 reduction in tuition and the $2,500 in family tax savings, this methodology puts the net

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What's Inside

Reduced Oversight

With the number of IRS employees involved in tax enforcement down 24% from 2010, audits of individuals are at an 11-year low.

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price of Alan's year of college at $30,000, not $40,000.

The College Board numbers for net prices are estimates. Some students will get more financial aid than others; some families will save more in tax from education-related benefits. This issue of the *CPA Client Bulletin* includes articles explaining how you may be able to maximize these opportunities.

Calculate carefully

Many colleges offer net price calculators on their websites. Working through several of them can be a practical way to compare actual costs at different institutions. However, the numbers you'll receive are based on estimates of financial aid. These net prices don't take possible tax savings into account.

In addition, check to see if a school's net price calculator counts loans as financial aid. Yes, loans will reduce the current cost of higher education but they'll probably have to be repaid, with interest. ■

Did You Know?

The number of health savings accounts (HSAs) rose 22% to 16.7 million in 2015, while HSA assets reached almost $30.2 billion, a gain of 25%. Most HSA money is in low-yield savings deposits but $4.2 billion (14% of the total) is in investments, where returns might be higher. By 2018, HSA investments are projected at $9.7 billion.

Source: Devenir Research

Make the Most of College Financial Aid

As the first article of this issue of the *CPA Client Bulletin* notes, the net price of higher education will depend on the amount of financial aid that's received. The greater the financial aid, the lower the net cost of college.

In order to obtain financial aid, a key step is filling out the Free Application for Federal Student Aid (FAFSA). This is a complex form with many questions; its aim is to get a picture of a student's family income and assets. Some of the questions request tax return information. Our office can help if you have difficulty with any FAFSA tax questions.

After filling out the FAFSA, your answers go through a formula that determines your expected family contribution (EFC). The lower your EFC, the greater the amount of financial aid a student might be awarded. This number may change every year, so if aid is requested each academic year, a FAFSA must be completed annually.

Potential financial aid awards are determined by comparing an applicant's EFC with a given school's listed cost.

Example 1: Carla Davis, a high school senior, fills out the FAFSA. Her EFC, based on family income and assets, is placed at $27,000 for the next academic year. Suppose Carla is accepted at a college where the published cost for the coming academic year is $44,000. Carla could be awarded as much as $17,000 in need-based aid: the $44,000 published cost minus her family's EFC of $27,000.

Note that this process would not result in any need-based aid for Carla at a college where the published cost is $25,000. Carla and her parents would be expected to pay the full price.

New rules for the FAFSA

Starting this October, new FAFSA rules go into effect. Under the current process, including the one for the 2016-2017 academic year, the FAFSA could be submitted no earlier than January 1 of the coming school year. Thus, Ed Franklin could submit his FAFSA no earlier than January 2016 for the 2016-17 academic year.

In October 2016, Ed will be able to submit a FAFSA for 2017-18. Because of this shift in submission timing, "prior-prior year" tax return information will be required, rather than prior year numbers.

Example 2: Assume Ed submitted his FAFSA in January 2016, as early as possible. Data show that early filers tend to get more aid than latecomers. However, in January 2016, Ed's parents had not yet prepared their 2015 ("prior year") tax return. Therefore, the FAFSA had to be submitted with estimated information, subject to subsequent verification once the Franklins' 2015 tax return had been filed.

If Ed wants to get an early start again, he can file his FAFSA for the 2017-18 year in October 2016. Under the new rules, Ed will use the 2015 tax return (now the "prior-prior year") information for the 2017-18 FAFSA. He won't have to estimate income numbers, assuming his parents' and his own 2015 tax returns already have been filed.

Going forward, the October submission date and the prior-prior year tax returns will be used on the FAFSA. A student applying for aid in the 2021-22 academic year, for example, will use the numbers from

2019 tax returns on an October 2020 filing of that FAFSA.

Planning pointers

As mentioned, reducing your child's EFC may result in increased financial aid. In determining an EFC, income typically is the most important factor. (Assets count, too, but generally to a lesser extent.) Therefore, holding down income can be helpful. Under the new rules, timing strategies have been changed.

Example 3: Greg and Heidi Irwin have a daughter Jodi, age 15. The Irwins expect Jodi to go to college, starting with the 2019-2020 school year. They hope that Jodi will receive some need-based aid.

Even so, the Irwins believe they'll have to dip into savings to pay college bills, and the money might come from selling stocks they feel have become overvalued. Selling those stocks at a gain in 2017 could increase the income they'll report on the FAFSA for 2019-2020, so the Irwins could decide to take gains this year. If those gains are realized in 2016, the income will never show up on the FAFSA.

On the flip side, suppose the last FAFSA filed for Jodi will cover the 2022-2023 school year. Then the last relevant tax return will be for 2020. If the Irwins plan a bump in income, perhaps from selling a vacation home at a profit or converting a traditional IRA to a Roth IRA, they might decide to wait until 2021 or later, when the income won't affect Jodi's financial aid.

Be aware that the new schedule poses a peril: income might decline in the interim. In example 3, Jodi Irwin files a FAFSA for the 2019-20 year, using tax return data from 2017. However, Jodi's family might have much lower income in 2018 or 2019, perhaps because of a job loss, so the FAFSA understates her financial need. In this case, the Irwins can request a professional judgment review by a college's admissions office, which could verify the increase in need. ■

Trusted Advice

Aid Without Need

- Many colleges award what's known as merit aid: grants or scholarships not based on financial need.
- The "merit" might be academic success in high school. It also might result from accomplishments in sports, music, community service, and so on.
- Colleges may restrict merit aid to students who fill out the FAFSA. Thus, youngsters from well-to-do families might gain by filling out the form, even if need-based aid isn't expected.
- Information sources can include the college guidance counselor at your child's high school as well as online sites that list scholarships awarded by companies or other organizations.
- Considering the rising cost of higher education, it can be well worthwhile to encourage youngsters to participate in pre-college activities and to actively seek merit-based money.

Campus Tax Credits Can Top Tax Deductions

Besides financial aid, specific tax benefits can reduce the net cost of sending a child to college. Among the three major tax breaks—American Opportunity Tax Credit, Lifetime Learning Credit, tuition and fees deduction—you can claim only one on your tax return.

American Opportunity Tax Credit (AOTC)

This credit, which recently was extended through 2017, typically will be the best choice for parents of collegians. The AOTC can produce the biggest tax saving: as much as $2,500 per student per year. In addition, the AOTC has the most generous income limits.

The maximum tax credit is available with modified adjusted gross income (MAGI) up to $80,000 for single filers, partial credits with MAGI up to $90,000. For married couples filing joint tax returns, the comparable income limits are $160,000 and $180,000. Typically, MAGI for this credit is the same as your AGI, reported on the bottom of page 1 of your return.

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To get the full $2,500 in tax savings, your spending must be at least $4,000 of qualified expenses for each college student. Qualified expenses include tuition and required fees but not room and board, transportation, insurance, or medical expenses. Unlike other education tax breaks, the costs of course-related books, supplies, and equipment that are not necessarily paid to the school can be qualified expenses.

You can take the AOTC for each of the first four years of a student's higher education but not for subsequent years. Each year that you claim the AOTC, you must claim the student as a dependent on your tax return. (You also can claim the AOTC for yourself and your spouse, if the other conditions are met.)

The AOTC is also refundable: If the AOTC reduces the tax you owe to zero before the full credit is used, 40% of the remaining credit amount (up to $1,000) can be paid to you in cash.

Lifetime Learning Credit

For the Lifetime Learning Credit, the income limits are lower than for the AOTC: for single filers, the MAGI phaseout range is $55,000-$65,000; for joint filers, the range is $110,000-$130,000 of MAGI. In addition, the tax savings can't be more than $2,000 *per return*, not per student. The Lifetime Learning Credit is set at 20% of the first $10,000 you spend on higher education. Otherwise, the rules for the Lifetime Learning Credit are similar to those for the AOTC.

If the AOTC is far more appealing, why use the Lifetime Learning Credit? Because the Lifetime Learning Credit might work when the rules for the AOTC can't be met. As mentioned, the AOTC only covers a student's first four years of higher education. Students for whom the credit is claimed must be enrolled in college at least half-time for one academic period during the tax year. The Lifetime Learning Credit, on the other hand, is available for all years of higher education as well as for courses taken to acquire or improve job skills. You can claim the Lifetime Learning Credit for an unlimited number of years, so it can be useful once you've claimed the AOTC for four years.

Tuition and fees deduction

A tax credit is generally better than a tax deduction, so either the AOTC or the Lifetime Learning Credit usually will save more tax than the tuition and fees deduction. You can deduct up to $4,000 of tuition and required college costs with MAGI up to $65,000 (single) or $130,000 (joint). With larger MAGI, up to $80,000 or $160,000, you can deduct up to $2,000 of those expenses. With even greater MAGI, no deduction is allowed.

Taxpayers with qualifying MAGI usually will be in the 15% or 25% federal tax bracket, so the tax savings may be modest.

Example: Ken and Kathy Long are in the 25% tax bracket. Taking a $4,000 tuition and fees deduction reduces their tax bill by $1,000: 25% times $4,000. Thus, their tax saving is less than the $2,000 possible from the Lifetime Learning Credit or the $2,500 per student from the AOTC.

If that's the case, why would anyone choose this deduction, instead of one of the tax credits? Note that the income limits for the Lifetime Learning Credit are lower than the limits for the deduction. Thus, if the Longs can't qualify for the AOTC (say, they've already used it for their child for four years) or for the Lifetime Learning Credit (their income is just over the Lifetime Learning Credit threshold), they may be able to benefit from the tuition and fees deduction.

Also, this deduction is taken as an adjustment to income, reducing your AGI. (A tax credit reduces your tax obligation, not your AGI.) A lower AGI, in turn, may offer benefits throughout your tax return. Our office can make sure you use the most effective education benefit on your tax return. ■

The Second Best Investment You Can Make

Many companies offer 401(k) or similar retirement plans to their employees, and an employer match might be available. If that's the case, you should contribute to the plan at least enough to get the full match.

Example 1: Melissa North earns $80,000 a year. Her company's 401(k) plan offers a full match for up to 6% of salary. Therefore, Melissa should contribute at least $4,800 (6% of $80,000) to her 401(k) account this year, which will entitle her to a $4,800 company match.

Whether you're offered a full or partial match, you should contribute at least enough to get all the dollars your company offers. Failing to get the maximum match means you're giving up free money: relinquishing part of your compensation package.

Paying down debt

Getting your employer match is a no-risk way to earn a 100% return (or a lesser return, with a partial match) on your money. If that's often someone's best investment move, paying down debt may be next best. When you reduce a loan balance and thus reduce the interest you're paying, you're effectively earning the loan interest rate.

Example 2: Owen Palmer has a credit card that charges 12% on unpaid balances. When Owen prepays $1,000 of his balance, he saves $120 (12% of $1,000) in interest that year. That's a 12% return on his outlay. What's more, credit card interest typically is not tax deductible. Thus, Owen earns 12%, after tax, by prepaying his loan.

It's possible that Owen could receive a higher return by doing something else with his $1,000, but that probably would mean taking substantial risk. Prepaying debt, conversely, has no investment risk beyond forgoing the chance for a higher return. In today's low-yield environment, prepaying debt can be appealing.

Evaluating education loans

Prepaying credit card debt may be attractive for many people, but prepaying student loans can be a tougher call. Interest rates may be lower than on credit card debt, so the benefit of prepaying is not as great. What's more, up to $2,500 of interest on student loan debt is tax deductible each year. To get the maximum deduction, your modified adjusted gross income (MAGI) can be no more than $65,000, or $130,000 on a joint return. Partial deductions are allowed with MAGI up to $80,000 or $160,000.

If interest is tax deductible, the benefit of prepaying the loan is reduced.

Example 3: Rita Simmons has outstanding student loans with a 7% interest rate. This year, she expects to fall in the 25% federal tax bracket, so paying the interest actually saves her 1.75% (25% of 7%) in tax. Thus, Rita's net interest rate cost for her student loans is 5.25%: the 7% she pays minus the 1.75% she saves in tax.

In her situation, Rita would earn 5.25%, after tax, by prepaying her student loans. That could be a good move, for an outlay without investment risk, but it's also possible that Rita could earn more by investing elsewhere. Moreover, Rita would have to relinquish liquid assets by prepaying, and replacing those assets in case of an emergency might not be simple.

Money from home

Prepaying a home mortgage may be even less beneficial than prepaying student loans. Assuming a 4% interest rate and a 25% tax rate, the after tax benefit of prepaying would be only 3%. Although virtually all homeowners can deduct mortgage interest, the net payoff is even smaller for taxpayers with tax rates higher than 25%.

The bottom line is that prepaying a loan makes the most financial sense with high interest rates and low tax benefits. State income tax also should be considered. Our office can help you calculate the true return of debt prepayments, so you can make informed decisions. ■

Using IRA Money to Buy a Business Can Be Dangerous

Business owners may need capital to support growth, and the money in their IRA can be tempting. Nevertheless, the pitfalls can be steep, as illustrated in a recent Tax Court case (*Thiessen v. Commissioner*, 146 T.C. No. 7 [3/29/16]). Here, the court ruled that because a married couple had entered into prohibited transactions with respect to their IRAs, the assets in the IRAs were deemed to have been distributed, resulting in a huge tax bill.

Describing the transaction

When James Thiessen left a long-held job after declining to relocate, he found a metal fabricating business (call it ABC Co.) for sale. Through a friend who had executed such a transaction and also from a broker, James heard about the use of IRA money to help finance the purchase.

Therefore, James and his wife, Judith, hired tax and legal advisers. Proceeding according to plan, the Thiessens created a new C corporation (call it DEF Co.); James and Judith were DEF's officers and directors. They both also established IRA accounts. Then they rolled a total amount of more than $430,000 from their employer-sponsored retirement accounts into the IRAs.

As the next step, the Thiessens' IRAs purchased all the shares of DEF, the new company they had created; then DEF used the money from the IRAs to buy the assets of ABC. In addition to the IRA

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money, DEF transferred a $200,000 promissory note to ABC's seller in the purchase. ABC's assets secured the note, which James and Judith personally guaranteed.

The seven year hitch

This all happened in 2003. In 2010, the IRS asserted that the Thiessens' guarantee of the note was a prohibited transaction, which resulted in a deemed distribution of all of the assets in their IRAs. The couple was taxed on the deemed distribution of the over $430,000 they had rolled over into the IRAs, plus a 10% early withdrawal penalty, because James and Judith were both younger than 59½. Ongoing tax deferral on the funds distributed was lost, and the Thiessens owed over $180,000 in income tax, according to the IRS. The Tax Court ruled in favor of the IRS, upholding the agency's claim.

Usually, there's a three-year statute of limitation on the time in which the IRS can assess extra income tax. However, there's a *six-year* window for the IRS in cases where the taxpayer substantially understates income. That was the case here because the Thiessens had not included the deemed distributions from their IRAs in income on their 2003 return. The IRS' 2010 filing came within six years of the date in 2004 when the Thiessens filed their 2003 tax return.

Debt was the downfall

The Tax Court agreed with the IRS that the Thiessen's plan failed because they had personally guaranteed the promissory note that DEF transferred in the purchase of ABC's assets. The Tax Court found that the Thiessens' "guaranties of the loan were prohibited transactions and [the Thiessens'] IRAs ceased to qualify as IRAs on account of the guaranties." As a result, all the funds in the IRAs were deemed distributed in a taxable transaction in the year the Thiessens guaranteed the promissory note.

This transaction proved to be very costly for the Thiessens. Other pitfalls can arise when IRA money is used to acquire a small business. If you desire to have your IRA own a business, our office may be able to help you put together an arrangement in keeping with the rules against prohibited transactions. ■

Clarification:

In the December 2015 issue of the *CPA Client Bulletin*, the article, "QTIP Trusts Still Offer Advantages," suggested that the executor and the trustee can make the required QTIP election. This election is made by the executor, not by the trustee. We regret any misunderstanding.

TAX CALENDAR

AUGUST 2016

August 1

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2016. Deposit or pay 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 August 10 to file the return.

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

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2015.

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2016. 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 2016

September 15

Individuals. If you are not paying your 2016 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2016 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 2015 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 six-month extension.

Deposit the third installment of estimated income tax for 2016. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2015 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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