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

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What's Inside

Seeking a Stable Retirement

Anecdotally, retirement finances formerly were based on a "three-legged stool." After people stopped working and no longer had earned income, their cash flow would come from Social Security, personal savings, and a pension from a former employer. This pension would have been a traditional defined benefit plan, paid out for the retiree's lifetime and perhaps for that of a surviving spouse.

It may or may not be the case that former decades were the "good old days" for retirees. It is true, though, that most private companies don't offer periodic pensions to retirees today. Thus, one "leg" of the fabled stool doesn't exist, for many people who have left the workforce.

What's more, an increasing number of retirees are living until their late 80s, 90s, and into triple figures these days. Running short of money may become a concern without a true pension to supplement Social Security.

The annuity answer

Financial professionals use the term *longevity risk* to describe this issue. People may live longer while their assets dwindle. One way to address this risk is to purchase an annuity.

Many products are sold as annuities these days, including life immediate annuities, which focus on managing longevity risk. Some insurers use other titles, such as income annuities or payout annuities, for these contracts.

Example 1: Greg Sawyer, age 65, pays $100,000 to ABC Insurance Co. for a single life immediate annuity. In return, ABC promises to send Greg a check for $500 each month for as long as he lives. That might be for 40 years, or it might be for 40 days, if Greg is hit by the proverbial truck soon after buying this annuity.

Some academic research supports the premise that an immediate annuity can provide financial benefits to retirees, when combined with other investments and Social Security. In the real world, though, relatively few people are willing to enter into such an uncertain transaction.

Less risk, lower yield

Responding to consumer concerns, insurance companies typically offer many options to a basic straight-life annuity. Married couples, for example, may prefer

continued on page 2

Pension Paucity

Fewer than 20% of workers in the private sector have access to a traditional employer-provided defined benefit pension plan.

continued from page 1

an annuity that will pay as long as either spouse is alive. Annuity issuers also may promise a "cash refund" in case of an untimely death.

Example 2: Insurer ABC offers Greg a cash refund policy that pays $475 a month, and he invests $100,000. Again, Greg will get a (somewhat smaller) check every month for as long as he lives. In this scenario, Greg lives for 10 years, collecting 120 checks at $475 apiece, for a total of $57,000. If Greg dies then, ABC will send a check for $43,000 (the $100,000 invested by Greg minus the $57,000 paid out) to a named beneficiary.

Other choices might include "period certain" annuities that will pay, say, at least 10 years of checks to either Greg or to a surviving beneficiary. Yet another possibility is an annuity that starts with a smaller payout but increases to keep up with inflation. Generally, the more safeguards that are added to a straight life annuity, the lower the amount the insurer will pay.

In recent years, the seemingly oxymoronic "deferred immediate" annuity has gained ground, as a way to offer higher yields on lifetime annuities. Insurers may call these products *deferred income annuities* or *longevity annuities*.

Example 3: Dissatisfied with the rates offered on standard immediate annuities, Greg pays $100,000 to ABC but defers the start of cash flow for 10 years, until he is age 75. At that point, he'll receive $1,200 a month for the rest of his life, a huge increase from the start-at-65 payout. On the downside, Greg's death will halt the payments, even if that occurs before he reaches 75.

Tax treatment

The cash flow from an immediate annuity will be taxed in one of two ways, depending on where the annuity is held.

Example 4: Greg Sawyer might hold his annuity inside a tax deferred retirement account—specifically, in an IRA. If so, all withdrawals will be taxed as ordinary income. If Greg is in a 25% tax bracket and receives $6,000 each year from the annuity, he'll owe $1,500 in tax (25% of $6,000) and net $4,500 a year.

Example 5: Instead, Greg might buy the annuity with after-tax dollars, in a taxable account. In that case, some annuity payments will be treated as an untaxed return of capital.

Assuming a 20-year life expectancy, Greg can expect to receive $120,000 from this annuity, at $6,000 per year. The "exclusion ratio" is $100,000 over $120,000 (investment/assumed return), or 5/6. (The insurance company will calculate the exclusion ratio, to facilitate tax return preparation.) Thus, only 1/6 of Greg's cash flow, or $1,000 a year in this hypothetical example, will be taxable. Greg would owe 25% of $1,000 in tax each year, so he'd net $5,750 a year, after tax.

Note that this tax treatment expires once 20 years have passed and Greg has excluded $100,000—his original outlay—from income tax. Any further cash flow from the annuity would be fully taxed.

Alternatives to annuities

Annuity payouts will vary from one issuer to another, and among various product features, so it may pay to shop among multiple issuers. The credit quality of the insurance company should be considered as well. Our office can help you evaluate immediate annuities, if you feel one would help your retirement income security.

Moreover, there are other approaches to reducing longevity risk. One way is to delay starting Social Security, perhaps as late as age 70. Foregoing Social Security benefits while in your 60s will lead to much larger payments later in retirement.

In addition, you can construct what amounts to a synthetic annuity via gradual portfolio withdrawals. The so-called 4% rule, which calls for distributing 4% of your portfolio in year one of retirement, followed by inflation adjustments as you grow older, is advocated by some advisers, perhaps with modifications for current circumstances.

The lack of a lifetime pension needn't mean financial stress over a long retirement, if you act prudently to put plans for long-term cash flow on a firm footing. ■

Foreign Stock Funds Can Be Doubly Taxing

Many U.S. investors hold foreign stocks. One of many advantages to holding foreign stocks is diversification because some foreign companies might outperform domestic stocks in bear markets. Some foreign countries, especially those in the developing world, are posting stronger economic growth than the American numbers. What's more, virtually every sizable nation boasts some excellent companies that are likely to reward investors. To find the best opportunities abroad, many U.S. investors use foreign stock mutual funds, to benefit from the fund companies' research and portfolio management expertise.

There may be another reason to invest in a foreign stock fund: Some foreign companies pay relatively high dividends. However, that may lead to double taxation and lower effective yields.

Example 1: Sheila Tucker invests $40,000 in a foreign stock fund. This fund pays a 5% dividend, so Sheila would earn $2,000 (5% of her $40,000 investment) a year. However, the host countries where the companies are based might withhold, say, 20% of the dividend payments ($400), to cover the tax due on those dividends. Thus, Sheila effectively pays tax on that $2,000 in dividends to the host countries, and pays tax again, to the IRS this time, when the foreign stock fund reports the dividend income generated by the foreign stocks.

Trimming the tax

Fortunately, there may be a way for investors such as Sheila to reduce this double tax burden. Foreign stock funds will report taxes paid via withholding on Form 1099-DIV. Then, investors may be able to claim a foreign tax credit up to $300 a year ($600 for couples filing jointly) directly on their Form 1040. (A deduction for foreign taxes paid may be taken on Schedule A, instead, but the credit is generally a greater tax saver.)

However, taking a foreign tax credit can become complicated if your foreign tax withholding exceeds the amounts mentioned in the previous paragraph, or if the tax withheld exceeds the tax due to the IRS. Then, the deduction cannot be taken directly on Form 1040, and Form 1116 must be filed; our office can assist with that form, if it's necessary.

Tax relief through the foreign tax credit (or a foreign tax deduction) won't help, though, if you hold a foreign stock fund in a tax-deferred account such as an IRA.

Example 2: As mentioned, Sheila Tucker has $2,000 in dividends from a foreign stock fund in 2016, and the host countries withhold $400 in tax, at a 20% rate. In this example, though, the fund is held in her IRA. Sheila does not report this dividend income to the IRS for 2016, because the money is in her IRA, so she can't claim a tax credit. Eventually, when Sheila withdraws the dividend income from her IRA, she'll owe tax at ordinary income rates.

As these examples indicate, the amounts involved may be modest, for many investors. If the advantages of investing in foreign stock funds appeal to you and your only practical choice is to use a tax-deferred account, double taxation may not be a meaningful drawback. If you do have options, though, you may find it more tax-efficient to hold foreign stock funds in a taxable account and use the credit. Similarly, if you invest in individual dividend-paying foreign stocks, you may want to hold them in a taxable account, if possible. ■

Trusted Advice

Foreign Tax Credit

- You may be able to claim a credit for foreign taxes imposed by a foreign country or U.S. possession.
- To claim the foreign tax credit, generally you file Form 1116. However, you may be able to claim the foreign tax credit without filing Form 1116 if you meet all of the following conditions:
    - All of your foreign source gross income was passive income, which includes most interest and dividends.
    - All the income and any foreign taxes paid on it were reported to you on a qualified payee statement such as Form 1099-DIV, Form 1099-INT, or Schedule K-1.
    - Your total creditable foreign taxes are not more than $300 ($600 if married filing a joint return).
- This opportunity is not available to estates or trusts.

Automatic Enrollment Retirement Plans

Some states have passed laws requiring employers, including many small businesses, to offer retirement plans to employees. Other states may follow in the coming years, with some form of a mandate. Often, these rules have an automatic enrollment feature.

Automatic enrollment plans may offer advantages to business owners, even if they're not required. Federal law, in effect for the last decade, provides a roadmap to show you how to get those benefits and avoid problems.

In, unless they're out

As the name implies, automatic enrollment plans put eligible workers into a company-sponsored retirement plan. These plans usually are 401(k)s, but they can be any type of plan that requires an employee contribution from earned income. Employers put a specified percentage of each covered worker's earnings into the plan, although each employee can contribute more or less, if desired. Conversely, employees can opt out of the plan and, thus, avoid a reduction in current cash flow.

Among the acceptable arrangements, many companies choose a "qualified" automatic enrollment plan. These plans require at least a 3% employee contribution, gradually increasing each year, along with either:

- a matching contribution of 100% of an employee's contribution up to 1% of compensation, and a 50%

continued on page 4

continued from page 3

matching contribution for the employee's contributions above 1% of compensation and up to 6% of compensation; or

- a nonelective contribution of 3% of compensation to all employees eligible to participate in the plan, including those who choose not to contribute any amount to the plan.

Commonly, employers choose to make the 3% nonelective contribution.

Example: XYZ Corp. enrolls employees Arlene Walker and Tim Miller in its 401(k) plan. Both have salaries of $40,000 a year. Arlene contributes 3% of her pay ($1,200), but Tim opts out and contributes nothing to the 401(k). Even so, XYZ contributes $1,200 to a 401(k) account for Tim as well as $1,200 to Arlene's 401(k) account this year.

Thus, offering an automatic enrollment plan can be expensive, considering administration costs and employer contributions. Why should business owners consider them?

For one reason, offering a qualified automatic enrollment plan can meet safe harbor provisions that exempt the plan from annual nondiscrimination testing requirements. Without this safe harbor, low plan participation among middle- and lower-income workers might limit allowable tax-deferred contributions from key employees of the sponsoring company, including the business owner or owners.

Offering any retirement plan, moreover, can deliver intangible benefits. Having a plan may help a company hire and retain desirable workers. Employee morale and productivity might improve. Furthermore, many business owners will find satisfaction in providing their workers with increased retirement security.

Another safe harbor

With automatic enrollment arrangements, questions regarding investment selection may arise. Some employees may stay in the plan, yet not say how they want their money invested. If you put them into a bank account or money market fund, returns will be negligible; put them into stocks or bonds and any investment losses might trigger lawsuits from unhappy plan participants.

To address this concern, the federal government has designated certain investments as qualified default investment alternatives (QDIAs). If a retirement plan participant does not choose an investment, and the sponsor puts that employee's money into a QDIA, the sponsor may be relieved of responsibility for poor investment results.

By far, the most popular QDIAs are life cycle funds, known as *target date funds*. (See the September 2016 *CPA Client Bulletin* for more on target date funds.) Balanced mutual funds (those holding equities and fixed-income securities) and professionally managed accounts also may be QDIAs. Stable value funds can be QDIAs, too, for certain short-time periods. All of these QDIAs may be used for any employer-sponsored retirement accounts when the participant does not select an investment, not just for automatic enrollment plans.

As might be expected, the rules on automatic enrollment plans can be complex. If you are interested in such a plan for your company, our office can help you comply with all the requirements. ■

Did You Know?

The U.S. economy is the world's largest, with gross domestic product (GDP) over $18.5 trillion in 2016. China ranks second, with $11.4 trillion in GDP, followed by Japan ($4.4 trillion), Germany ($3.5 trillion), the U.K. ($2.8 trillion), France ($2.5 trillion), and India ($2.3 trillion). Italy, Brazil, and Canada round out the top 10.

Source: statisticstimes.com

TAX CALENDAR

December 2016

December 15

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

Corporations. Deposit the fourth installment of estimated income tax for 2016.

JANUARY 2017

January 17

Individuals. Make a payment of your estimated tax for 2016 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2016 estimated tax. However, you don't have to make this payment if you file your 2016 return and pay any tax due by January 31, 2017.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2016 if the monthly rule applies.

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