



# Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor<sup>sm</sup>

## Offering an Educational Assistance Program Can Be a Smart Move

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payments that are tax deductible for the company and tax free to the employee.

### Covered costs

To establish an educational assistance program, your company must create a written plan and notify eligible employees. The plan can't favor highly compensated employees. Generally, highly compensated employees include anyone who owns 5% of the company's shares during the year or preceding year, as well

as people who received compensation in excess of a threshold amount in the preceding year (\$115,000 in 2012). The actual calculation can be complicated; our office can help you set up an educational assistance program that complies with this requirement. Once an educational assistance program is operating, it can't provide more than 5% of the program's annual benefits to shareholders or owners (or their spouses or dependents) that separately own more than 5% of the company on any day of the year.

When you have an acceptable educational assistance program in place, it can cover tuition, fees, books, supplies, and equipment. Your educational assistance program can't pay for meals,

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For business owners, attracting and retaining talented employees can be vital. To enhance your company's appeal to key workers, consider offering valuable fringe benefits. For example, you might establish an educational assistance program.

As the name suggests, companies with such programs will pay for employees' educational expenses. Graduate level courses can be included, so your company can pay for employees' MBA courses through the program. For each covered employee, your company can pay up to \$5,250 per year; such payments are tax deductible for your company and tax free for the employee. Alternatively, your company can reimburse employees for their educational outlays with

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## Nest Eggs

*In mid-2011, Americans held over \$18 trillion in retirement plans, or 37% of all their financial assets.*

## Trusted Advice

### Favorable Fringe

- ❖ Companies can deduct the money spent on working condition fringe benefits.
- ❖ Employees who receive such benefits aren't taxed on their value.
- ❖ These benefits consist of property and services provided to employees, so they can do their jobs.
- ❖ The favorable tax treatment applies to the extent the employee could deduct the cost as a business expense if he or she had paid for it.
- ❖ Examples of working condition benefits include an employee's use of a company car for business and job-related education provided to an employee.

lodging, or transportation. Similarly, the plan can't cover education involving sports, games, or hobbies unless such courses are related to your company's business or are required for a degree.

### Setting standards

If your company is going to pay for employees' schooling, it can include some requirements in the educational assistance program. For example, you might say that participating employees must provide evidence that they've attended the

classes and done the necessary schoolwork. The plan can state that covered courses must be related to the participating employee's careers. You can require certain grades, as reported on a transcript, and you can require employees not to leave your company for a certain length of time after they've finished the course for which your company has paid.

### Over the limit

As mentioned, the maximum payment or reimbursement from an educational assistance program is \$5,250 per year. What if an employee signs up for a course that costs more, and your company pays the excess amount? If the excess amount can be considered a "working condition benefit" (see the **Trusted Advice** column, "Favorable Fringe"), the same tax rules apply. Your company will get a tax deduction, and the employee reports no taxable income. However, employees will have to report compensation for other types of paid education.

**Example:** Megan Palmer is an executive assistant at your company. Megan, who has not attended college, signs up for some courses that will eventually lead to a degree. Your company, which offers an educational assistance program, pays \$7,000 in 2012 for Megan's tuition, fees, books, and supplies.

In addition, Megan pays \$1,000 to take a course on a new computer software program, which she uses at work. Your company reimburses her for this outlay.

Of the \$7,000 that your company pays for Megan's college costs, the first \$5,250 is covered by its educational assistance program, so Megan reports no taxable income from the company's \$5,250 outlay. The additional \$1,750 is not a working condition benefit, so Megan must count that amount as taxable income this year. Conversely, the \$1,000 reimbursement for the software course is related to Megan's job, so it counts as a working condition benefit. Thus, your company can deduct the payment, and Megan will not have to report that \$1,000 as taxable income. ■

### Correction

The article "Trim the Tax on Your Social Security Benefits" in the December 2011 issue of the *CPA Client Bulletin* contains an error in the example under the heading "Numbers crunch." The third paragraph in the example, which states that \$2,000 will be added to Kim's taxable income, is incorrect. The paragraph actually should read as follows:

Therefore, part of Kim's Social Security benefit is taxable. The taxable amount can be calculated using the Social Security Benefits Worksheet in the Instructions to Form 1040. In Kim's case, she must include \$1,000 of the \$14,000 in benefits she received in taxable income.

## How IRA Distributions Are Taxed

According to the Investment Company Institute, Americans hold over \$4 trillion in traditional IRAs. Chances are that you either have such an account now or will have one in the future. In fact, you may have

more than one traditional IRA, held at different financial firms.

At some point, either you or your beneficiaries will have to withdraw money from an IRA. The tax treatment may be simple—or it may not.

### Taxing pretax dollars

When you withdraw money from a traditional IRA, generally, you'll owe federal income tax in the year of withdrawal on any portion of the money withdrawn that never has

been taxed. In some cases, you can determine the taxable portion of the withdrawal easily.

**Example:** Janet Wilson worked for ABC Corporation for many years, contributing to the company's 401(k) plan. Janet contributed through salary deferrals, so she never paid tax on the money going into the plan. Participants do not pay tax on any investment earnings inside their 401(k) account or on employer matching contributions. Thus, Janet held only pretax money within the 401(k) plan.

When Janet retired, she rolled all the money in her 401(k) to a traditional IRA. Then she began to take withdrawals. All of the money in her traditional IRA was pretax, so Janet now owes income tax on every dollar she withdraws.

### Cream in the coffee

Some people have after-tax as well as pretax money in their traditional IRAs. Because they have already paid tax on part of the money in the IRA, they have to figure out the taxable portion of each withdrawal.

Withdrawals from a traditional IRA are subject to what some experts have termed the "cream in the coffee" rule. Once you put cream in your coffee, you can't drink only cream or only coffee. Similarly, once pretax and after-tax dollars are in a traditional

IRA, they're mixed together, for tax purposes, and you cannot withdraw only pretax dollars or only after-tax dollars. All withdrawals are taxed in proportion to your IRA's pretax and after-tax amounts.

What's more, you must aggregate all of your IRAs to make this calculation. (That includes any money in simplified employee pension (SEP)-IRAs or SIMPLE IRAs.) If you have multiple IRAs, you'll owe the same amount of tax no matter which one or ones you tap for a withdrawal. In addition, for purposes of the calculation, you treat all of your withdrawals in a year as one withdrawal, and you perform the calculation as of the end of the calendar year.



The calculation of the taxable amount of your IRA withdrawals is reported on Form 8606, Nondeductible IRAs. You also use Form 8606 to report nondeductible

contributions to a traditional IRA; conversions of traditional, SEP, and SIMPLE IRAs to Roth IRAs; distributions from Roth IRAs; and certain distributions from designated Roth accounts.

### Fine points

When you convert all or part of a traditional IRA to a Roth IRA, you must go through the same exercise. You'll owe tax on the conversion, in proportion to the pretax money in all of your traditional IRAs. After a conversion, you don't include money in a Roth IRA for determining the tax on a traditional IRA distribution or a subsequent Roth IRA conversion.

In addition to ordinary income tax on traditional IRA distributions, if you take a distribution before you reach age 59½, you also may owe a 10% surtax on the distribution. You can avoid this surtax, though, if you qualify for one of the exceptions to the penalty. Exceptions include distributions made on account of disability or made to a beneficiary who has inherited the account.

Moreover, state and local income tax may apply to IRA distributions, or they may not. Some states have specific tax exemptions for withdrawals from retirement plans. ■

## Qualified Dividends Still Have Tax Advantages

If you invest in a corporate bond, you'll receive interest. Such interest is taxed as ordinary income at rates up to 35% in 2012. If you invest in that same company's stock, you may receive dividends as a shareholder's portion of company profits. Such dividends probably will be taxed no higher than 15%, in 2012, whereas low-income investors owe 0% tax on qualified dividends.

What are "qualified" dividends? These are generally dividends that have been paid by a U.S. corporation or a qualified foreign corporation that are not specifically excepted from qualified dividend treatment on stock that a taxpayer has held for a certain period.

In order to treat dividends paid on a stock as qualified dividends, you must hold on to the stock for at least 61 days during the 121-day period

that began 60 days before the ex-dividend date. The ex-dividend date is the first date on which the stock buyer will not receive the dividend paid on behalf of the shares being sold.

**Example:** In March 2012, XYZ Corp. announces a dividend to all stockholders, as of April 19, 2012. The ex-dividend date is April 17. Any purchaser who buys before April 17 will receive that dividend.

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Say you buy that stock on April 16 to get the dividend. That opens up a window of time extending from February 17 (60 days before the ex-dividend date) to June 17, 121 days later. You must hold the stock for at

least 61 days during this period for the dividend to be qualified and for you to owe tax at the 0% or 15% rate. If you sell the stock too soon, you'll owe tax on that dividend at your ordinary income tax rate.

The 61- and 121-day requirements refer to common stock, which most investors hold. For preferred stock, the same rules apply, but the numbers are 91 and 181 days to owe tax at the low rates. ■

## TAX CALENDAR

### MARCH 2012

#### March 15

**Corporations.** File a 2011 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporations.** File a 2011 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporation election.** File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2012. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2013.

**Electing large partnerships.** Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

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

### APRIL 2012

#### April 17

**Individuals.** File a 2011 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868,

Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2012 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2012 estimated tax. Use Form 1040-ES.

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

**Household employers.** If you paid cash wages of \$1,700 or more in 2011 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of \$1,000 or more in any calendar quarter of 2010 or 2011 to household employees. Also report any income tax you withheld for your household employees.

**Partnerships.** File a 2011 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 17.

**Electing large partnerships.** File a 2011 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

**Corporations.** Deposit the first installment of estimated income tax for 2012.