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Client Bulletin

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

August 2013

Make Student Loans Less Taxing

With the 2013–2014 academic year about to begin, parents of college students and youngsters preparing for college must confront the costs of higher education. As those costs soar, you or your children (or both) may have to use student loans to pay the bills. Repaying such loans can create painful choices.

In a recent AICPA survey of student loan borrowers, 75% of respondents said that they or their family members have made personal or financial sacrifices because of student loan repayments. Those sacrifices included postponing contributions to retirement plans (41% of respondents), delaying car purchases (40%), putting off buying a house (29%), and even deferring marriage (15%). Of those surveyed, 60% have at least some regret over their choice of education financing.

Deductive reasoning

Some of the hardships faced by student loan debtors may be reduced by deducting the interest paid on a student loan. If you qualify for the deduction, you take it as an "adjustment to income" on page 1 of your tax return, so you don't need to itemize deductions on Schedule A to get the deduction. Adjustments to income also lower your adjusted gross income (AGI), and a lower AGI can help you claim other income tax deductions and credits.

In order to deduct interest on student loans, you must meet several criteria. For instance, you must be legally obligated to pay interest on a *qualified* student loan. Your loan qualifies if you borrowed solely to pay certain education expenses for yourself, your spouse, or a dependent. Those expenses include tuition, fees, room and board, books, supplies, equipment, and other necessary expenses, such as transportation. There are some limits to room and board in this context, but you can borrow enough to cover the cost of school-operated housing and meal plans.

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What's Inside

Care Concerns

In a 2012 survey by the Employee Benefit Research Institute, 45% of individuals said medical expenses are extremely important for retirement planning, up from a 27% response to that question in 2003.

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Even if you pass all of the tests mentioned here, you can't deduct the interest on a loan from a relative. Similarly, if you borrow from an employer plan, such as a 401(k), the interest you pay will not be deductible student loan interest. Among other restrictions, you can't take this deduction if your filing status is married filing separately or if you can be claimed as a dependent on someone else's return. However, you can take the deduction if you borrowed to pay for the education of someone—such as your child—who is married and files a joint return.

Income limits

You can deduct up to $2,500 of qualified student loan interest you pay each year. (Your lender probably will send you IRS Form 1098-E, showing the amount of interest you paid on your student loans for the year in Box 1.) However, your deduction might be capped or eliminated because of your modified adjusted gross income (MAGI). Typically, your MAGI for this deduction is the same as your AGI, before subtracting any deduction for student loan interest.

You can take a full $2,500 tax deduction for qualified student loan interest with MAGI up to $60,000, if you are a single taxpayer, a head of household, or a qualifying widow(er). You're allowed smaller deductions with MAGI up to $75,000, but no deduction for student loan interest is allowed if your MAGI is higher than $75,000. For couples filing joint returns, this deduction phaseout is between $125,000 and $155,000 of MAGI.

As you can see, a lower MAGI can boost your deduction, if you are near the phaseout range. You can reduce your MAGI with 401(k) contributions and by taking capital losses. In addition, graduates who are beginning their careers might have lower MAGI than their parents and, thus, be more likely to qualify for the student loan deduction. This can be a consideration for families trying to decide whether parents or students should be the borrowers on student loans. ■

Trusted Advice

Credit Check

- A tax credit reduces your tax obligation, dollar for dollar, while a tax deduction reduces your income subject to tax. Thus, a tax credit is more valuable.
- You can claim the foreign tax credit even if you do not itemize deductions on Schedule A of your tax return. You are allowed to take the standard deduction in addition to this tax credit, if this tactic provides more tax savings.
- If you take the foreign tax credit and the foreign taxes you pay exceed the credit you're allowed, you may be able to carry forward or carry back the excess amount to another tax year.

Cashing In on Foreign Stocks

Many investors who seek income are turning to dividend paying stocks. While bank accounts and money market funds pay meager amounts, the dividend yield on the S&P 500 is around 2%. That's the average yield, so many established companies are paying 3%, 4%, or even more to shareholders. Moreover, stock market investors have the potential for future growth and, as explained later in this article, typically receive favorable tax treatment on dividend income.

If the idea of investing in dividend paying stocks appeals to you, consider allocating a portion of your portfolio to foreign stocks that make such payouts to shareholders. The benchmark Morgan Stanley Capital International (MSCI) EAFE Index, which tracks the performance of large companies based in Europe, Australasia, and the Far East, has a dividend yield over 3%, as of this writing. Thus, foreign stocks not only can diversify your portfolio, they may offer dividends higher than the yields on U.S. issues.

U.S. investors who want to invest in foreign stocks have several options. You can invest in American Depositary Receipts (ADRs), for example. ADRs, which represent ownership of equity shares in a foreign company, trade on U.S. exchanges or over-the-counter, so you can buy or sell them as you would with domestic stocks. Rather than buying individual foreign issues, you can invest in a fund holding foreign stocks. Choices include familiar mutual funds; closed-end funds, which trade on a stock exchange between investors; and exchange-traded funds (ETFs), which track a specific stock index.

Did You Know?

Of the nearly 20 million Americans who attend college each year, close to 12 million—or 60%—borrow annually to help cover costs.

Source: American Student Assistance

Tax traps

Selected carefully, dividend paying foreign stocks and funds that hold such issues may play a valuable role in a diversified portfolio. However, you should be aware of two tax issues these investments may raise.

Dividends may not qualify for low tax rates. As explained in the April 2013 *CPA Client Bulletin*, qualified dividends enjoy favorable tax rates. Most investors pay 15% tax on such dividends, whereas high and low bracket investors pay 20% and 0%, respectively. On dividends that are not qualified, though, investors pay tax at higher rates, ranging from 10% to 39.6%.

Typically, dividends from ADRs qualify for the low tax rates. Similarly, dividends from companies based in countries that have specific types of tax treaties with the U.S. also can qualify. Not all foreign stock dividends are from such countries, though. If you invest in a fund that receives nonqualified dividends from the stocks it owns, some of your dividend income may be taxed at high, ordinary tax rates, rather than the lower rate on qualified dividends.

Foreign tax withholding can reduce your yield. When foreign companies pay dividends to investors from other countries, some money may be withheld to cover the income tax obligation to the host country. The amount of withholding varies from country to country, depending on factors such as local law, tax treaties with the United States, and whether the stock is held in an IRA.

Example: Luke Miller invests in ADR shares that pay a dividend equivalent to $1,000 in U.S. dollars in 2013. The company represented by the ADR is based in a country that requires 15% withholding on dividends paid to U.S. investors. Thus, Luke receives $850 in dividend income in 2013 from that ADR, after $150 of withholding. If the posted yield on that stock is 5%, Luke actually receives the equivalent of a 4.25% dividend.

Foreign stock funds also withhold dividends in this manner. If your foreign stock or fund dividend income is subject to withholding, you may be able to get some IRS relief. One approach is to deduct the amount withheld (and thus paid to a foreign government) as an itemized deduction on Schedule A of your tax return. You can include such foreign taxes along with other deductible tax payments.

However, you'll receive only partial tax relief from an itemized deduction. If Luke is in a 28% tax bracket, for instance, a $150 deduction for foreign taxes paid saves him only $42 in tax: 28% of $150. Also, high-income taxpayers might lose some tax benefits under a new law that devalues some itemized deductions.

Taking credit

Instead of deducting the foreign tax you've paid, you may prefer to claim a credit for those taxes. (See the "Credit Check" Trusted Advice column for more information.) Generally, for foreign tax paid up to $300 ($600 for married couples filing a joint tax return), you can claim the credit on your Form 1040 tax return. Luke Miller, for example, could use the tactic to reduce his tax bill by the $150 of foreign dividends withheld from his investment income.

If you have a larger amount of foreign dividends withheld in a given year, you generally must file IRS Form 1116 to claim a tax credit. This form can be complex, but our office can help you provide the information necessary to get the credit.

Unfortunately, neither the tax credit nor the itemized deduction for foreign taxes paid will help if you hold your dividend-paying foreign stocks in a tax-deferred retirement account, such as an IRA. Luke, in our example, would wind up with a 4.25% dividend yield, not a 5% yield, if he holds his ADR in an IRA.

If the dividends you receive are qualified dividends, you may prefer to hold foreign dividend paying stocks in a taxable account. You'll be able to use the low tax rates on qualified dividends, and you can take a deduction or a tax credit to address the impact of any foreign tax withholding. ■

Employers May Owe Health Insurance Penalties

Under federal health insurance legislation, some employers will owe penalties for not offering health plans or for offering unacceptable plans to employees. This portion of the law takes effect in 2014, so business owners should start learning now about the coming rules and their possible effects.

Who will be covered

The relevant legislation, passed in 2010, is commonly known as the Affordable Care Act (ACA). The ACA will impose penalties on *large* employers that fail to meet health plan requirements. To be a large employer, a company must have employed at least 50 full-time employees in the previous calendar year.

Full time, for this purpose, is 30 hours a week. Thus, companies with 50 or more employees working at least 30 hours a week are considered large and subject to possible penalties.

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Companies with fewer full timers may still qualify as large, if they use part-time employees. (Seasonal employees in some cases will be excluded.) Employers must convert hours worked by part timers into the equivalent of full-time employees to see if their inclusion brings them up to 50 full timers. In the calculation, overall hours worked by part-time employees during a month are added up, and the total is divided by 120.

Example 1: ABC Corp. has 40 full-time employees. In addition, ABC has 24 part timers who all work 65 hours a month. Thus, the part timers work a total of 1,560 hour a month (24 multiplied by 65). Dividing 1,560 by 120 equals 13, which is the number of full-time equivalent employees. With 40 full timers plus 13 full-time equivalent employees, ABC has a total of 53 full timers, which makes the company subject to possible health plan penalties.

Acceptable coverage

Companies that are defined as large, by the standard just described, must provide employees with health insurance that is affordable and provides minimum value. Such coverage must be offered to employees and their children under age 26. (The insurance does not have to cover spouses.)

The IRS has indicated that health insurance will be considered affordable if an employee's required share of the premiums does not exceed 9.5% of the employee's income. A worker earning $40,000 in 2014, for example, must not be required to pay more than $3,800 (9.5% of $40,000) in premiums, in order for the company to avoid a penalty. Employer provided health insurance will be considered to provide minimum value if the plan is structured to pay at least 60% of the actuarial value of the cost of the benefits.

Paying the penalty

Calculating the health plan penalty a large company may owe can be complex. Companies that offer no coverage will owe different amounts than companies that offer expensive or inadequate plans. Generally, the total penalty for an employer in 2014 will be as much as $2,000 for each full-time employee (those working at least 30 hours a week) in excess of 30.

Example 2: ABC Corp. has the equivalent of 53 full-time employees, as noted, including 40 who work full time. In 2014, the company does not offer a health plan to its employees. ABC may owe $20,000 in penalties in 2014: 40 full-time employees minus 30 is 10; multiply by $2,000 to get $20,000.

More details on this complicated topic probably will emerge by year-end 2013. Our office can review your company's situation and let you know how much, if anything, your company is likely to owe in health plan penalties. ■

TAX CALENDAR

AUGUST 2013

August 12

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2013. 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 2013

September 16

Individuals. If you are not paying your 2013 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2013 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 2012 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 6-month extension.

Deposit the third installment of estimated income tax for 2013. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2012 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic 6-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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