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SEPTEMBER 2015

BORROWING FROM RETIREMENT PLANS – A BAD IDEA

Many people see their plan balance in their employer's qualified retirement plan as a source of "rainy day" funds that are available to them by loans from the plan. There are many details and complexities in borrowing money from a retirement plan, such as the prohibition on deducting the interest payments on those loans as well as the adverse income tax consequences for the failure to repay plan loans. These factors alone cause us to conclude that such borrowing is almost always a very bad idea. In the words of the TV pitchman, "but wait – there's more." There are also many other significant problems that might arise when a key employee or business owner borrows from the retirement plan. In two cases, the Internal Revenue Service revoked the plan's tax-deferred status after the owner borrowed from the plan.

Business owners who are also plan participants and want to borrow from their company's plan should seek professional advice. Even where participant loans are allowed under the law, the cost of a loan to a key employee is increased because the interest on participant loans to key employees is never deductible in computing taxable income. Accordingly, most plans will save administrative expenses and complexity, and most plan participants and sponsors will be best served by plan provisions that prohibit participant loans.

PART-TIME BUSINESSES AND RETIREMENT PLANS

We have long believed in the benefits of saving with pre-tax dollars from the standpoints of the current tax deduction and the tax-free compounding. The accompanying *Tax & Business Alert* contains on page 1 an article describing the benefits of one-person retirement 401(k) plans. Although the article is factual for the scenario of a full-time business, it omits, we believe, a very significant point if the business owner is contributing to the plan for a sideline or part-time business. In the case of a part-time business, it is possible for the owner of the part-time business to shelter 100 percent of the net self-employment income from income tax as is more fully described below.

For example, assume that Joe Jones (age 50 at calendar year-end) works full time and participates in his employer's pension and profit-sharing plans. He is able to meet his cost of living from his net-of-tax salary or "take home" pay from his employment. Additionally, he has net self-employment income of $30,000 per year from an unrelated business operated from his home. Joe has been paying income tax at 33 percent on that net self-employment income and saving what was left after taxes, or $20,100.

If Joe were to adopt and fund a profit-sharing plan with a 401(k) feature for his part-time business, he could defer the income tax on and save for retirement the entire $30,000. His

(Continued on reverse)

deduction for his contributions to the plan would be computed as follows:

A. A profit-sharing contribution of 20 percent of the $30,000 of net earnings from self-employment (or $6,000) plus

B. An amount contributed under the 401(k) feature of the plan, which is limited to the net earnings from self-employment of $30,000 minus the profit-sharing contribution of $6,000, or $24,000. The general limit for the 401(k) contribution is the lesser of (1) $59,000 minus the profit sharing contribution, (2) $18,000 ($24,000 if age 50 or over), or (3) net earnings from the business less the profit sharing contribution.

In Joe's case, the limitation from (2) and (3), (which are, in this case, the same) would apply. Thus, Joe's total deduction would be the profit-sharing contribution of $6,000 and the 401(k) feature contribution of $24,000 for a total deduction of $30,000. Joe's taxable income from his sideline business would be zero. If Joe were less than age 50 at December 31 of the calendar year, he could receive total income from his business of $22,500 and have an equal deduction [($22,500 x .20 = $4,500) + $18,000 = $20,625)] for the retirement savings of $22,500 and zero taxable income from the business.

The above example uses a profit-sharing contribution combined with 401(k) deferral to illustrate the limits. If the self-employment income in the example were less than the 401(k) deferral amount of $18,000 ($24,000 if the participant is age 50 or older), the full self-employment income could be contributed to the 401(k) portion of the plan without making a profit-sharing contribution.

If the taxpayer has employees in the sideline business, they must be included in the 401(k) plan. Also, if Joe contributes to a 401(k) plan with his full-time employer, that contribution must be aggregated with the sideline 401(k) contribution and the sum of the two deferrals cannot exceed $18,000 ($24,000 if Joe is age 50 or older).

Self-employed retirement plans are very attractive tax reduction vehicles for anyone who is saving and has (or the spouse has) self-employment income from an activity with no employees. One-person plans are simple and inexpensive to adopt and do not require significant cost for administration.

Over long periods of time, tax shelters for sideline or small businesses can aid significantly in obtaining financial security. We will be pleased to discuss pretax saving with you and to answer your questions.

REQUIRED DISTRIBUTIONS FROM QUALIFIED PLANS AND IRAS DUE DECEMBER 31, 2015

As you will probably recall, participants in qualified plans and owners of IRAs who are age 70½ or more must generally receive a required minimum distribution from the plan or IRA on or before December 31, 2015. The distributions are based on the December 31, 2014 account balances.

The penalty for failure to take a required distribution is substantial (50 percent of the undistributed amount). If you have received minimum required distributions in the past, a distribution will probably be required for 2015. If you believe that you are required to take a required minimum distribution from a plan or IRA, the plan administrator or IRA custodian should be made aware and provide for an appropriate distribution.

We will be happy to answer any questions you might have concerning required minimum distributions or distribution planning in general.

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Tax & Business Alert

SEPTEMBER 2015

BOOSTING RETIREMENT SAVINGS WITH A ONE-PERSON 401(K) PLAN

One-person 401(k) plans can provide a valuable source of retirement savings for successful entrepreneurs. Given the right circumstances, such plans allow large contributions on behalf of a business owner and maintain flexibility for making contributions in future years.

For 2015, a business owner can make an elective deferral contribution of up to $18,000 (and an additional $6,000 catch-up contribution if he or she is age 50 or older at year-end) plus an employer contribution of up to 20% of self-employment (SE) income unreduced by the elective deferral or 25% of compensation.

The total contributions (elective deferrals of up to $18,000, plus the employer contribution) cannot exceed the lesser of (1) 100% of the participant's SE income or compensation or (2) $53,000 for 2015. Catch-up contributions to 401(k) plans of up to $6,000 in 2015 are not included in the annual additions limit.

Example: Maximizing contributions with a one-person 401(k) plan.

Kevin, age 63, is the sole owner and employee of Training Solutions, a sole proprietorship. In 2015, Kevin earns $145,000 (net of the SE tax deduction) and wishes to maximize contributions to a retirement account. He believes the business will probably continue to be profitable, but would like the flexibility of determining the amount to contribute each year. Kevin does not expect to hire employees.

The following table reflects the maximum amount that Kevin can contribute to a 401(k) plan for 2015.

Employer contribution ($145,000 × 20%)	$29,000
Elective 401(k) deferrals	18,000
Contributions subject to annual limit	47,000
Catch-up contribution	6,000
Total contributions for 2015	$53,000

As an additional benefit, a business owner can borrow from his or her 401(k) plan if the plan document so permits. The maximum loan amount is 50% of the account balance or $50,000, whichever is less.

When the business employs someone other than just the owner, 401(k) contributions may be required for the other employees, in which case the plan would become a standard 401(k) plan with all the resulting complications. However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period.

Also, if the business's only other employees are the owner's spouse and/or children, a 401(k) plan covering those individuals may be even more attractive than a one-person 401(k) plan, especially for owners hitting the $53,000 contribution limit. ■

SUPREME COURT LEGALIZES SAME-SEX MARRIAGES IN ALL STATES

Since the Supreme Court's 2013 *Windsor* decision, same-sex couples who are legally married under state or foreign laws are treated as married for federal tax purposes just like any other married couple. The Supreme Court's *Obergefell* decision (issued in late June) now requires all states to license and recognize marriages between same-sex couples. Specifically, the decision states that same-sex couples can exercise the fundamental right to marry in all states and that there is no lawful basis for a state to refuse to recognize a lawful same-sex marriage performed in another state.

Therefore, same-sex couples who are *legally* married in any state are now allowed to file joint state income tax returns wherever they reside. They are also entitled to the same inheritance and property rights and rules of intestate succession that apply to other legally married couples. Therefore, same-sex couples should now be able to amend previously filed state income, gift, and inheritance tax returns for open years to reflect married status and claim refunds. Furthermore, these couples likely need to rethink their estate and gift tax plans.

Before the *Obergefell* decision, members of married same-sex couples who live in states that did not previously recognize same-sex marriages had to file state income, gift, and inheritance tax returns as unmarried individuals. This caused additional complexity and expense in filing state returns.

Other implications of an individual's marital status include spousal privilege in the law of evidence; hospital access; medical decision-making authority; adoption rights; the rights and benefits of survivors; birth and death certificates; professional ethics rules; campaign finance restrictions; workers' compensation benefits; health insurance; and child custody, support, and visitation rights.

Note: The ruling does not apply to individuals in registered domestic partnerships, civil unions, or similar formal relationships recognized under state law, but not denominated as a marriage under the laws of that state. These individuals are considered unmarried for federal and state purposes. However, these state-law "marriage substitutes" might be eliminated now that all states must allow same-sex marriages. Individuals in these relationships can now obtain marriage licenses, get married, and thereby qualify as married individuals for both state and federal tax purposes. ■

MAXIMIZING FDIC INSURANCE COVERAGE OF BANK DEPOSITS

The Federal Deposit Insurance Corporation (FDIC) has provided deposit insurance coverage to depositors of insured banks since 1933. This protection is important to all investors, especially those who tend to be invested heavily in cash and who are dependent on these accounts to cover living expenses.

Note: The covered institutions must display an official sign at each teller window or teller station. All FDIC institutions should have a brochure available to answer other questions regarding coverage. Additional information can be obtained at **www.fdic.gov**.

Types of Deposits Protected. All types of deposits received by a financial institution in its usual course of business are insured. For example, savings deposits, checking deposits, Certificates of Deposit (CDs), cashier's checks, and money orders are all covered. Certified checks, letters of credit, and traveler's checks, for which an insured depository institution is primarily liable, are also insured when issued in exchange for money or its equivalent, or for a charge against a deposit account.

Any person (U.S. citizen or not) or entity can have FDIC insurance coverage in an insured bank. However, only deposits that are payable in the U.S. are covered. Deposits only payable overseas are not insured.

Securities, mutual funds, and similar types of investments, even if purchased through a bank, are not covered, nor are safe deposit boxes or their contents. Similarly, treasury securities purchased by an insured institution on the customer's behalf are not insured, but these investments are backed by the full faith and credit of the U.S. government.

Amount of Coverage Available. A depositor is normally insured up to $250,000 in each insured

Continued on page 4

PLANNING TO AVOID OR MINIMIZE THE 3.8% NET INVESTMENT INCOME TAX

The net investment income tax, or NIIT, is a 3.8% surtax on investment income collected from higher-income individuals. It first took effect in 2013. After filing your 2014 return, you may have been hit with this extra tax for two years, and you may now be ready to get proactive by taking some steps to stop, or at least slow, the bleeding for this year and beyond.

NIIT Basics. The NIIT can affect higher-income individuals who have investment income. While the NIIT mainly hits folks who consistently have high income, it can also strike anyone who has a big one-time shot of income or gain this year or any other year. For example, if you sell some company stock for a big gain, get a big bonus, or even sell a home for a big profit, you could be a victim. The types of income and gain (net of related deductions) included in the definition of net *investment income* and, therefore, exposed to the NIIT, include—

- Gains from selling investment assets (such as gains from stocks and securities held in taxable brokerage firm accounts) and capital gain distributions from mutual funds.
- Real estate gains, including the *taxable* portion of a big gain from selling your principal residence or a taxable gain from selling a vacation home or rental property.
- Dividends, taxable interest, and the taxable portion of annuity payments.
- Income and gains from passive business activities (meaning activities in which you don't spend a significant amount of time) and gains from selling passive partnership interests and S corporation stock (meaning you don't spend much time in the partnership or S corporation business activity).
- Rents and royalties.

Are You Exposed? Thankfully, you are only exposed to the NIIT if your Modified Adjusted Gross Income (MAGI) exceeds $200,000 if you are unmarried, $250,000 if you are a married joint-filer, or $125,000 if you use married filing separate status. However, these thresholds are not all that high, so many individuals *will* be exposed. The amount that is actually hit with the NIIT is the *lesser* of: (1) net investment income or (2) the amount by which your MAGI exceeds the applicable threshold. MAGI is your "regular" Adjusted Gross Income (AGI) shown on the last line on page 1 of your Form 1040 plus certain excluded foreign-source income net of certain deductions and exclusions (most people are not affected by this add-back).

Planning Considerations. As we just explained, the NIIT hits the *lesser* of: (1) net investment income or (2) the amount by which MAGI exceeds the applicable threshold. Therefore, planning strategies must be aimed at the proper target to have the desired effect of avoiding or minimizing your exposure to the tax.

- If your *net investment income amount* is less than your excess MAGI amount, your exposure to the NIIT mainly depends on your net investment income. You should focus first on strategies that reduce net investment income. Of course, some strategies that reduce net investment income will also reduce MAGI. If so, that cannot possibly hurt.
- If your *excess MAGI amount* is less than your net investment income amount, your exposure to the tax mainly depends on your MAGI. You should focus first on strategies that reduce MAGI. Of course, some strategies that reduce MAGI will also reduce net investment income. If so, that cannot possibly hurt.

Perhaps the most obvious way to reduce exposure to the NIIT is to invest in tax-exempt bonds via direct ownership or a mutual find. There are other ways, too. Contact us to identify strategies that will work in your specific situation. ■

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financial institution. Accrued interest is included when calculating insurance coverage. Deposits maintained in different categories of legal ownership are separately insured. Accordingly, an individual can have more than $250,000 of insurance coverage in a single institution, provided the funds are owned and deposited in different ownership categories.

Deposits held in one insured bank are insured separately from any deposits held in another separately insured bank. For instance, if a person has a checking account at Bank A and has a checking account at Bank B, both accounts would be insured separately up to $250,000. Funds deposited in separate branches of the same insured bank are not separately insured.

Up to $250,000 in deposit insurance is provided for the money a consumer has deposited at the same insured institution in a variety of retirement accounts, including traditional IRAs, Roth IRAs, SEP IRAs, and SIMPLE Plans.

Maximizing FDIC Insurance Coverage. FDIC insurance coverage is not determined on a per-account basis, but on an ownership basis. Thus, the type of account has no bearing on the amount of insurance coverage, and the social security numbers or tax identification numbers do not determine coverage. Instead, separate insurance coverage is provided for funds held in different ownership categories. This means that a bank customer who has multiple deposits may qualify for more than $250,000 in insurance coverage if the customer's accounts are deposited in different ownership categories and the requirements for each ownership category are met. Thus, increasing your available FDIC coverage may be as simple as retitling accounts so they fall into different ownership categories.

For example, an individual with three individual accounts each worth $100,000 for a total of $300,000 would have only $250,000 of coverage. However, a joint account worth $500,000 would be fully covered ($250,000 per person). ■