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Saving for college

DEBUNKING SOME COMMON SECTION 529 PLAN MYTHS

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1005 La Posada Drive • Austin, TX 78752
512-346-2086 • Toll free: 877-977-6850 • Fax: 512-338-9883
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Saving for college

Debunking some common Section 529 plan myths

Section 529 plans have become one of the most popular tools used by parents to save for their children's college education. One reason they're so "in" is their favorable tax treatment: If the funds are used to pay for qualified education expenses, the earnings accumulate tax-free.

However, some common misperceptions have arisen about Section 529 plans since they were first introduced in 1996. These have prevented some families from using them to full advantage.

JUST THE FACTS

Here are five common myths about Section 529 plans, along with some key facts:

Myth: My child can go to school only in the state where the plan is opened.

Fact: 529 plan funds can be used at any *eligible* college or university. There are even some qualifying foreign institutions where 529 funds can be used.

As long as the funds are used for higher education, you may be eligible to use your 529 plan — whether for a two- or four-year school, vocational-technical school or graduate school. But for 529 prepaid tuition plans (see "The lowdown on 529 plan types" at right), there's more uncertainty about how plan benefits will be applied if the child attends a different school.

Myth: The money saved in a 529 plan may only be used for tuition expenses.

Fact: As long as the plan is a savings plan (again, see "The lowdown on 529 plan types" at right), there's a wide range of college expenses the funds can be applied toward. These include room and board, textbooks, supplies, computers, software and Internet access. Expenses related to services for a special-needs student also can be paid with 529 funds.

Myth: If my child decides not to go to college, the money saved in the plan will be forfeited.

Fact: While 529 plans must fund qualified education expenses to retain their tax-advantaged treatment, you do have some options if your child doesn't attend college. For example, the money can be used by another child who is attending college. Or you could use the money yourself if you go back to school.

If neither of these solutions works for you, you can withdraw the money you've saved in a 529 plan. But you'll have to pay federal income taxes at your ordinary rate plus a 10% tax penalty on the earnings portion of the distribution. Note that the 10% penalty is waived if your child receives a college scholarship. (State tax consequences vary. If you received a state tax break for contributing, for example, you might owe state income tax on the entire distribution.)

Myth: Opening and contributing money to a 529 plan will make it harder to receive financial aid.

Fact: Technically this is true, but practically, the effects are minimal. Here's why:

While 529 plans must fund qualified education expenses to retain their tax-advantaged treatment, you do have some options if your child doesn't attend college.

The money saved in a 529 plan will generally be reported as a parental asset on the Free Application for Federal Student Aid (FAFSA). But 529 savings only reduce eligibility for need-based aid by up to 5.64%. So if you have saved $10,000 in a 529 plan, your need-based aid would only be reduced by $564 at the most.

The lowdown on 529 plan types

There are two main types of Section 529 plans:

1. Prepaid tuition plans. These lock in a specific amount of future tuition at current prices. For example, you could buy four years of college now for your newborn child at today's tuition rate, which is probably much lower than it will be when your child eventually goes to college.

2. Savings plans. These operate more like retirement savings accounts, allowing you to invest your savings in an effort to maximize returns. But there's no guarantee that your investments will generate positive returns; there could be more risk with this option.

Myth: I can't earn market-based returns on my 529 savings.

Fact: With a savings plan, you can invest in a wide range of vehicles to try to boost your returns. You're limited to the investments the plan offers. But the options can include stocks, bonds and cash equivalents, as well as index funds that try to match the performance of a benchmark index, such as the S&P 500. If certain investment options are important to you, shop for a plan that offers them. Keep in mind that you can contribute to a 529 plan in a different state.

You also generally can choose an age-based asset allocation in which the mix of investments is automatically adjusted to reduce risk as your child nears college age. For example, riskier stocks might be replaced with more conservative bonds and cash equivalents once your child reaches age 15 or 16.

AVOIDING FALSITIES

Don't let myths or misperceptions keep you from realizing the benefits of saving for college expenses with a Section 529 plan. For more details on 529 plans, talk to your tax advisor. •

They're back: Audit rules targeting partnerships can now be applied

The IRS has reissued proposed partnership audit regulations, withdrawn earlier this year as part of the Trump administration's regulatory freeze. The proposed Centralized Partnership Audit Regime regulations (Reg-136118-15) — reportedly identical to the withdrawn regulations — apply to partnership tax years starting after December 31, 2017. But partnerships can elect to apply them for partnership tax years starting after November 2, 2015.

WHO'LL BE AFFECTED?

The new audit rules, prompted by the Bipartisan Budget Act of 2015, will affect all partnerships, regardless of size. Certain partnerships with 100 or fewer partners will be able to opt out of the new rules. However, the opt-out process itself involves additional reporting and disclosure requirements.

Under the new rules, the IRS will assess and collect taxes at the partnership level. This is a major departure from current rules, under which the IRS generally assesses and collects taxes at the individual partner level. By easing the administrative burden associated with collecting tax from individual partners, the new rules will likely produce a dramatic rise in the number of partnership audits.

HOW WILL THE NEW RULES WORK?

The new rules don't just streamline the audit process; in some cases they'll actually increase the aggregate tax liability of the partnership and its partners. In an audit under the new rules, the IRS will determine any adjustments to the partnership's income, gains, losses, deductions or credits — as well as to partners' distributive shares of these items — and assess any additional taxes, penalties and interest against the *partnership*.

Additional taxes will be determined by multiplying the net adjustment by the highest marginal individual or corporate tax rate for the audited year. The result is an "imputed underpayment," which the partnership takes into account in the *adjustment year*.

This approach will create several problems for partnerships and their partners. For example, because the new rules assess the tax at the highest marginal rate, partners lose the benefit of partner-level tax attributes that ordinarily would reduce their tax liability.

To ease this burden, partnerships will be allowed to reduce their imputed underpayment by proving that a portion of it is attributable to tax-exempt partners, partners taxed at lower rates, or income taxed at lower rates (such as capital gains). But compiling this information from all one's partners may be time-consuming.

HOW WILL THE RULES AFFECT TAX LIABILITY?

Because the new rules take additional taxes into account in the adjustment year, current partners may be liable for tax mistakes that benefited former partners. Two exceptions will allow a partnership to shift the liability back to its former partners. Partnerships can reduce or avoid entity-level taxation by:

1. Having some or all of the partners from the year under review file amended returns reporting their distributive shares of partnership adjustments and pay the tax within 270 days, or

2. Making an election, within 45 days after the audit, to provide partners from the year under review with adjusted information returns. Those partners would then take the adjustments into account on their individual returns for the adjustment year.

These exceptions allow a partner to avoid inequitable results, but meeting them will be a challenge.

WHO'S YOUR "PARTNERSHIP REPRESENTATIVE"?

For partners only: By the time the new rules take effect, you'll need to replace your "tax matters partner" with a "partnership representative." This person can be a partner or nonpartner and must have a substantial U.S. presence.

Choose your representative carefully. He or she will have broad authority to bind the partnership and its partners in dealing with the IRS, and partners will no longer have the right to participate in a partnership audit.

WHAT ABOUT OPTING OUT?

Partnerships with 100 or fewer partners may opt out of the new audit rules. But you can opt out only if your partners are individuals, C corporations (including foreign entities that, were they domestic, would be treated as C corporations), S corporations or estates of deceased partners. A partnership with just one nonqualifying partner (another partnership or a trust, for instance) doesn't qualify, regardless of its size.

BIG CHANGES

The new audit rules alter many significant aspects of partnership audits. Consult with your tax advisor to learn, in detail, how your partnership will be affected. •

Reap the tax benefits of a qualified small business retirement plan

Establishing an employer-sponsored retirement plan is an attractive way to save for your own retirement and help your employees do the same. As a plus, your business may enjoy tax advantages for setting one up.

NOT TOO LATE

The good news is that it may not be too late to set up and fund a retirement plan for 2017. While a 401(k) or other plan may be of interest, some businesses are dissuaded by the paperwork and oversight involved. Here are three popular small business retirement plans that may be more palatable:

1. **Simplified Employee Pension (SEP).** This plan was designed with small businesses and self-employed individuals in mind, although other entities also are eligible. With a SEP, your business makes tax-deductible contributions for you and your employees. Employees can't contribute to their own SEPs; all SEP contributions are made by the business.

SEPs feature relatively high annual contribution limits — the lesser of $54,000 or 25% of salary (20% of allowable self-employment income) for 2017. While you must contribute the same percentage of compensation to all SEP accounts, you have the flexibility to change this percentage every year.

out loans, which may make this type of plan preferable. Under either of the SIMPLE offerings, employers avoid the nondiscrimination tests, a key component of regular 401(k) plans. (The test, which involves a calculation based on the organization's employees, may serve to restrict the allowable contributions of higher-earning employees unless there's a sufficient level of participation by those earning less.)

2. Savings Incentive Match Plan for Employees (SIMPLE) IRA. This plan is similar to a SEP but there are a couple of key differences. First, eligible employees may contribute to their accounts themselves. And second, the annual contribution limits are lower: Up to $12,500 can be contributed to each employee's account in 2017, or up to $15,500 for employees age 50 or over. There is also a required match from the employer.

Generally, the employer chooses between:

- Matching contributions of up to 3% of an employee's compensation, or
- Nonelective contributions of 2% of an eligible employee's compensation.

Most businesses (including self-employed individuals) with up to 100 employees are allowed to establish a SIMPLE IRA. The business's contributions are tax-deductible and employee contributions are made on a pretax basis. Thus, the payment of taxes is deferred until distributions begin.

You may decide to opt for a SIMPLE 401(k) plan. Although similar to the SIMPLE IRA regarding contribution limits and employer matching, participants in a SIMPLE 401(k) plan may take out loans, which may make this type of plan preferable.

3. Safe Harbor 401(k). This plan enables small businesses to reap the same advantages that large companies have typically enjoyed with 401(k) plans, while relaxing much of the costly recordkeeping. And, as with the SIMPLE IRA and SIMPLE 401(k) plans, this plan eliminates the nondiscrimination rules. The contribution limits are the same as the regular 401(k)s: $18,000 plus a $6,000 catch-up for those age 50 and above. For that reason, the safe-harbor 401(k) is often preferable to its SIMPLE cousin with the lower contribution limit.

Another key difference from the SIMPLE IRA and SIMPLE 401(k) is in the mandated employer match percentages.

CONTRIBUTION DEADLINE

For each of these plans, your business has until the due date of your 2017 tax return (including extensions) to make contributions for tax year 2017. For plans that allow employees to contribute, their deadline is December 31, 2017. Different deadlines for setting up the plans apply.

Contact your tax advisor to discuss the particulars of these and other small business retirement plans in more detail. •

Hobby or business?

The IRS wants to know

If you generate a side income from a passion like cooking, woodworking or bookselling — or anything else — you should be aware of the tax implications of earning this money. These will vary depending on whether the activity is treated as a hobby or a business.

The bottom line: The income generated by your activity is taxable. But different rules apply to how income and related expenses are reported.

FACTORS TO CONSIDER

The IRS has identified several factors that should be considered when making the hobby vs. business distinction. The greater the extent to which these factors apply, the more likely your activity will be considered a business:

- The time and effort you devote to the activity indicate that you intend to make it profitable and you depend on income from the activity for your livelihood.
- Your losses (if any) are due to circumstances beyond your control or they took place in the start-up phase of the business.
- You change your methods of operation to improve profitability.
- You or your advisors have the knowledge needed to carry on the activity as a successful business.
- You previously made a profit in similar activities, or your activity makes a profit in some years.
- You can expect future profit from the appreciation of assets used in the activity.

The IRS stresses that the final determination should be based on all of the relevant facts and circumstances related to your activity.

LIMITATIONS FOR HOBBY DEDUCTIONS

If the activity is a hobby, you'll still generally be allowed to deduct ordinary and necessary expenses associated with it. But you can deduct hobby expenses only up to the total amount of the hobby's income.

That is, if you have a loss from the hobby, you won't be able to deduct it from your other income. In fact, having a money-losing hobby could actually *increase* your taxable income. How? You must report all income from your hobby — but, to the extent allowed, deductions are itemized. Conversely, if you don't itemize you'll be unable to use the expenses to offset the income.

If, instead, the activity is considered a business, you *can* deduct a loss from your other income in the same tax year or even carry that loss back to a previous tax year or forward to a future tax year.

Incorrect deduction of hobby expenses leads to up to $30 billion in unpaid taxes every year, according to the IRS. Keep on top of the rules; the agency is watching carefully. •

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