Tax Impact

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Tax Tips

Do you have unused funds in your college savings plan?

Consider a 529 plan-to-Roth IRA rollover

Given the exorbitant costs of higher education, many parents begin saving for college when their children are very young. A popular and effective tool for doing so is a 529 plan. Contributions to these plans aren't tax deductible, but they grow on a tax-deferred basis. Plus, the earnings used to pay qualified education expenses can be withdrawn tax-free. Earnings used for other purposes, however, may be subject to income tax plus a 10% penalty.

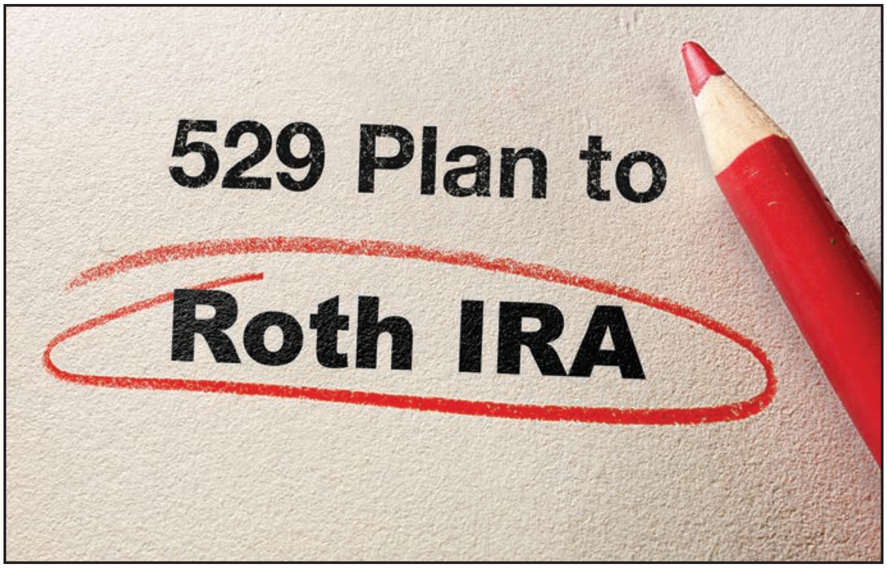
Fast-forward 15 years or so: You now have a substantial balance in your 529 plan, but your child doesn't need all the funds for college expenses. This can happen for many reasons: Your child may have opted not to attend college or received a generous scholarship that covers some or all of his or her tuition. Or perhaps you saved for an Ivy League tuition, but your child decided to attend a less expensive state university. Whatever the reason, you need to figure out what to do with the unused 529 plan funds.

One option, of course, is to bite the bullet, pay the tax and penalties, and spend the remaining funds on whatever you wish. But there are more tax-efficient strategies to consider, including the newly authorized 529-to-Roth IRA transfer.

How it works

Under the SECURE 2.0 Act, beginning in 2024, you can transfer unused funds in a 529 plan to a Roth IRA for the same beneficiary, without tax or penalties. These tax-free rollovers are subject to several requirements and limitations:

- Transfers are subject to a lifetime maximum of $35,000 per beneficiary.
- The 529 plan must have existed for at least 15 years. (Note that it's not entirely clear whether changing beneficiaries restarts the 15-year clock.)
- The rollover must be accomplished through a direct trustee-to-trustee transfer.
- Transferred funds can't include contributions made within the preceding five years or earnings on those contributions.
- Transfers are subject to the usual annual limits on contributions to Roth IRAs (without regard to modified adjusted gross income limits).



Other options for unused 529 funds

Roth IRA rollovers aren't the only option for avoiding tax and penalties on leftover 529 plan funds. Other options include:

Saving the funds for future educational needs. Perhaps your child will attend graduate school down the road. Or you might save the funds for your grandchildren's education.

Using the funds for another beneficiary. You can change a 529 plan's beneficiary to another family member, even you or your spouse. Keep in mind that 529 plans aren't limited to college expenses. You can also use them for continuing education, certain vocational or trade schools, or even for up to $10,000 per year in elementary, middle school or high school tuition.

Paying down student loans. You can withdraw 529 funds tax-free to pay down student loan debt, up to a lifetime maximum of $10,000 per beneficiary.

It's not unusual for parents to end up with unused 529 funds because their children receive scholarships that cover all or a portion of their tuition and other expenses. If that happens, you're entitled to withdraw up to the scholarship amount penalty-free and to spend the funds any way you like. However, you'll have to pay income tax on the earnings.

Here's an example: Ken and Lorraine opened a 529 plan for the benefit of their daughter, Wendy, shortly after she was born in 2001. When Wendy graduates from college in 2023, there's $30,000 left in the account. Under the new rule, in 2024, Ken or Lorraine (or, more specifically, the one designated as the 529 plan owner) can begin transferring those funds into Wendy's Roth IRA. Since the 529 plan was opened at least 15 years ago (and assuming that no contributions were made in the last five years), the only restriction on the ability to roll over the funds is the annual contribution limit for Roth IRAs. Assuming the 2023 limit is unchanged in 2024, and that Wendy hasn't made any other IRA contributions for the year, Ken and Lorraine can roll over up to $6,500 (assuming Wendy has at least that much earned income for the year).

Important caveats

A few things to keep in mind: If Ken and Lorraine had opened the 529 plan when Wendy started middle school in 2012, they'd have to wait until the account was 15 years old, in 2027, to start transferring the funds. And if they made contributions within the last five years, those contributions — together with any earnings on them — wouldn't yet be eligible for a rollover. If the account balance were large enough, however, the five-year limit probably wouldn't be an issue.

Beginning in 2024, you can transfer unused funds in a 529 plan to a Roth IRA for the same beneficiary, without tax or penalties.

Finally, if Wendy's earned income for the year was less than $6,500, the amount eligible for a rollover would be reduced. For example, if she took an unpaid internship in 2024 and earned

$4,000 during the year from a part-time job, the most Ken and Lorraine could roll over in that year would be $4,000.

A head start on retirement savings

The 529-to-Roth IRA rollover is an attractive option to avoid tax and penalties on unused 529 funds, while helping your children or other beneficiaries start their retirement savings. Roth IRAs are an ideal savings vehicle for young people because they'll enjoy tax-free withdrawals decades later, when their incomes will likely be much higher, maximizing their tax benefits. ■

Cash vs. accrual

Choosing the right accounting method for business tax purposes

Many businesses have a choice between using the cash or accrual method of accounting for tax purposes. The cash method often provides significant tax benefits for those that qualify, though some businesses may be better off using the accrual method. Thus, it's wise for your business to evaluate its tax accounting method to ensure that it's the most advantageous approach.

TCJA expanded cash method eligibility

"Small businesses," as defined by the tax code, are generally eligible to use either cash or accrual accounting for tax purposes. (Some businesses may also be eligible to use various hybrid approaches.) Prior to the Tax Cuts and Jobs Act (TCJA), the gross receipts threshold for classification as a small business varied from $1 million to $10 million depending on how a business was structured, its industry and whether inventory was a material income-producing factor.

The TCJA simplified the definition of a small business by establishing a single gross receipts threshold. It also increased the threshold to $25 million (adjusted for inflation), expanding the benefits of small business status to many more companies. For 2023, a small business is one whose average annual gross receipts for the three-year period ending before the 2023 tax year are $29 million or less.

In addition to eligibility for the cash method of accounting, small businesses enjoy simplified inventory accounting, an exemption from the uniform capitalization rules, an exemption from the business interest deduction limit and several other tax advantages. Be aware that some businesses are eligible for cash accounting even if their gross receipts are above the threshold, including

S corporations, partnerships without any C corporation partners, farming businesses and certain personal service corporations. Also, tax shelters are ineligible for the cash method, regardless of size.

Cash vs. accrual methods

For most businesses, the cash method provides significant tax advantages. Because cash-basis businesses recognize income when it's received and deduct expenses when they're paid, they have greater control over the timing of income and deductions. For example, they can defer income by delaying invoices until the following tax year or shift deductions into the current year by accelerating the payment of expenses.

In contrast, accrual-basis businesses recognize income when it's earned and deduct expenses when they're incurred, without regard to the timing of cash receipts or payments. That means they have little flexibility to time the recognition of income or expenses for income tax purposes.

The cash method also provides cash flow benefits. Because income is taxed in the year it's received, it helps ensure that a business has the funds it needs to pay its tax bill.

For some businesses, however, the accrual method may be preferable. For instance, if a company's accrued income tends to be lower than its accrued expenses, the accrual method may result in lower tax liability than the cash method. Other potential advantages of using the accrual method include the abilities to deduct year-end bonuses paid within the first 2½ months of the following tax year and to defer taxes on certain advance payments.

Should you switch accounting methods?

Even if your business would gain a tax advantage by switching from the accrual method to the cash method, or vice versa, it's important to consider the administrative costs involved in making the change. For example, if your business prepares its financial statements in accordance with U.S. Generally Accepted Accounting Principles (GAAP), then it's required to use the accrual method for financial reporting purposes.

That doesn't mean it can't use the cash method for tax purposes, but to do so would require it to maintain two sets of books. Changing accounting methods for tax purposes may also require IRS approval. Contact your tax advisor to learn more about the ins and outs of each method. ■

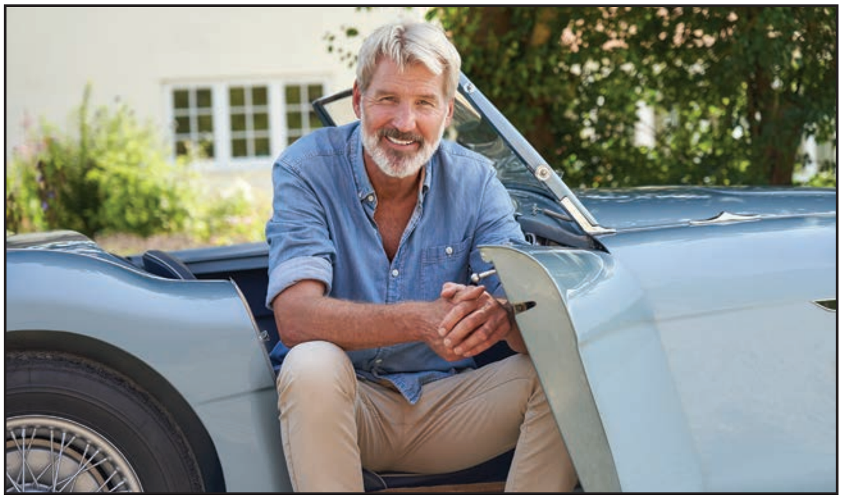
Even single people without children need an estate plan

Estate planning is important for everyone. This is equally true for single individuals without children. While the law makes certain assumptions involving a married couple regarding financial and medical decisions should one spouse die or become incapacitated, that's not necessarily the case with a single person. Indeed, without an estate plan, undesirable tax consequences could be more likely for single individuals without children.

Asset distributions

It's critical for single people to execute a will that specifies how and to whom their assets should be distributed when they die. Although certain assets can pass to your intended recipient through beneficiary designations, absent a will, many types of assets will pass through the laws of intestate succession.

Those laws vary from state to state, but generally they provide for assets to go to the deceased's spouse or children. For example, the law might provide that if someone dies intestate, half of the estate goes to his or her spouse and half to the children.



If you're single with no children, however, these laws set out rules for distributing your assets to your closest relatives, such as your parents or siblings. Or, if you have no living relatives, your assets may go to the state. By preparing a will, you can better ensure that your assets are distributed according to your wishes, whether it's to family, friends or charitable organizations.

Financial and medical decisions

It's a good idea to sign a durable power of attorney that appoints someone you trust to manage your investments, pay your bills, file your tax returns and otherwise make financial decisions should you become incapacitated. Although the law varies from state to state, typically, without a power of attorney, a court would have to appoint someone to make these decisions on your behalf. Not only will you have no say in who the court appoints, but the process can be costly and time consuming.

It's critical for single people to execute a will that specifies how and to whom their assets should be distributed when they die.

You should prepare a living will, a health care directive (also known as a medical power of attorney) or both to ensure that your wishes regarding medical care — particularly resuscitation and other extreme lifesaving measures — are carried out in the event you're incapacitated. These documents can also appoint someone you trust to make medical decisions that aren't expressly addressed.

Absent such instructions, the laws in some states allow a spouse, children or other "surrogates" to make these decisions. In the absence of a suitable surrogate, or in states without such a law, medical decisions are generally left to the judgment of health care professionals or court-appointed guardians.

Gift and estate taxes

When it comes to taxes, married couples have some significant advantages. In particular, the marital deduction generally allows spouses to transfer an unlimited amount of property to each other — either during life or at death — without triggering immediate gift or estate tax liabilities. Further, married individuals generally are able to take advantage of estate portability.

For single people with substantial assets, it's important to consider employing trusts and other estate planning techniques. These tools can be used to avoid, or at least defer, gift and estate taxes.

Revise as needed

If you're currently single and have no children, contact your estate planning advisor. An experienced professional can help draft a basic estate plan based on your current situation. You can then revise it as major life events, such as marriage or the birth of child, happen. ■

Watch out for accumulated earnings tax

Corporations have an incentive to retain earnings, rather than distribute them to shareholders, to avoid, or at least delay, double taxation. The accumulated earnings tax (AET) is designed to discourage that practice. If the IRS concludes that a corporation is retaining unreasonably high levels of earnings, then it may assess the AET — a 20% penalty tax on the corporation's accumulated taxable income.

To determine a corporation's accumulated taxable income, a CPA takes the corporation's taxable income, subtracts dividends paid and an accumulated earnings credit, and makes certain other adjustments. The accumulated earnings credit allows corporations to accumulate up to $250,000 in earnings ($150,000 for certain service corporations) without fear of triggering the AET.

If a corporation has accumulated taxable income, the IRS may impose AET if it finds that the corporation is retaining, rather than distributing, earnings beyond the "reasonable needs of the business." To avoid the tax, a corporation should be prepared to explain and document its need to retain earnings for working capital, business expansion, equipment purchases or other purposes. ■

State income tax liability for remote sellers?

In recent years, many states have expanded their imposition of sales tax on out-of-state e-commerce businesses and other remote sellers. But what about state income tax? For decades, Public Law (P.L.) 86-272 has prohibited states from imposing their income tax on out-of-state businesses whose only activities in the state are the solicitation of orders for the sale of tangible personal property, provided those orders are accepted and filled from outside the state.

Recently, however, the Multistate Tax Commission (MTC) issued revised guidance that may prompt states to expand the reach of their income tax. The guidance lists several activities that the MTC believes are unprotected by P.L. 86-272 and, therefore, may support taxation of remote sellers.

A few examples: 1) regularly providing post-sale assistance to in-state customers via electronic chat or email that customers initiate by clicking on a website icon, 2) placing cookies on in-state customers' computers or other devices to gather search information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale, and 3) offering and selling extended warranty plans via the company's website to in-state customers who purchase its products.

Keep in mind that the MTC's new guidance will have an impact only if states adopt new laws that expand their power to tax remote sellers. Additionally, those laws will need to survive the inevitable challenges under P.L. 86-272. ■