volume 34, number 2

assets

a business, tax, and financial newsletter

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Automobile leasing has grown in popularity over the past several years, but many people still hesitate to enter into a lease. This may be because there are so many factors to consider that it seems easier to buy a vehicle. Under the right circumstances, however, leasing an automobile can save you considerable money, and even taxes. No one can tell you which option is better without knowing your particular situation, but these factors may impact your decision.

How Does Leasing Work?

When you lease an automobile, you only pay for the portion of it that you use, or the amount by which it depreciates. Many people hesitate because, at the end of the lease, they don't own anything. But, that's exactly why lease payments are lower than loan payments. You're not buying the leftover value in the car—you're buying only what you use.

A lease payment consists of a depreciation charge and a finance charge. The finance charge is much like the interest you would pay on a car loan. The depreciation charge is determined by dividing the value of the car that you use by the number of months in the lease. Without considering the tax effects, the short-term cost of leasing compared to buying is about the same. This assumes that you sell your car after the loan is paid off for its full market value. But as you well know, this is often not the case, especially if the car is used as a trade-in. If you are apt to keep your car for 10 years, then buying may be your best option. What about the tax effects? Ultimately, the *tax cost* of leasing versus buying may be about the same. However, the timing of when you get the deductions can be greatly impacted by your decision.

Claiming Tax Deductions on Leases

Because you do not own a car that you lease, you are not allowed to depreciate it. You can, however, deduct at least some of the cost of operating a car leased primarily for business purposes. Keep in mind that you are only allowed to deduct the business portion of the costs of a lease if the car is also used for personal purposes, such as commuting.

You have two options for figuring your deductible expense on a business vehicle that is leased for more than 30 days: the standard mileage rate

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Roth IRAs for Kids

It may be difficult to convince your teenagers to participate in their financial futures, but if you can persuade them to contribute at least part of their babysitting or after-school job money to a Roth Individual Retirement Account (IRA), they may thank you later.

Anyone with earned income below $129,000 for single filers and $191,000 for married joint filers in 2014 can open a Roth IRA retirement account. Contributions are nondeductible, but earnings and qualifying distributions accumulate tax free. Because children seldom make enough to owe income tax, they are usually better off with a Roth IRA than a tax-deferred traditional IRA. For 2014, your child can contribute $5,500 (or earned income, whichever is less) to a Roth IRA.

Saving for retirement early can generate substantial results. Suppose your 14-year-old daughter uses $1,000 to open a Roth IRA. If she makes no additional contributions and the funds grow at 8% annually, she will have more than $50,000 to withdraw tax free at age 65. Or suppose your son opens a Roth IRA with $2,000 when he is 15-years-old, and then he contributes $2,000 annually for the next 10 years. The estimated value of his tax-free fund balance at age 65 will exceed $700,000, if the annual growth rate is 8%.*

A Roth IRA offers the greatest growth potential if the account is left untouched until the holder reaches the age of 59½. At that age, the holder can withdraw earnings tax free, provided he or she has owned the account for five years. The IRS does permit penalty-free early withdrawals to pay for education or to help with a first-time home purchase. However, taxes will be owed on nonqualified early withdrawals.

Before you open a Roth IRA for your child, keep in mind that you cannot stop your child from withdrawing money from the account whenever he or she wants after reaching the age of majority, which is 18 in most states. If you are uncertain about your child's ability to handle money, opening an account in his or her name may not be the best choice.

Also, be aware that only taxable compensation income can be contributed to a Roth IRA. In general, paying your children for doing chores around the house does not qualify as compensation income, as this is an intra-family transaction not usually reported to the IRS. However, if you own your own business, you are permitted to hire your minor children to do certain jobs. Provided you pay your children a fair market wage for the services performed, their earnings would be considered compensation income and could be invested in a Roth IRA.

It is essential to keep detailed records of how the money placed in a Roth IRA was earned, even if a teenager's working arrangements were informal (e.g., babysitting or mowing the lawn for neighbors) and he or she did not earn enough to owe income tax. Penalties could apply if the IRS determines the funds contributed to a Roth IRA were not compensation income.

The good news is that if, for example, your teenage son goes out and blows his paycheck on a new smartphone and skateboard, all is not lost. If he earned $2,500 over the summer but spent all the money, you could still contribute the amount equivalent to his taxable earnings into a Roth IRA on his behalf, thereby helping to ensure some funds have been set aside for his retirement when skateboarding days are behind him. ■

**These hypothetical examples are for illustrative purposes only. They are not intended to reflect an actual security's performance. Investments involve risk and may result in a profit or a loss. Seeking higher rates of return involves higher risks.*

Can a Living Trust Replace Your Will?

When planning your estate, you may consider setting up a **revocable living trust**. A properly managed revocable living trust can provide unique benefits; however, it does not completely replace a **will**. In determining whether this type of trust is appropriate for you, it helps to understand the overall benefits and tradeoffs of this estate planning tool.

A revocable living trust is created during your lifetime, and you can alter it in any way, and at any time. One key feature is that it allows you to retain control of the management and distribution of your assets.

The Probate Connection

Many people establish a revocable living trust to avoid **probate**, which is the legal process of settling your estate. Assets distributed from a trust upon your death *do* avoid probate. However, the probate process itself is not as burdensome for many estates as in the past. Many states have adopted the Uniform Probate Code, which greatly simplifies the process for many small- to medium-sized estates.

But, even with these improvements, the probated assets in your estate still become a matter of public record, which may raise privacy concerns. Avoiding probate may also be appropriate if you own properties outside your state of domicile, which may involve multiple probate proceedings.

Once you set up a revocable living trust, you must transfer your assets into the trust. Failing to do so will subject your assets to probate. Simply signing a trust document *without* retitling assets renders your living trust useless.

Do I Still Need a Will?

The short answer is yes. Generally, a revocable living trust cannot entirely replace the need for a will. There are some assets you may not wish to place in a trust. For example, it may be impractical to transfer tangible personal property such as automobiles, furniture, and jewelry to a trust. Consequently, some of your assets will remain outside your trust, making a will necessary to name your intended beneficiaries of those particular assets. If you have minor children, a will may also be used to designate a **guardian** for them.

Other assets may require special consideration. For example, retirement plan accounts (Individual Retirement Accounts (IRAs), 401(k)s, and profit-sharing plans) cannot be retitled to a living trust, although you could change the beneficiary designation to the trust. However, naming someone other than a spouse as beneficiary of a qualified retirement plan often requires spousal consent, because in many states, spouses now have rights to retirement plan benefits. In addition, naming your trust, rather than your spouse, as the beneficiary of your qualified retirement plan may have income tax consequences at the time of your death.

Trusts and Taxes

Other benefits that properly funded living trusts may offer under the right circumstances include a possible reduction in estate taxes. Your legal professional can help you examine all the variables affecting your property—the *type* of assets (e.g., real estate, life insurance, bank accounts, savings, business interests, and personal property), *where* they are located, and *how* they are titled to determine if a revocable living trust can help you meet your short- and long-term estate planning goals. ■

to buy or not to buy: exploring the leasing option

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allowance or actual expenses method. The standard mileage rate allowance is easier to calculate, but it may provide less tax relief than the actual expenses method if you do not drive a lot of miles or if your car is relatively expensive.

The standard mileage allowance is a cents-per-mile allowance that takes the place of deductions for lease payments; vehicle registration fees; and the expenditures on gas, oil, insurance, maintenance, and repairs. The standard mileage allowance rate for the business use of a car—leased or owned—is 56 cents a mile in 2014. To figure out your deduction, simply multiply the rate by the number of miles driven.

The actual expenses method generally allows you to deduct all out-of-pocket expenses for operating your car for business, from lease payments to repair costs. If the car you have leased has fair market value in excess of the luxury vehicle threshold according to the IRS, your deduction is reduced by a so-called "inclusion amount," which is added to your gross income. This additional sum brings your deduction roughly in line with the depreciation you would have been able to claim as the car's owner.

Inclusion amount tables in IRS Publication 463 can help you determine the inclusion amount that applies in your case. Because the inclusion amounts increase from year to year in the course of a lease, you may want to consider taking out a lease with a term of no more than two years.

Any advance payments on the lease must be deducted over the entire lease period. If you take out a lease with an option to buy, you can deduct the payments if the arrangement is set up as a lease. If, however, the arrangement amounts to a purchase agreement, the payments are not deductible.

Leases—Hidden Traps

Despite the limits on deductions for luxury vehicles, the available tax breaks for business owners are generous enough to make leasing an attractive alternative to buying—especially if you want to change cars frequently. Before you sign on the dotted line, consider the potential pitfalls involved in leasing:

Mileage limits: All leases have mileage limits, usually 12,000 or 15,000 miles. If it's probable that you'll rack up more miles, you could face costly penalties. Try to negotiate the mileage limit up in exchange for higher lease payments. Or, buy the car.

Open-end leases: In an open-end lease, the residual value is redetermined at the end of the lease. If the residual value is lower than initially projected, you have to make up the difference. Closed-end leases avoid this problem, but your payments may be higher.

Early termination: When leasing, be sure to keep the car for the entire lease period. Penalties for early termination are severe and are usually difficult to get out of. If you're not sure how long you'll keep the car, consider a shorter lease term or purchase it.

While laws require dealers to disclose more information on leases, key information can be buried in the fine print or omitted completely, like the interest rate that you are being charged. Be sure you completely understand the terms before signing on the dotted line. Leasing your next automobile can either make a lot of sense, or it can be a big mistake. Your tax professional can help you consider all of the factors and make the right choice. ■

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