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SELECT Portfolio Management, Inc.
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Second-Income Analysis (After-Tax Benefit of Both Spouses Working)

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What is a second-income analysis?

A second-income analysis involves an evaluation of the net after-tax benefit derived from a second income. For some couples, a second income is a financial necessity. For others, it is simply a means of achieving specific financial goals, such as ensuring a comfortable retirement.

There are two situations in particular that warrant a second-income analysis: (1) when a nonworking spouse considers entering the workforce, and (2) when a retired person considers full- or part-time employment to supplement Social Security and other retirement income.

If you wish to determine whether a second household income is advisable, you need to consider personal ramifications as well as the financial and tax aspects of your decision.

Personal ramifications

How will time spent away from the home impact you, your relationship with your spouse, and your children (if any)? For instance, if an at-home spouse with children is thinking about entering the workforce, the impact of such a move on the children may be a primary concern. In some cases, the economic benefit provided by a second income may not justify the loss in family or personal time. In other cases, of course, personal preference must take a back seat to financial necessity.

Financial aspects

Clearly, a second income can offer financial benefits. These advantages include: additional wages, salary, or self-employment income brought into the household, as well as additional fringe benefits (if any). You'll want to look closely at the potential for saving additional income toward retirement and whether one spouse's employer-provided health plan is more comprehensive than another.

There is also a financial downside to a second household income. Financial costs include possible extra expenses for commuting, parking, meals, clothing, child care, housecleaning, and dry cleaning.

Tax aspects

A second income could trigger certain unanticipated tax consequences, resulting in more or less after-tax income than you may have expected. Therefore, you must evaluate the overall tax impact of the second income, particularly if you're collecting Social Security benefits.

What information must you gather to perform an analysis?

You'll need to obtain information about your current and projected financial and tax position. Regarding your current situation, you can review last year's tax return and a recent pay stub for tax and salary information. You should also gather details about the second income, including estimated hours to be worked, wage rates, and benefits. Then, you'll want to estimate expenses associated with the second income. Finally, you can fill out a worksheet to determine the net economic benefit of a second income. For information about how the net economic benefit of a second income affects your overall financial picture (as a couple), you might want to construct a cash flow analysis .

Which tax considerations are especially important?

Generally, each additional dollar of income is subject to regular income tax, as well as payroll tax (i.e., FICA).

You'll also want to consider whether extra earnings will push your household into a higher marginal tax bracket (e.g., from the 15 percent bracket to the 25 percent bracket). But you'll also need to consider how your increased adjusted gross income (AGI) affects the amount allowed for certain types of tax deductions. (Your AGI may be defined as your gross or total income minus certain deductions.) Common deductions that are subject to AGI limitations include the following:

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- Miscellaneous itemized deductions subject to 2 percent AGI floor
 - Medical expenses subject to 10 percent of AGI floor
 - Phaseout of the child tax credit based on modified AGI
 - Phaseout of deductible IRA contributions for certain qualified plan participants based on modified AGI
 - Phaseout of exclusion of Social Security benefits based on modified AGI
 - Phaseout of Roth IRA and Coverdell education savings account contributions based on modified AGI

Caution: Prior to 2013, the floor on itemized deductions for medical expenses was 7.5 percent. Taxpayers age 65 and over remain subject to the 7.5 percent floor until 2017.

Tax impact of second income on earned income credit

The earned income credit (EIC) is a refundable credit available to certain low-income individuals who have some earned income and meet certain other requirements. Because the EIC phases out as modified adjusted gross income increases, a second income may reduce or even eliminate your eligibility for the EIC, resulting in an after-tax benefit from the second income that is substantially less than you had anticipated.

Tax impact on retirees who receive Social Security benefits

Retirees receiving Social Security should consider the impact that supplemental earned income may have on those benefits before making the decision to work. In certain cases, taxpayers may have to include 50 percent to 85 percent of Social Security benefits in taxable income. In addition, Social Security recipients under full retirement age who have earnings in excess of an annual exemption amount are subject to a reduction in Social Security benefits.

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