

# Client Tax Letter

Tax Saving and Planning Strategies *from your Trusted Business Advisor*<sup>sm</sup>

## Is It Time to Trim Stocks?



In 2013, the benchmark Standard & Poor's 500 Index returned more than 32%, and the average domestic stock fund was up more than 31%, according to Morningstar. Major domestic stock market indexes are still at or near record levels, as of this writing. Since the nadir of the financial crisis in early 2009, stocks have enjoyed a powerful five-year run.

Is it time to move out of stocks, or at least trim your holdings? Most commentators advise against trying to time the market. There's no way of knowing if we're at the top of the market, as we were in 2000 and 2007, or if we're just beginning an 18-year bull run like the one we enjoyed from 1982 to the 2000 peak.

### Rebalancing act

Market timing may not be recommended, but many financial

advisers favor the concept of rebalancing your portfolio. Here, you determine an asset allocation to suit your investment goals and your risk tolerance. If your actual allocation departs from the plan, you'll act to get your investment mix back on the chosen path.

**Example 1:** Megan Harris has a basic asset allocation of 65% stocks and 35% bonds. After a few years of a bull market, Megan's \$400,000 portfolio is \$300,000 in stocks (75%) and \$100,000 (25%) in bonds. To rebalance, Megan would sell \$40,000 of stocks and buy \$40,000 of bonds. This would bring her to \$260,000 in stocks (65%) and \$140,000 in bonds (35%).

Note that Megan will still have a substantial amount invested in stocks, so she will continue to profit if stocks perform well. At the same time, she will have less exposure to a possible stock market reversal.

The Megan Harris example is extremely simplified. Today, many financial advisers advocate a portfolio that's diversified among multiple asset classes. Megan might hold international and domestic equities, large company and small company stocks, high grade and lower quality bonds, real estate securities, commodities and so on. Each asset class will have an allocation, and

April/May/June 2014

## What's Inside

- 1 Is It Time to Trim Stocks?
- 2 Benchmark Based Life Insurance and Annuities
- 3 Underused Business Tax Deductions
- 3 SEP Plans Go Separate Ways
- 4 Estimated Taxes for Business Owners
- 6 Mixing IRA Distributions With Social Security

*continued on page 2*

periodic rebalancing can keep the mix on track.

### Tax tactics

One advantage of continual rebalancing is that it encourages investors to sell after assets have appreciated and buy other assets that are currently out of favor. Long term, that can be a formula for successful investing. It's also a formula for realizing taxable gains. Some astute planning can reduce the tax bill, though.

One approach is to rebalance by executing your asset sales in a tax-favored retirement plan such as a 401(k) or an IRA. Then, any gains on the sale won't be taxed right away. By building up a substantial amount in such an account and holding a blend of asset classes in there, you'll

increase your ability to rebalance without triggering taxes.

Another tax reduction method is to sell assets from a large holding within your portfolio, acquired at different times. Specify the shares you'd like to sell, choosing those with the least tax impact.

**Example 2:** As in our previous example, Megan Harris wants to rebalance her portfolio by selling \$40,000 of stocks. She sells \$15,000 of stock funds held inside her 401(k), avoiding a current tax bill, but Megan would like to sell another \$25,000 of stocks in her taxable account.

Megan holds a large position in mutual fund ABC, which she has amassed over several years. She wants to reduce her exposure to this fund, so she sells \$25,000 worth of

fund ABC in her taxable account. When instructing her broker to make this sale, Megan specifies which shares to sell, choosing those that (a) have declined since her purchase or (b) have relatively small paper profits. Among the gainers, Megan focuses on the shares that have been held more than one year and, thus, qualify for the favorable tax rate on long-term capital gains.

Yet another way to reduce the tax on rebalancing gains is to build up a bank of capital losses by periodically selling assets that lose value after you buy them. (See the *CPA Client Tax Letter* for January/February March 2014). Such capital losses can offset taxable capital gains.

Our office can help you find the right tax reduction strategy if you are interested in rebalancing. ■

---

## Benchmark Based Life Insurance and Annuities

The stock market crashes of 2000–2002 and 2008–2009 have made many people less tolerant of investment volatility. In response, some insurance companies and financial advisers are suggesting so-called “index” products that reduce downside exposure. These products may or may not be suitable for you; as always, you should consider the details carefully before making any commitments.

### Index universal life

These policies are a form of permanent life insurance. You pay a substantial premium, a portion of which goes into a savings component, sometimes called the cash value. In this respect, indexed universal life (IUL) insurance resembles whole life, universal life and variable life insurance.

The difference between IUL and the others lies in the way your cash value grows. That growth is tied to an index such as the S&P 500, or to a

mix of various indexes. If the relevant benchmark goes up by, say, 7% in a 12-month period, your cash value might increase by 7%.

As straightforward as that might seem, IUL policies can be complex. Often, cash value growth is capped in some manner. In return, your cash value typically is shielded from market losses. Proponents argue that this product design (possible upside with scant downside) will result in substantial growth over the long term. Eventually, perhaps after you retire, you can take tax-free policy loans.

Once you sort out all the details, you might consider IUL if you have a long-term need for life insurance.

### Fixed index annuities

People who do not need additional life insurance but who want supplemental retirement cash flow can evaluate fixed index annuities (FIAs). These are deferred annuities, so the basic tax

rules apply. No income tax is due on buildup within the annuity contract. Withdrawals are on a LIFO basis (last in, first out), meaning that you'll owe tax as long as you're withdrawing untaxed earnings. Alternatively, you can annuitize the contract and receive a stream of income, perhaps over your entire life, and spread out the tax obligation.

Again, with an FIA, the contract growth is pegged to one or more market indexes. You sacrifice some potential accumulation in return for protection against loss if the index declines.

IUL policies and FIAs are offered by many insurers, and the fine print varies greatly, from company to company. Our office can help you determine whether a particular offering provides a desirable mix of risk reduction and growth potential. ■

# Underused Business Tax Deductions

As we move towards midyear, business owners should intensify their efforts to use every available tax deduction. Documentation is crucial, so keeping all relevant receipts will help. You also should maintain a log, explaining why certain items are business related and thus tax deductible. Our office can help you set up a system to increase your tax deductions in 2014 and future years.

## Auto expenses

If you use your own car on business, you can use either the standard mileage or the actual expense method for tracking deductions. Using the standard cents per mile rate is simpler, but tracking actual expenses, including depreciation, can result in more tax savings.

The actual expense method may be especially helpful after purchasing a new vehicle you'll use for business. Be sure to track business versus personal use because the IRS tends to be skeptical with reports of 100% business use.

## Educational materials

You can deduct the cost of any books that you purchase

to improve your company's profitability. Again, keeping records can help to support your deductions. It's not likely you can deduct a James Patterson thriller, but nonfiction books may be a different story. A book that helps you negotiate with vendors, for example, or one that shows you how to hold down legal fees for your company may justify a tax deduction.

Similarly, the cost of audiotapes and videotapes may be deductible. If you drive to work listening to a tape about improving your employee management skills, that might be considered a reasonable business expense. Likewise, you can deduct the costs of publications such as magazines and newsletters that can help you in your business.

Taking a broader look at education, you can deduct the cost of any courses you take if you enroll to maintain or improve skills that are valuable in running your business. For example, you even might be able to deduct golf lessons: if you keep records that show 50% of your days on the golf course are business related (teeing off with clients or prospects), you

may be able to deduct half the money you spent so you won't look foolish out there.

## Advertising and marketing

You probably realize that the costs of traditional advertising in magazines or on the radio are tax deductible. In addition, other efforts to get your name out to potential customers and enhance your company's reputation also may be deductible.

That includes the cost of business card preparation, for example. If you participate in trade shows or send out samples, you probably can deduct your outlays. Even the costs of sponsoring a local soccer league might be deductible, as long as your company's name is displayed and may reach people who can favorably affect your business prospects.

Some of these items might be small, but you can wind up with substantial tax savings by keeping careful track throughout the year. ■

---

## SEP Plans Go Separate Ways



Simplified employee pension (SEP) plans are commonly used by self-employed individuals and others with part-time self-employment income. In addition, SEPs can offer many benefits to small companies, so business owners may want to consider using a SEP for themselves and the firm's workers.

### On your own

Self-employed individuals choose SEPs for several reasons. There are virtually

no costs or paperwork to setting up and maintaining a SEP. Many financial firms offer them, and the investment options are broad. Contribution limits are generous, with a \$52,000 maximum for 2014. (SEP contributions may be as high as 25% of compensation, but special rules effectively limit contributions to around 20% of your net self-employment income.)

In addition, SEPs offer a rare opportunity to make retroactive

*continued on page 4*



tax deductions. Each year, you can deduct SEP contributions made until the filing date of your tax return, including extensions.

**Example 1:** Beth Carson, a freelance graphic artist, qualifies for a \$15,000 SEP contribution based on her 2013 earnings. She has requested a six month filing extension for her 2013 tax return. On October 1, 2014, Beth contacts a mutual fund company and creates a SEP, funded with a check for \$15,000. As long as Beth makes the contribution by the time she files her 2013 tax return on October 15, she can take a \$15,000 tax deduction on that return.

### Strictly business

Small companies also can use SEPs. Again, the simplicity of such plans, the flexibility, and the high ceiling for contributions may make SEPs appealing to business owners. Employers must fill out and retain IRS Form 5305-SEP to establish the plan, but there are no subsequent required filings with the IRS. The downside is that a SEP is funded entirely by employer contributions; SEPs are different from 401(k)s and similar plans, which are funded largely by employees' salary deferrals.

To set up a SEP for your company, you merely have to sign a document with the financial firm you have chosen. Then you must notify each eligible employee about the plan and create an account (a SEP-IRA) for each qualified employee at the financial firm.

Once the plan is established, your company must make equivalent contributions for each eligible employee, as a percentage of compensation.

**Example 2:** ABC Corp. has two co-owners and four employees. If the owners want maximum SEP contributions of 25% of their pay, the company also must contribute 25% of pay to the SEP-IRAs of the other four employees. (See the Trusted Advice box for guidelines for which employees must be included in a SEP.)

Fortunately, SEP-IRAs are flexible. Even if ABC makes a 25% contribution in a given year, it can make a contribution of any percentage of pay in the following year. The company also can skip contributions altogether, if cash is tight.

With a SEP, business owners have plenty of time to decide about contribution levels. You can set up and make deductible contributions to a SEP plan as late as the due

## Trusted Advice

### SEP Requirements

When a company has a SEP plan, it must include all employees who have done all of the following:

- ❖ Reached age 21
- ❖ Worked for the company in at least 3 of the last 5 years
- ❖ Received at least \$550 in compensation from your business for the year, subject to annual cost-of-living adjustments in later years

Your company can impose less restrictive requirements, such as reaching age 18 or working there for 3 months.

Certain union members and nonresident aliens may be excluded.

date (including extensions) of your company's income tax return for that year. Therefore, your company may still have time to set up a SEP plan and make deductible contributions for 2013, if you have yet to timely file that return for last year. ■

## Estimated Taxes for Business Owners



April 1 may be April Fool's Day, but April 15 might be considered April's cruel day. Not only do you have to pay any income tax due for the previous year, you also may have to make an estimated tax payment for the current year. A poor estimate might result in either an underpayment that triggers a penalty or an overpayment that deprives you of valuable cash flow.

### Paying as an individual

Many business owners will pay estimated tax on the same IRS

Form 1040-ES that individuals use for estimated tax. That's the case if you run your business as an S corporation, a partnership, an LLC electing partnership taxation, or a sole proprietorship.

Business owners filing estimated taxes on Form 1040-ES must pay in four installments. The first payment is due on April 15 each year; the next payment is due only two months later, on June 15, so there may be a cash crunch. Subsequent deadlines give you more time; payments are due on

September 15 and January 15 of the following year.

You generally have to file estimated tax on Form 1040-ES if you owe \$1,000 or more in tax when you file your return for the year. Thus, estimated tax won't be a concern for businesses that will show a loss on their annual tax return.

## Preventing penalties

You can avoid an underpayment penalty if all of your tax payments for the year—including withholding and tax credits—cover your ultimate tax bill, or at least go far enough that you come up short by less than \$1,000. However, few business owners can accurately predict their annual tax obligation on April 15 or even June 15.

Thus, there are two safe harbors for those required to pay estimated tax. If you pay either (a) 90% of your current year's tax obligation, or (b) 100% of the prior year's tax, you won't owe any penalty.

**Example:** Pam Owens has an interior design practice, set up as a sole proprietorship. Next year, when Pam prepares her tax return for 2014, it shows a \$60,000 tax obligation for the year. Pam has no overpayment to put towards her 2015 tax obligation and she does not plan to have tax withheld during the year.

If Pam were confident of owing another \$60,000 in tax in 2015, she could pay \$54,000 (90% of \$60,000) in estimated tax next year: \$13,500 in each of four scheduled installments. That would avoid any risk of owing a penalty.

However, Pam does not know how much business income she'll earn in 2015. If Pam's income is much greater than in 2014 and she follows that \$54,000 schedule, she could underpay her estimated tax and owe a penalty.

As an alternative, Pam could make four \$15,000 estimated tax payments for 2015. That would total \$60,000 in

estimated tax—100% of her 2014 tax bill—and exempt Pam from a penalty.

However, if Pam's adjusted gross income (AGI) in 2014 exceeded \$150,000, she must pay more estimated tax under the safe harbor. Above that threshold, the safe harbor requires paying 110% of the prior year's taxable income, rather than 100%. Thus, Pam decides to pay estimated tax for 2015 in four \$16,500 installments. This will bring Pam's estimated tax total to \$66,000—110% of the \$60,000 in tax that she owed for 2014—so she won't owe a penalty.

Note that this example assumes that Pam expects an increase in business this year, and a larger tax obligation. If there is some reason to expect a smaller tax obligation, Pam can reduce her obligation accordingly to meet the 90% safe harbor requirement.

## Corporate calculation

The estimated tax rules for regular C corporations are similar but slightly different than those for individuals. Corporations must make installment payments on IRS Form 1120-W if the expected estimated tax for the year is \$500 or more. Equal payments are due on the 15th day of the company's 4th, 6th, 9th, and 12th months of the corporation's tax year. A corporation with a tax year ending June 30, for example, would make payments by October 15, December 15, March 15, and June 15. (As is the case with

individual estimated tax payments, the deadline is postponed to the next business day if the 15th is on a weekend or a legal holiday.)

The safe harbors for corporate estimated tax are both 100%. Thus, each installment should be at least 25% of the company's current year income tax or 25% of the prior year's income tax, whichever is smaller, in order to avoid an underpayment penalty.

Some businesses are seasonal, and estimated installment payments may be revised in keeping with two alternate methods. Our office can help you with seasonal estimated payments, if that's an issue with your company.

## A matter of interest

Some IRS penalties are fixed, such as the 10% penalty for early withdrawals from retirement accounts. That's not the case with underpayments of estimated tax. For estimated tax infractions, the penalty is based on current interest rates, which are relatively low now. Still, the penalties can mount up, for large underpayments, and those penalties can be easily avoided by mooring in safe harbors. ■

## Did You Know?

Last year was the best year for the U.S. IPO market since 2000. A total of 222 companies went public, raising \$55 billion, including recognizable names such as Hilton, Twitter, and Coty.

Source: Renaissance Capital

# Mixing IRA Distributions With Social Security

Many workers save for the future in a 401(k) or another employer sponsored retirement plan. Contributions avoid income tax, and the same is true for investment earnings inside the plan. Often, 401(k) participants roll over the money to a traditional IRA after they retire, which extends the tax deferral.

Many people try to keep their IRAs intact as long as possible, continuing tax free buildup inside the plan.

**Example 1:** Alice Wells retired at age 62. To make up for her lost earnings, Alice draws down her taxable accounts, so her IRA can keep growing untaxed. Alice's plan is to wait as long as possible before taking distributions from her IRA. (She'll have to take at least the required minimum distributions from her traditional IRA after age 70½.)

However, once she retires, Alice finds that she is still short of cash flow. She can start to receive Social Security retirement benefits as early as age 62, so Alice puts in her claim to get the additional monthly income.

## Lower brackets are likely

Alice's strategy, as described, is followed by many seniors. That is, they take Social Security early and eventually tap their IRA. That may not always be the best approach.

What might indicate taking a different route? Taxes, for one thing. The value of tax deferral depends on your tax bracket. The higher your bracket, the more putting off the IRS makes sense.

Suppose Alice typically was in a 28% or 33% tax bracket during

her working years. In 2014, those brackets cover single taxpayers with about \$90,000 to \$400,000 of taxable income after deductions. Deferring income tax while she worked saved Alice 28 cents or 33 cents on the dollar.

Now that she's retired, Alice's taxable income is sharply reduced. In our example, Alice can tap her IRA for cash flow and keep taxable income below \$90,000, which would put her in the 25% bracket. At 25 cents on the dollar, tax deferral isn't as valuable as it was during her working years. On the other hand, taking IRA distributions and paying 25% tax isn't as painful as it would be in a higher bracket.

Indeed, many retired couples are in the 15% bracket now, which goes up to nearly \$75,000 of taxable income, after deductions. Such couples will owe even less tax on IRA distributions.

## A plumper pension

There's another reason to consider reversing the plan to take Social Security early and IRA distributions late. The longer you wait to start Social Security, the larger your monthly benefits will be.

**Example 2:** Suppose that Alice Wells has an earnings history that would qualify her to receive \$2,000 a month at 66, which Social Security considers the "full retirement age" for people now in their 60s. If Alice starts Social Security at age 62, she'll get only 75% of that benefit: \$1,500 a month, plus cost-of-living adjustments (COLAs), for the rest of her life.

On the other hand, Alice can wait as late as age 70 to start Social Security. That would increase the monthly payment from her full retirement age by 32%, from \$2,000 to \$2,640 a month, plus all the COLAs along the way. Not counting COLAs, waiting from 62 to 70 will increase Alice's annual benefit from \$18,000 a year to \$31,680 a year, which she'll receive for the rest of her life.

Once Alice starts to receive Social Security, those much larger payments may reduce the amounts she'll need from her IRA. If that's the case, Alice will be substituting Social Security dollars, which are partially taxed under current law, for traditional IRA distributions, which usually are fully taxable.

Building up Social Security benefits might have another appeal for married couples. When the first spouse dies, the survivor will receive the decedent's Social Security payments, if they are larger than the benefits the survivor had been receiving. Thus, waiting to start Social Security may provide extra cash flow for a surviving spouse.

This plan to tap your IRA early and wait to start Social Security will help some people but not others. Calculations involve each individual's health and work history as well as some complicated navigation through the tax code. When you are ready to make your decision, our office can help you determine a course of action likely to maximize cash flow and income security as you grow older. ■