



# Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*<sup>SM</sup>

## Contrarian Investing Versus Momentum Strategies



spread of the Internet in the mid-1990s, prospered in the dot-com boom of the next few years, and then taken profits when technology stocks relinquished market leadership.

Can either of these methods work in this century's investment environment? You might weigh them by looking at recent results among so-called "sector" mutual funds. These funds invest solely or primarily in companies within a particular industry, such as real estate or health care.

Some people advise stock market investors to be contrarians: buy low and sell high. That is, you should put your money into market sectors that are out of favor. Those stocks are likely to ride the next leg of the business cycle and ultimately enable you to sell at a profit. Such a strategy, applied to the broad stock market, would have paid off in 1982. In that year the Dow Jones Industrial Average dipped below 777, from a previous high of 1050, before increasing to more than 11,700 in 2000.

Other investors advocate a momentum-based approach: look for stocks or industries that are gaining favor, as shown by rising prices, then ride that wave of investor enthusiasm before it wanes. A canny investor could have spotted the

### Counting on comebacks

Morningstar lists nine categories of specialty stock funds. In 2004, a contrarian investor might have invested in a precious metals mutual fund. While the Standard & Poor's 500 Index returned nearly 11% that year, precious metals funds (which mainly own stocks of gold mining companies) lost more than 8%, on average. In hindsight, that would have been an ideal time to buy a precious metals fund. Such funds returned over 30% in 2005 and have continued to gleam as the price of gold has soared. Through August 2011, the average precious metals fund had an annualized return over 13% a year for

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## Social Security Roll Call

*At the end of 2010, about 54 million people were receiving benefits from Social Security: 37 million retired workers and dependents of retired workers, 6 million survivors of deceased workers, and 10 million disabled workers and dependents of disabled workers.*

the past five years, the best of all Morningstar categories.

In 2004, technology funds were the second worst performers, returning only 4.2%. Those funds have not done as well as precious metals funds. If you had invested then, you would have seen tech funds fall to last place among sector funds in 2005 and finish next-to-last in 2006. Tech fund investors didn't see a substantial payoff until 2009, when the category returned 62%.

Similarly, contrarians might have bought financial services funds (which largely own bank stocks) and real estate funds in 2007. Both categories suffered double-digit losses while the broad market had positive returns. As we've seen, though, troubled financial institutions and collapsing real estate values led the market down in the crash of 2008 and have yet to recover. Financial funds, in fact, are showing steep annualized losses for the past three and five years.

### Going with the flow

If the results for contrarian investors have been mixed, how have momentum investors fared? In 2004, when contrarians might have been buying precious metals and tech funds, momentum investors may have put money into equity energy funds (up 33%) or real estate (32%). Real estate funds had two more good years, in 2005 and 2006, then suffered in 2007 and 2008. Altogether, real estate funds had a negative return, on average, for the five years through August 2011.

What about equity energy funds, which own stocks of oil companies and of other companies in related industries, such as well services? These funds tend to ebb and flow with the price of oil. They've generally been strong in the past decade, with oil prices much higher than they were in 2001. Savvy investors might have made money in

the past few years, especially if they managed to sell last May, when the price topped \$110 a barrel. However, fear of an economic slowdown caused this category to lose nearly 11% in August 2011, and recession worries could continue to deplete past profits. Precious metals fund investors could have benefitted from momentum investing in 2010, when that category set the pace, but the price of gold has soared so rapidly that further growth may be difficult to sustain.

### Drawing conclusions

Both the contrarian and the momentum styles of investing have produced positive results in some instances, so you may want to incorporate these concepts into your investment planning. However, there is no simple way to achieve investment success. ■

## Dodge a Real Estate Tax Trap With a Like-Kind Exchange

The real estate slump of recent years has reduced the value of many investment properties. Therefore, you may expect to owe little or no tax on a sale. You may, however, have to pay a surprising amount to the IRS because of a "recapture" provision in the tax code.

### Repaying prior deductions

Owners of investment property generally reduce their taxes each year with depreciation deductions. Those deductions, however, also reduce your basis in the property and thus result in increased tax on a future sale.

**Example:** Paul Matthews bought a small apartment building many years ago for \$500,000, of which \$50,000 was allocated to nondepreciable land. The remaining \$450,000 of the

purchase price has been fully depreciated over the years.

Paul has seen the building's value rise to \$800,000 and then fall back towards \$500,000 in recent years. He wishes to relinquish property management responsibilities and relocate to a distant state in retirement. He assumes that a sale that nets him \$500,000 would result in no tax: paid \$500,000, received \$500,000.

However, Paul has taken \$450,000 worth of depreciation deductions, as noted. Consequently, his basis in this property is only \$50,000, not \$500,000. If Paul sells the property for \$500,000, his \$450,000 of depreciation deductions would be recaptured at 25% and he would owe the IRS \$112,500.

### Trading places

In this scenario, Paul can execute a so-called "like-kind exchange" under Section 1031 of the tax code. If he meets all the requirements of Section 1031, some of which are outlined in the following section, taxes can be deferred. Such exchanges can involve any kind of investment property and they don't have to be a straight one-for-one trade.

To give a simplified illustration of how a like-kind exchange might work, suppose Paul lives in New



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Jersey and wants to retire in North Carolina. He sells his New Jersey apartment building, and nets \$500,000 from the sale, but he does not pocket the money. Instead, Paul arranges for the proceeds to be held by a qualified intermediary, sometimes known as an accommodator. (The accommodator can't be Paul's agent or relative. Many financial and real estate companies offer to serve as qualified intermediaries; if you are interested in a like-kind exchange, check prospective accommodators' experience and safety procedures carefully.)

Next, Paul finds a storage facility near his desired retirement home that he can buy for \$500,000. He instructs the accommodator to purchase the property with the \$500,000 from the sale of his apartment building. As a result, Paul has "exchanged" his New Jersey investment property for one he'll be able to manage once he retires in North Carolina.

### Deferral defined

Like-kind exchanges can take many forms in addition to the one in the previous example. Regardless of the exchange's form, you must follow many rules in order to defer the full amount of tax due on the sale of

your original property. In a deferred like-kind exchange, certain deadlines regarding the identification and receipt of the replacement property must be met (see the Trusted Advice column "Deferred Like-Kind Details" for further explanation).

Assuming you follow all the rules, here are the requirements for a full tax deferral:

- You must pay at least as much for the new property as you received for the original property you relinquished.
- You must reinvest any cash you receive from the original sale into the new property.
- If you are relieved of any debt on your old property, you must replace that debt with a combination of new debt or cash, or both, that you add to complete the purchase of the new property.

If you implement an exchange and wind up with cash in your pocket or a smaller mortgage than you had before, the amount by which you benefit will be considered "boot" and subject to income tax. Like-kind exchanges are complex but they may result in substantial savings; if you're interested, our office can help you meet all the requirements. ■

## Trusted Advice

### Deferred Like-Kind Details

- ✓ In a deferred like-kind exchange, you must identify potential replacement properties, in writing, within 45 days of the date you sell your original property. This notification can go to the accommodator.
- ✓ You can name up to three potential replacement properties of any value.
- ✓ Alternatively, you can name more than three properties. If you name more than three, their total value can be no more than 200% of the value of the property you relinquished.
- ✓ You must receive the replacement property within 180 days after the sale of your original property or the due date (with extensions) of the relevant tax return for your property sale, whichever is earlier.

## Trim the Tax on Your Social Security Benefits

While politicians consider changes in Social Security, millions of people continue to receive benefits. Are those benefits taxable? That's determined by a complicated formula, and if you know how it works, you may be able to reduce or eliminate the tax you owe on your Social Security benefits.

To begin the calculation, determine your combined income (CI) for this purpose. To find your CI

- start with half of your Social Security benefits, then

- add that number to all of your other income, including tax exempt income and other exclusions from income.

Once you've determined your CI, compare it with certain base amounts. The first base amounts are \$25,000 for single taxpayers and \$32,000 for married couples filing jointly.

### Numbers crunch

If your CI is over the relevant base amount, you'll owe tax on some of your Social Security benefits.

**Example:** Kim Phillips receives \$14,000 in Social Security benefits in 2011. She also has \$20,000 in other income. Thus, Kim's CI is \$27,000: \$7,000 (half of \$14,000) plus \$20,000.

Kim is single so her base amount is \$25,000. With \$27,000 of CI, Kim is \$2,000 over the threshold.

The next step is to compare the excess (\$2,000) with half of Kim's Social Security benefits (\$7,000). The smaller of the two numbers—\$2,000, in this example—

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will be added to her taxable income. Here, Kim receives \$14,000 in benefits and owes income tax on \$2,000 of those benefits.

If your CI is high enough, you will encounter a second set of base amounts: \$34,000 for singles and \$44,000 for joint returns. Over those thresholds, up to 85% of your Social Security benefits may be added to your taxable income. Note that this doesn't mean you would owe 85% tax on your Social Security benefits. If you receive \$20,000 in benefits and you owe the maximum tax, you'd add \$17,000 (85% of \$20,000) to your taxable income. Assuming a 28% tax rate, you would owe \$4,760 in tax on the \$17,000. That's an effective tax rate of less than 24% on your Social Security benefits.

## Tax tactics

Once you understand the process, you can see whether tax planning makes sense.

- If your CI is under \$25,000 (single) or \$32,000 (joint) and likely to stay there, you don't need to do anything. You won't owe any tax on your Social Security benefits.
- If your CI is now or is expected to be above \$25,000 (single) or \$32,000 (joint), you may be able to profit from tax planning. Our office can let you know if there are practical strategies you can use. By lowering your CI, you might be able to reduce the tax on your Social Security benefits.
- If you expect your CI to be far above the \$34,000 (single) or \$44,000 (joint) thresholds, there might be nothing you can do in

this area. Our office can help you determine whether you are in this category. If so, you may have to resign yourself to having 85% of your benefits taxed.

Possible tactics for reducing your CI include taking losses to offset capital gains and investing in growth stocks rather than dividend paying stocks. Tapping an immediate annuity for income or taking out a reverse mortgage also may provide cash flow that won't count towards your CI. Make such decisions carefully because their impact can go beyond the tax on your Social Security benefits. Our office can help you evaluate possible strategies for reducing this tax. ■

# TAX CALENDAR

## DECEMBER 2011

### December 15

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in November if the monthly rule applies.

**Corporations.** Deposit the fourth installment of estimated income tax for 2011.

## JANUARY 2012

### January 17

**Individuals.** Make a payment of your estimated tax for 2011 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2011 estimated tax. However, you don't have to make this payment if you file your 2011 return and pay any tax due by January 31, 2011.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December if the monthly rule applies.

### January 31

**All businesses.** Give annual information statements (Forms 1099) to recipients of certain payments you made during 2011. Payments that are covered include: (1) compensation for workers who are not considered employees, (2) dividends and other

corporate distributions, (3) interest, (4) amounts paid in real estate transactions, (5) rents, (6) royalties, (7) amounts paid in broker and barter exchange transactions, (8) payments to attorneys, (9) profit-sharing distributions, (10) retirement plan distributions, (11) original issue discounts, (12) prizes and awards, (13) medical and health care payments, (14) debt cancellations (treated as payment to debtor), (15) payments of Indian gaming profits to tribal members, and (16) cash payments over \$10,000. There are different forms for different types of payments.

**Employers.** Give your employees their copies of Form W-2 for 2011.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2011 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2011. Deposit or pay any undeposited tax under the accuracy of deposit rules. If your tax liability is less than \$2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2011. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.