CPA
Client Bulletin
Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

January 2014

Five Years Later, Tax Lessons Learned

Five years ago, as the year 2009 dawned, investors weren't celebrating. The broad stock market had crashed, many other asset classes had fallen as well, and pessimism had spread throughout the world.

As 2014 begins, investors' spirits are brighter. Major stock market indexes are near record levels, real estate prices in many areas are recovering, and the U.S. economy seems to be growing steadily.

Looking back, investors can learn some lessons. We've already had two severe stock market crashes in this century, and chances are that more downturns will appear from time to time. Taking advantage of certain provisions in the tax code can reduce your stress and keep you in position to benefit from the following upswing, whenever that might occur.

Harvest capital losses

When stocks or other investments lose value, one possible reaction is to hold on until they recover. That may not be the best approach, however, for tax effective returns.

Instead, consider selling investments that trade below your original purchase price. That will give you a capital loss; if all your trades in a given year produce more losses than gains, you generally can deduct up to $3,000 of net capital losses on that year's tax return. A $3,000 net capital loss will reduce your adjusted gross income (AGI), and a lower AGI may provide various tax savings on that return.

The tax advantages of harvesting capital losses go beyond a $3,000 deduction in the year of sale. Excess net losses can be carried over to future years, with no time limit.

Example 1: In a future year, the stock market drops sharply and Lynn Matthews takes $40,000 worth of capital losses, her only trades that year. Lynn takes a $3,000 deduction and carries over the $37,000 balance.

With $37,000 of net capital losses, Lynn has a great deal of investment

continued on page 2

What's Inside

Ready to Shop

About one in six consumers (17%) have expressed willingness to purchase life insurance coverage directly from a retail outlet such as such as Costco, Walmart or Target.

continued from page 1

flexibility. If the stock market recovers, as it has done in the past, Lynn can sell securities when it suits her investment strategy. She won't have to consider the tax consequences of taking profits as long as she has a capital loss carryover to use as an offset.

Recent tax legislation has increased the effective tax rate on capital gains for many high-income taxpayers. Such investors may benefit significantly from having a "bank" of capital losses to net against capital gains.

Avoid wash sales

If you sell a particular investment at a loss and immediately buy back the same thing, you will have executed what the IRS calls a wash sale. Then you won't be able to count the capital loss on your tax return.

There are several ways to avoid a wash sale. One is to immediately invest in something different from the security you sold. Another is to wait more than 30 days and then execute a buyback. Either way, you can maintain the strategy you believe fits the current environment.

Example 2: Suppose that Lynn Matthews took her $40,000 of losses in tech stocks and tech funds when the market tumbled. Now Lynn thinks the best opportunities lie in health care stocks, so she can reinvest there right away. On the other hand, if Lynn thinks the tech sector will bounce back, she can buy different tech stocks and funds—or she can wait more than 30 days and repurchase the holdings she sold.

The important thing is that Lynn can invest the way she pleases, as long as she doesn't enter into a wash sale. By staying invested, she will be in a position to use her capital losses in a future market recovery.

Rebalance regularly

Many financial advisers believe that investors should have a predetermined asset allocation, based largely on their risk tolerance and their time horizon. Periodically, this asset allocation should be reviewed and, if necessary, adjusted back to the desired levels.

With this strategy, investors may be able to buy low and sell high, which can generate favorable long-term results. However, the "sell high" portion of this plan might lead to taxable gains. If an investor has a bank of capital loss carryovers, rebalancing can be less taxing.

Example 3: In a previous example, Lynn Matthews takes $40,000 worth of capital losses during a bear market for stocks. Lynn reinvests her sales proceeds in different stocks and stock funds. Indeed, she notices that her asset allocation to stocks had fallen below her desired level, so she sells bonds and buys stocks. The profitable gains from her bond sales can be offset by the losses on her stock sales.

Going forward, if stocks rally and need to be trimmed in a future rebalancing effort by Lynn, any still unused capital loss carryovers can offset that year's capital gains.

Invest through employer plans

Many companies offer retirement plans such as 401(k)s. Contributions are untaxed, so the tax bill is deferred until money is withdrawn. In most such plans, contributions are automatically made via monthly paycheck withholding.

While tax deferral is considered a prime benefit of these plans, periodic contributions also play a valuable role. If you contribute a certain amount each month to a designated mutual fund, you will buy more shares when prices are down, fewer shares when prices are up. This tactic is known as dollar cost averaging, and it is a valuable technique for lowering your cost per share and increasing future profits.

Investors who maintained their retirement plan contributions during the 2008–2009 downturn bought more shares of stock funds during that time, so they gained more in the subsequent market rally. Persistent contributions to employer retirement plans can boost your long-term accumulation and do so with the added benefit of tax deferral. ■

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. ■

Trusted Advice

Early Withdrawals

- Most distributions from deferred annuities before you reach age 59½ are subject to an additional tax of 10%.
- This 10% tax applies to the part of the distribution that you must include in gross income.
- The additional tax does not apply to any part of a distribution that is tax-free, such as amounts that represent a return of your cost.

Underused Deductions for Business Owners

As the year begins, 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

continued on page 4

continued from page 3

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. ■

Did You Know?

To be eligible for Social Security, you must have 40 quarters of earned income. Your monthly Social Security benefits are based on your 35 highest earning years. If you only work 30 years, for example, you would have five years of zero earnings that will lower the amount you'll receive from Social Security.

Source: Robert W. Baird & Co.

TAX CALENDAR

JANUARY 2014

January 15

Individuals. Make a payment of your estimated tax for 2013 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 2013 estimated tax. However, you don't have to make this payment if you file your 2013 return and pay any tax due by January 31, 2014.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2013 if the monthly rule applies.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2013. Payments that are covered include (1) compensation for workers who are not considered employees, (2) dividends and other corporate distributions, (3) interest, (4) rents, (5) royalties, (6) profit-sharing distributions, (7) retirement plan distributions, (8) original issue discounts, (9) prizes and awards, (10) medical and health care payments, (11) debt cancellations (treated as payment to debtor), (12) payments of Indian gaming profits to tribal members and (13) 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 2013.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2013 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 2013. Deposit or pay any undeposited tax. 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 2013. 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.

FEBRUARY 2014

February 18

All businesses. Give annual information statements to recipients of certain payments you made during 2013. This due date applies only to the following types of payments: (1) amounts paid in broker and barter exchange transactions, (2) amounts paid in real estate transactions, (3) amounts paid to an attorney and (4) substitute payments in lieu of dividends or interest.

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 28

All businesses. File information returns (for example, Forms 1099) for certain payments you made during 2013. If you file the forms electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2013. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is March 31.

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