DB&B
CPA
Dermody, Burke & Brown, CPAs, LLC

Syracuse 315.471.9171 | New Hartford 315.732.2991 | Auburn 315.253.6373
www.dbbllc.com
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Client Tax Letter

Tax Saving and Planning Strategies *from your* **Trusted Business Advisor**[sm]

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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

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What's Inside

Healthy Returns

Through September, health care sector funds had average total returns of 36.47% for 2013, topping all categories tracked by Morningstar.

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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. g

Pay Premiums or Pay a Penalty

As of 2014, most Americans must

you may have to make what the

have health insurance. If you don't,

law calls a "shared responsibility payment." Such payments will be made to the IRS, so they will look and feel like additional taxes on uncovered individuals.

Should you be concerned? That depends on many factors.

Multiple exemptions

exemptions. Those exempted

The new law contains several

include members of Indian tribes and members of religious groups recognized by the federal government as being opposed to government insurance benefits and receive an exemption certification.

Did You Know?

for employer-sponsored

rom 2003 to 2013, average annual premiums

family health insurance rose from $9,068 to $16,351. During those years, the average worker contribution rose from $2,412 to $4,565.

Source: Kaiser Family Foundation

The exemptions likely to affect most people are income-based. For example, people with income so low that they don't have to file an income tax return are not required to have health insurance. The same is true for people who can't afford coverage; those who would have to pay more than approximately 8% of their household income for the least expensive available policy are exempt.

Example 1: Bob and Carol Anderson have household income of $50,000 in 2014. To obtain acceptable health insurance, the Andersons would have to pay $400 a month, or $4,800 a year. That would be 9.6% of their income, so the Andersons are exempt from the health insurance mandate.

Unless you qualify for these or other exemptions (one is for people in jail, for instance), you must have health insurance, and all of your dependents also must have coverage.

Qualifying coverage

The good news is that you probably have qualifying coverage already. Medicare and Medicaid qualify; so do most employer sponsored health plans, including retiree health benefits and COBRA coverage for people who leave employer plans. Individual and family coverage also qualifies, if you purchase a policy that's offered to the public.

You should be aware that large companies (those with at least 50 full-time employees or full-time employee equivalents) are required to offer health insurance that covers employees' dependents under age 26, but not employees' spouses. An uncovered spouse may owe a penalty.

Example 2: Dan and Ellie Franklin both work at companies with health plans. Dan's employer offers family coverage, so Dan can buy health insurance for himself and for the couple's children. However, Dan's employer structures its group health plan so that it will not cover spouses who can obtain employer sponsored health insurance. Thus, Dan's family health plan excludes Ellie.

In this situation, Ellie must carry her own health insurance. She can enroll in her company plan or, if that plan is unappealing, she can buy coverage from a health insurer. If Ellie does not comply, and she does not qualify for any exemption, she'll owe a penalty.

Paying the price

Individuals who are covered by the health insurance mandate will owe a penalty if they don't follow the rules. The penalty appears to be modest.

Example 3: Carrie Nelson, age 27, is a freelance Web designer in good health. She has been covered by her father's group health insurance, but that's no longer the case. After investigating her options, Carrie finds that she would pay at least $2,500 a year for acceptable health insurance.

If Carrie, who typically sees a doctor once every year for a checkup, goes without health insurance, she'll owe a fine of $95 or 1% of her taxable income, whichever is greater. Carrie believes her taxable income in 2014 will be around $35,000, so she would owe a $350 penalty.

Paying a $350 penalty rather than $2,500 for unwanted health insurance seems like a rational choice, especially considering that the Affordable Care Act says Carrie can't be turned down for health insurance in the future, even if she develops a medical condition. That will still be the case in 2016, when the penalty will reach 2.5% of taxable income or $695 per person, whichever is greater.

Look before leaping

Nevertheless, forgoing health insurance might not be a wise choice, even for a healthy person with a modest income. Healthy individuals can sprain an ankle in karate class or get an eye abrasion that leads to a trip to the emergency room. That could mean a bill that runs into thousands of dollars, far more than the savings from going without health insurance.

Moreover, it might not be so simple to get health insurance if and when a medical condition appears. Once the initial enrollment period ends on March 31, 2014, you will be able to purchase a qualified health insurance policy only during each year's enrollment window, from October 15 to December 7 which may mean waiting uncovered in the interim.

The bottom line is that coverage versus no coverage might not be a simple decision. If you (or your adult children) are thinking about skipping health insurance and paying the fine, you should do so only after carefully weighing all the consequences. g

Trim Steep Taxes With a Charitable Trust

High-income taxpayers face escalated effective tax rates as a result of recent tax law changes (see the *CPA Client Tax Letter* for April/May/June 2013). Moreover, the higher rates are not limited to athletes, entertainers, and corporate CEOs who regularly collect substantial paychecks and bonuses. Taxpayers who ordinarily are in moderate tax brackets may trigger the new premium rates, surtaxes, and deduction phaseouts in any year when they sell a business, sell

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investment property, or take portfolio profits.

One strategy can defer these extraordinary gains for years or even decades. This tactic allows you to spread the gains over many years, so you may be able to keep your annual income down and, thus, avoid the extra taxes aimed at the top earners. If you might face such a situation in the future, consider setting up a charitable remainder trust (CRT) for the asset sales.

Convert gains into income

With a CRT, you transfer assets you own into an irrevocable trust. Often, you'd transfer appreciated assets that you plan to sell. For a CRT, you name an income beneficiary or beneficiaries, who will receive cash flow for a specified time period. The beneficiaries could be yourself and your spouse, for example. You also name one or more charities to receive the remainder interest in the trust—the assets left in the CRT after the income payout period.

Example 1: Matt Reese is about to sell investment property he has owned for many years. He expects to sell the property for $1 million and owe around $350,000 in various federal and state taxes, leaving him $650,000 to invest in securities for his retirement.

Instead, Matt transfers the property to a CRT he has created, and the CRT sells the property for $1 million. As a charitable trust, the CRT will owe no tax on the sale. Thus, the CRT has the full $1 million to reinvest in securities.

The 5% Solutions

When creating the CRT, Matt names himself and his wife, Janice, as income beneficiaries; he instructs the attorney drawing up the trust to have the CRT pay out income as long as either of them is alive. Matt can choose between two modes of payments:

- Matt can select an *annuity trust*, which will pay out a fixed amount each year. That amount must be at least 5% of the initial trust fund. If Matt sets up the CRT with $1 million of real estate, the trust can pay out at least $50,000 a year to Matt and Janice or to the surviving spouse. When they both die, the assets still in the trust will pass to charities Matt has named.
- Alternatively, Matt can structure his CRT as a *unitrust*, which will pay out a fixed percentage of the net fair market value of the trust's assets, valued annually, each year. Again, the minimum is 5%.

Example 2: Suppose Matt decides on a unitrust with a 6% payout rate. The first year, Matt and Janice will receive $60,000: 6% of $1 million. In future years, the CRT payout will be more or less than $60,000, depending on whether the trust's assets have appreciated or lost value. Thus, the unitrust structure offers the potential for more income, over time, but also the risk of reduced income if the CRT value falls.

Deducting the donation

Besides future cash flow, the creator of a CRT also will receive an upfront tax deduction. The deduction will be the present value of the remainder interest in the trust donated to charity after all the payouts to the income beneficiaries. This calculation is based on several factors, including the ages of the income beneficiaries and the CRT payout rate.

Under federal law, for a CRT to be treated as a charitable trust, the value of the expected donation must be at least 10%. If Matt Reese funds a CRT with a $1 million asset transfer, his deduction (the present value of the remainder interest in the trust) must be $100,000. This provision effectively caps a CRT's income payout—Matt might be able to stipulate a 6% or 7% unitrust lifelong payout for himself and Janet but not a 12% lifelong payout, if the larger payout leads to a projected remainder interest under $100,000.

Tax relief

If Matt and Janice Reese receive $50,000 a year from their CRT, that's the amount of income they will report. Such a relatively modest payout may keep this couple below the annual thresholds for higher taxes, whereas selling the investment property for $1 million in their own names might trigger a much more painful tax bite on the sale.

How will the CRT payout be taxed? That depends on how the money is invested inside the trust. If the trustee buys corporate bonds, for example, the taxable interest income will pass through to the trustee, taxed at high rates. On the other hand, if the trustee invests in growth stocks that generate no income for the trust, the taxable payout will retain the favorable capital gains tax treatment of the investment property sale. g

Cashing In on Foreign Stocks

Many investors who seek income are turning to dividend paying stocks. While bank accounts and money market funds pay meager amounts, the dividend yield on the S&P 500 is around 1.9%. That's the average yield, so many established companies are paying 3%, 4%, or even more to shareholders.

Moreover, stock market investors have the potential for future growth and, as explained later in this article, typically receive favorable tax treatment on dividend income.

If the idea of investing in dividend paying stocks appeals to you, consider allocating a portion of your portfolio to foreign stocks that make such payouts to shareholders. The benchmark Morgan Stanley Capital International (MSCI) EAFE Index, which tracks the performance of large companies based in Europe, Australasia, and the Far East, has a dividend yield of about 2.75%, as of this writing. Thus, foreign stocks not only can diversify your portfolio, they may offer dividends higher than the yields on U.S. issues.

U.S. investors who want to invest in foreign stocks have several options. You can invest in American Depositary Receipts (ADRs), for example. ADRs, which represent ownership of equity shares in a foreign company, trade on U.S. exchanges or over-the-counter, so you can buy or sell them as you would with domestic stocks. Rather than buying individual foreign issues, you can invest in a fund holding foreign stocks. Choices include familiar mutual funds; closed-end funds, which trade on a stock exchange between investors; and exchange-traded funds (ETFs), which track a specific stock index.

Tax traps

Selected carefully, dividend paying foreign stocks and funds that hold such issues may play a valuable role in a diversified portfolio. However, you should be aware of two tax issues these investments may raise.

Dividends may not qualify for low tax rates. As explained in the April/May/June 2013 *CPA Client Tax Letter*, qualified dividends enjoy favorable tax rates. Most investors pay 15% tax on such dividends, whereas high and low bracket investors pay 20% and 0%, respectively. On dividends that are not qualified, though, investors pay tax at higher rates, ranging from 10% to 39.6%.

Typically, dividends from ADRs qualify for the low tax rates. Similarly, dividends from companies based in countries that have specific types of tax treaties with the U.S. also can qualify. Not all foreign stock dividends are from such countries, though. If you invest in a fund that receives nonqualified dividends from the stocks it owns, some of your dividend income may be taxed at high, ordinary tax rates, rather than the lower rate on qualified dividends.

Foreign tax withholding can reduce your yield. When foreign companies pay dividends to investors from other countries, some money may be withheld to cover the income tax obligation to the host country. The amount of withholding varies from country to country, depending on factors such as local law, tax treaties with the United States, and whether the stock is held in an IRA.

Example: Luke Miller invests in ADR shares that pay a dividend equivalent to $1,000 in U.S. dollars in 2014. The company represented by the ADR is based in a country that requires 15% withholding on dividends paid to U.S. investors. Thus, Luke receives $850 in dividend income in 2014 from that ADR, after $150 of withholding. If the posted yield on that stock is 5%, Luke actually receives the equivalent of a 4.25% dividend.

Foreign stock funds also withhold dividends in this manner. If your foreign stock or fund dividend income is subject to withholding, you may be able to get some IRS relief. One approach is to deduct the amount withheld (and thus paid to a foreign government) as an itemized deduction on Schedule A of your tax return. You can include such foreign taxes along with other deductible tax payments.

However, you'll receive only partial tax relief from an itemized deduction. If Luke is in a 28% tax bracket, for instance, a $150 deduction for foreign taxes paid saves him only $42 in tax: 28% of $150. Also, high-income taxpayers might lose some tax benefits under a new law that devalues some itemized deductions.

Taking credit

Instead of deducting the foreign tax you've paid, you may prefer to claim a credit for those taxes. (See the "Credit Check" Trusted Advice column for more information.) Generally, for foreign tax paid up to $300 ($600 for married couples filing a joint tax return), you can claim the credit on your Form 1040 tax return. Luke Miller, for example, could use the

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Trusted Advice

Credit Check

- A tax credit reduces your tax obligation, dollar for dollar, while a tax deduction reduces your income subject to tax. Thus, a tax credit is more valuable.
- You can claim the foreign tax credit even if you do not itemize deductions on Schedule A of your tax return. You are allowed to take the standard deduction in addition to this tax credit, if this tactic provides more tax savings.
- If you take the foreign tax credit and the foreign taxes you pay exceed the credit you're allowed, you may be able to carry forward or carry back the excess amount to another tax year.

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tactic to reduce his tax bill by the $150 of foreign dividends withheld from his investment income.

If you have a larger amount of foreign dividends withheld in a given year, you generally must file IRS Form 1116 to claim a tax credit.

Unfortunately, neither the tax credit nor the itemized deduction for foreign taxes paid will help if you hold your dividend-paying foreign stocks in a tax-deferred retirement account, such as an IRA. Luke, in our example, would wind up with a 4.25% dividend yield, not a 5% yield, if he holds his ADR in an IRA.

If the dividends you receive are qualified dividends, you may prefer to hold foreign dividend paying stocks in a taxable account. You'll be able to use the low tax rates on qualified dividends, and you can take a deduction or a tax credit to address the impact of any foreign tax withholding. g

Leasing Company Cars

Among consumers, leasing cars is increasingly popular. According to Experian Automotive, a data provider, 27.6% of new cars financed in the second quarter of 2013 were leased, compared with 24.4% one year earlier. Lease penetration has grown to the highest point since Experian started keeping track in 2006. Considering this trend, if you provide company cars to one or more employees, you might think about leasing rather than the traditional purchase arrangement.

Leasing company cars offers obvious advantages. Assuming that your company leases the cars for two or three years, your employees will always be driving a new or relatively new car on business. Leasing cars for no longer than three years can present a more professional image to clients and prospects and reduce the chance your employees will have major operating problems, which can affect productivity.

Leasing cars can deliver financial advantages, too. Upfront costs may be lower when you lease rather than buy a car. Monthly payments likely will be lower than you'd pay on a car loan.

The downside, of course, is that your company won't actually own the cars. Leased cars won't deliver the same resale value, and your company won't be able to enjoy the long-term cost savings that come from keeping a car after the purchase price has been fully paid. In addition, when you lease company cars, you'll have to urge employees to observe mileage restrictions and avoid unnecessary wear and tear.

Superior tax savings

Your company also may save tax by leasing its company cars. You'll pay sales tax only on the monthly lease payments, rather than on the full purchase price.

Once your employees are driving their leased company cars, your company can deduct the lease payments as well as all the related costs, from gas and oil to inspections and maintenance. You should make your employees aware that this tax treatment applies only to the business use of their company car. Therefore, they must keep a log or use some other method of substantiating their percentage of business car use, rather than personal use.

For your employees, personal use of their company car is considered a taxable fringe benefit. Thus, each year the company must determine the value of the fringe benefit for their employees with company cars, so those employees can pay the resulting income tax.

Among several allowable methods to put a value on personal use, most companies use the Annual Lease Value table, found in IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, to determine the value of personal use of leased company cars.

Example: ABC Corp. provides employee Sarah Perkins with a leased car; Sarah gets the car when it's new with a fair market value of $35,000. According to the IRS lease value table, the annual lease value of that car is $9,250.

Sarah's logs show that she drives the leased car a total of 15,000 miles this year, including 3,000 miles (20%) for personal use. Therefore, she has a personal use factor of 20%, so her personal use is valued at $1,850: 20% of $9,250. Consequently, ABC reports that Sarah had $1,850 of taxable fringe benefits from her used car.

Our office can help your company create a reporting system that complies with IRS regulations. g

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