



Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business AdvisorSM

Tax-Wise Portfolio Rebalancing

July/August/September
2017



Studies indicate that savvy asset allocation may lead to long-term investment success. Individuals can find a desired mix of riskier asset classes, such as stocks, and relatively lower risk asset classes, such as bonds. Sticking with a chosen strategy might deliver acceptable returns from the volatile assets, as well as fewer fluctuations along the way from the stable assets. An asset allocation could consist of a simple blend of stocks and bonds, plus an emergency cash reserve. Alternatively, an asset allocation can include multiple asset classes, ranging from small-company domestic stocks to international mega corporations to real estate.

Investors may put together their own asset allocation, or they might work with an investment professional. Either way, the challenge is to maintain the desired allocation through the ups and downs of

the financial markets. The answer generally recommended by financial advisors is to rebalance periodically.

Sell high, buy low

Once your asset allocation is in place, it can be reviewed at regular intervals or after significant market moves.

Example 1: Ellen King has a basic asset allocation of 60% in stocks and 40% in bonds. However, the bull market of recent years moved her portfolio to 75% in stocks and 25% in bonds. Ellen is uncomfortable with such a large commitment to stocks, which have crashed twice in this century.

One solution is for Ellen to move money from stocks to bonds, going back to her desired 60-40 allocation. Many investors are reluctant to follow such a plan, leaving a hot market for one that's out of favor. Nevertheless, investors who follow market momentum—buying what's been popular and selling what's been devalued—historically have received subpar results. Going against the crowd by buying low and selling high may turn out to be more effective.

Tax trap

Rebalancing is inherently an inefficient tax process. Investors are always selling assets that moved above the desired allocation,

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Money on the Move

In 2016, nearly \$260 billion flowed out of stock funds, almost \$107 billion flowed into bond funds, and another \$86 billion or more went into taxable money market funds.

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Gaining From Losses

- ✓ If your capital losses in a calendar year exceed your capital gains, you will have a net capital loss to report on your tax return for that year.
- ✓ Up to \$3,000 of net capital losses can be deducted on your tax return each year.
- ✓ Larger net capital losses can be carried over to future years.
- ✓ By accumulating losses, you may eventually be able to take taxable gains when you rebalance yet owe little or no tax due to losses taken in prior years.

which generally means taking gains. Such gains can be taxable and may add to an individual's reluctance to rebalance.

How can investors rebalance their asset allocation without feeling whipsawed by taxes? Here are some possibilities:

- **Bite the bullet.** As long as the securities are held for more than 12 months, profits on a sale will qualify for long-term capital gains rates, which are lower than ordinary

income tax rates. Paying some tax may be worthwhile if it reduces portfolio risk.

Also, if Ellen has a diversified mix of stocks and stock funds, she could selectively sell long-term shares with the least appreciation, resulting in the lowest tax bill, unless she believes there are investment reasons to sell her big gainers.

- **Don't sell.** If there are no sales, no tax will be due.

Example 2: Assume that Ellen's portfolio consists of \$100,000 in bonds and \$300,000 in stocks. Instead of selling stocks, Ellen could hold on to them and avoid a taxable sale. Meanwhile, her future investing could go entirely into bonds; dividends from her stocks and stock funds could be invested in bonds and bond funds. Gradually, her asset allocation would move from 75-25 to 70-30 to 65-35, heading towards her 60-40 goal.

Suppose that Ellen is retired, spending down her investment portfolio instead of building it up for the future. In this situation, Ellen could tap her stocks for income, decreasing her allocation. To hold down taxes, she could liquidate stocks selectively, as mentioned.

- **Bank losses.** Investors may hold various positions in individual

securities and funds, including some that have lost value since the original purchase. Health care stocks and funds, for instance, generally had losses in 2016, although the broad market had gains. When price drops on specific holdings are significant, a sale can generate a meaningful capital loss, perhaps making rebalancing easier in the future (see Trusted Advice column "Gaining From Losses").

- **Use tax-favored retirement accounts.** Taking gains inside plans such as 401(k)s and IRAs won't generate current taxes. Therefore, Ellen may be able to do some or all of her rebalancing, tax-free, by moving from stocks to bonds within her IRA. This tax-efficient flexibility may be one factor to consider when deciding whether particular investments should go into a taxable or a tax-deferred account. Holding a mix of asset classes on both sides may permit more tax-efficient rebalancing.

The methods described here are not mutually exclusive. You might find that combining tactics will help you rebalance and maintain your asset allocation without triggering steep tax bills. ■

The Third Best Investment You Can Make



The second-best investment you can make is paying off high interest rate debt (see *CPA Client Tax Letter, January/February/March 2017*). That could come after you've contributed enough to your 401(k) to get a full match from your employer. What should come next? If you have no expensive debt to pay down and you're getting the full employer match, where should you direct your money? Here are some suggestions.

Unmatched 401(k) contributions

In 2017, employees can contribute up to \$18,000, or \$24,000 if they're at least age 50. Few (if any) company matches are that generous.

Example 1: Julie Benson earns \$100,000 a year. Her employer's 401(k) match is dollar-for-dollar, up to 6% of pay, so Julie will put at least \$6,000 into the plan this year to get \$6,000 in "free money" from the match. Julie, age 45, could contribute another \$12,000.

Such a contribution is easy to do, with the money flowing directly into the 401(k) with every paycheck. The deferred income won't be subject to income tax and any investment earnings can compound, untaxed. Other possible advantages include access to plan loans, offered by many companies, and considerable shelter from creditors.

That said, the main benefit of an unmatched 401(k) contribution is income tax deferral. If you are in a relatively high tax bracket now and expect to be in a lower bracket when you take withdrawals in retirement, maximizing 401(k) contributions could pay off. On the other hand, tax deferral might not appeal to workers in their 20s with modest incomes, perhaps deferring tax in a 15% bracket, who will face uncertain tax rates on distributions decades from now.

Roth IRA contributions

A Roth IRA is always funded with after-tax dollars, so there is no upfront tax benefit. However, distributions from a Roth IRA, made after the 5-year period beginning with the first tax year of a contribution to a Roth IRA and after the Roth IRA owner reaches age 59½, are completely tax-free. Therefore, putting some money into a Roth IRA can provide a source of tax-free cash in retirement instead of, or in addition to, taxable withdrawals of money from a 401(k). Roth IRA contributions can be up to \$5,500 in 2017, or \$6,500 for those 50 or older.

Example 2: Assume that Julie Benson, with her \$100,000 salary, desires to save \$15,000 for retirement this year. Julie might put \$6,000 into her 401(k) to get the match and put \$5,500 into a Roth IRA. That would total \$11,500, so Julie could achieve her \$15,000 savings goal by contributing another \$3,500 to her 401(k) without a match.

Roth IRA owners never have required distributions, which generally impact pretax retirement funds after age 70½. It's true that income limits may

crimp Roth IRA contributions—single taxpayers can't contribute for 2017 with modified adjusted gross income of at least \$133,000, or \$196,000 on joint tax returns.

However, there are no income limits for making nondeductible contributions to a traditional IRA and then converting that amount to a Roth IRA. This workaround won't generate income tax for people who have no pretax money in traditional IRAs.

Roth IRAs may be especially appealing to people in relatively low tax brackets now, who will get only modest tax savings from unmatched 401(k) contributions.

Health savings accounts

Another possibility exists for people with certain high deductible health insurance coverage. Besides paying for the insurance, such people can have a health savings account (HSA) that offers unique tax advantages.

HSAs have no income limits. Contributions, which are tax deductible, can go up to \$3,400 for 2017 and up to \$6,750 for those with family coverage. (People 55 or older can contribute \$1,000 more.) Inside an HSA, earnings are tax-free and distributions are untaxed if the HSA owner spends at least that much on qualified health care costs.

Example 3: Suppose that Julie Benson is eligible for an HSA. With single coverage, Julie contributes \$3,400 this year, which she invests in stock funds. Although past performance is no guarantee of future success, stocks historically have done well over long time periods. Therefore, Julie hopes that annual contributions to her HSA will provide her with a substantial fund to tap for medical bills in retirement.

Besides contributing \$6,000 to her 401(k) to get the full match, and \$3,400 to her HSA, Julie can still contribute \$5,500 to a Roth IRA for a total of \$14,900 in 2017. Each of these options has features that go beyond those mentioned in this article, but they all may

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Roth IRA Distributions

- ✓ Roth IRA owners do not include distributions that are a return of regular contributions in their gross income.
- ✓ "Qualified distributions" from a Roth IRA also are not included in gross income.
- ✓ A qualified distribution is any payment from a Roth IRA made after the 5-year period beginning with the first taxable year of a contribution to a Roth IRA, and
 - ✓ made after the date the Roth IRA owner reaches age 59½;
 - ✓ made because of the Roth IRA owner's disability;
 - ✓ made to the Roth IRA owner's beneficiary or estate after death; or
 - ✓ that qualifies as a "first-time homebuyers' distribution" (up to a \$10,000 lifetime limit).

be viable choices for retirement investing. Our office can explain their tax impact on your particular situation. ■

Did You Know?

For the lowest air travel prices, purchase tickets on a Sunday. If you're traveling within the United States, buying on Sunday can cut prices by 11% compared with the average for other days. Sunday savings for flights from the United States to Europe are even better for travelers: 16%.

Source: expedia.com

After-Tax Dollars in Traditional IRAs

Workers under age 70½ can deduct contributions to a traditional IRA, as long as they are *not* covered by an employer's retirement plan. The same is true for those workers' spouses.

If these taxpayers *are* covered by an employer plan, they may or may not be able to deduct IRA contributions, depending on the taxpayer's income. (See Trusted Advice, "Deducting IRA Contributions.") However, all eligible workers and spouses can make nondeductible contributions to a traditional IRA, regardless of income.

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Deducting IRA Contributions

- ✓ Single filers who are covered by a retirement plan at work cannot deduct traditional IRA contributions for 2017 with modified adjusted gross income (MAGI) of \$72,000 or more in 2016 (\$72,000 for 2017 IRAs).
- ✓ On joint tax returns, covered workers are shut out from deductible IRA contributions with MAGI of \$119,000 or more for 2017.
- ✓ A spouse who is not covered by a retirement plan at work and files jointly with a covered worker can deduct IRA contributions as long as joint MAGI is less than \$196,000 for 2017.
- ✓ Other income limits apply to contributions to Roth IRAs in which contributions are never deductible, but future distributions may be tax-free.

Inside a traditional IRA, any investment earnings will be untaxed.

Dealing with distributions

Problems can arise for people who hold nondeductible dollars in their IRAs when they take distributions. Unless they're careful, they may pay tax twice on the same dollars.

Example 1: Marge Barnes has \$100,000 in her traditional IRA on September 15, 2017. Over the years, she has made deductible and nondeductible contributions. Assume that \$25,000 came from nondeductible contributions, \$45,000 came from deductible contributions, and \$30,000 came from investment earnings inside Marge's IRA.

Now Marge wants to take a \$20,000 distribution from her IRA. She might report \$20,000 of taxable income from that distribution; indeed, Marge's IRA custodian may report a \$20,000 distribution to the IRS. However, Marge would be making a mistake, resulting in a tax overpayment.

Cream in the coffee

To the IRS, a taxpayer's IRA money must be stirred together to include pre-tax and after-tax dollars. Any distribution is considered to be proportionate. If Marge were to pay tax on a full \$20,000 distribution, she would effectively be paying tax twice on the after-tax dollars included in this distribution.

Example 2: After hearing about this rule, Marge calculates that her \$25,000 of after-tax money (her nondeductible contributions) was 25% of her \$100,000 IRA on the date of the distribution. Thus, 25% of the \$20,000 (\$5,000) represented after-tax dollars, so Marge reports the \$15,000 remainder of the distribution as a taxable withdrawal of pre-tax dollars. Again, this would be incorrect.



Year-end calculation

Tax rules require an IRA's after-tax contributions to be compared with the year-end IRA balance, plus distributions during the year, to calculate the ratio of pre-tax and after-tax dollars involved in a distribution.

Example 3: Assume that Marge's IRA holds \$90,000 on December 31, 2017. Her \$100,000 IRA was reduced by the \$20,000 distribution in September, but increased by subsequent contributions and investment earnings. Therefore, Marge's IRA balance for this calculation is \$110,000 (the \$90,000 at year-end plus the \$20,000 distribution). This assumes no other distributions in 2017.

Accordingly, Marge divides her \$110,000 IRA balance into the \$25,000 of after-tax money used in this example. The result—22.7%—is the portion of her distribution representing after-tax dollars. Of Marge's \$20,000 distribution, \$4,540 (22.7%) is a tax-free return of after-tax dollars, and the balance (\$15,460) is reported as taxable income. Marge reduces the after-tax dollars in her IRA by that \$4,540, from \$25,000 to \$20,460, so the tax on future IRA distributions can be computed.

Form 8606

As you can see, paying the correct amount of tax on distributions from IRAs with after-tax dollars can be

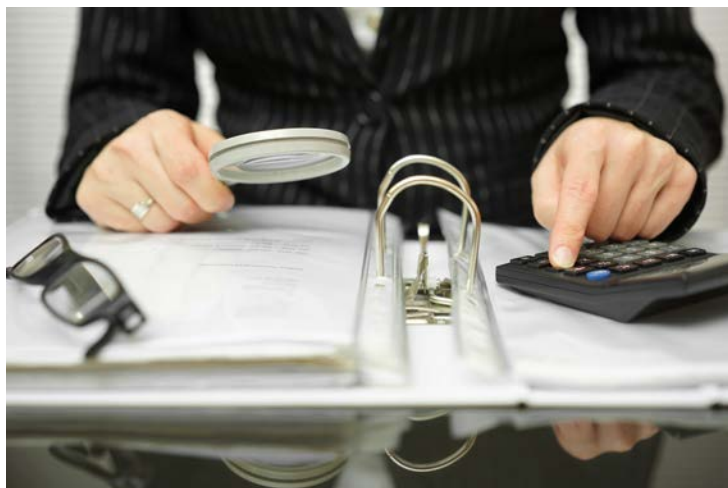
complicated. Without knowledge of the rules, an IRA owner may overpay tax by reporting already-taxed dollars as income. However, keeping track of after-tax and pre-tax dollars may not be simple, especially for taxpayers

with multiple IRAs and multiple transactions during that year.

The best way to deal with this issue is to track pre-tax and after-tax IRA money by filing IRS Form 8606 with your federal income tax

return each year that your IRA holds after-tax dollars. Our office can help prepare Form 8606 for you, when it's indicated, and, thus, prevent this type of double taxation. ■

Dealing With an IRS Audit



IRS data indicate that fewer than 1% of all individual income tax returns are audited each year. That's true, but some taxpayers are more vulnerable than others. For starters, the IRS is more likely to audit taxpayers who report high incomes because that's where larger amounts of underpaid taxes might be found.

The latest numbers from the IRS reveal that about 1.5% of all taxpayers with income in the \$200,000-\$500,000 range are audited. With income from \$500,000 to \$1 million, the percentage increases to around 3.8%, while more than 8.4% of taxpayers with seven-figure incomes may face IRS questions.

In addition, certain taxpayers face more scrutiny because of how they earn their living. Self-employed individuals—generally, those who file Schedule C, Profit or Loss From a Business—may be audited more than

other taxpayers. The same is true for professionals and business owners, who could see their business as well as their individual tax returns examined. The bottom line is that taxpayers with relatively high incomes as well as those

who have control over their workplace bookkeeping can expect to face IRS queries at some point.

Triple threats

If you're wondering how you should respond when you're audited, the answer is straightforward: Call our office. We'll let you know how to proceed, and offer assistance if professional help is warranted. Nevertheless, receiving correspondence from the IRS (or from your state's tax authority) can be a stressful experience. The following summary of audit types may ease the pressure a bit, by spelling out what will be required:

- **Correspondence audit.** These audits are the most common. Generally, they relate to a relatively minor discrepancy, such as faulty paperwork. You often can respond by mail to verify an item on your tax

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Audit rights

- ✓ Notices must include the amount (if any) of the tax, interest, and certain penalties you owe and must explain why you owe these amounts.
- ✓ If the IRS fully or partially disallows a refund claim, it must explain the specific reasons why.
- ✓ If the IRS proposes to assess tax against you, it must provide a letter with an explanation of the entire process from examination (audit) through collection, and explain that the Taxpayer Advocate Service may be able to assist you.
- ✓ This IRS letter must tell you about a possible review by an independent Office of Appeals.
- ✓ Help with *Understanding Your IRS Notice or Letter* is available online at IRS.gov.

return and never have to meet anyone from the IRS.

- **Office audit.** These examinations involve a visit to an IRS office, where you'll meet with someone from the agency. In a typical situation, you'll be informed of the issue involved and instructed to bring documents to support what you reported on your tax return. If you've

deducted substantial charitable contributions, for example, you could be asked to bring canceled checks, acknowledgment letters from the recipients, and other required materials.

- **Field audit.** Here, the IRS will visit your home or office for the audit. These audits might be more far-reaching, or the examiner might want to check on something specific, such as home office deductions you've claimed.

Know your rights

For any type of audit, professional assistance can be valuable. Indeed, you're entitled to have a CPA, an

attorney, or an enrolled agent represent you at an office or a field audit. In such a situation, it may be possible for the audit to take place at your CPA's office.

You also can receive help in requesting a postponement, if you need time to gather your records. If you must be present during the audit, you should answer all questions accurately, but there's no need to volunteer any information that the IRS does not request. If an appeal of IRS findings seems warranted, your CPA can handle that as well.

Practice prudence

Avoiding an audit may be difficult if you're self-employed, a business owner,

or a highly-compensated employee. Probability may put you under the IRS spotlight someday.

Recognizing your vulnerability, take steps to minimize your financial exposure in case the IRS selects you for an audit. Report your income and your justifiable deductions accurately. Don't overlook income reported on various 1099 Forms. In case of grey areas, discuss the matter thoroughly with the professional preparing your tax return and carefully consider extremely aggressive positions.

Keep in mind that the IRS communicates first by U.S. mail. If you receive an email purporting to be from the IRS, or a phone call demanding immediate payment, it's a fake. ■

Safe Harbor 401(k) Plans for Small Companies

Among employer-sponsored retirement plans, 401(k)s have become the standard. Some prospective employees assume that a job will come with a 401(k). Therefore, offering a 401(k) at your company may help you hire desired workers, and help you retain valued employees.

That said, there can be drawbacks to sponsoring a traditional 401(k). Such plans require annual testing to ensure that a 401(k) does not discriminate in favor of highly compensated employees, including owner-employees. Failing such a test may limit the amount that company principals and certain others may contribute to the plan, resulting in a reduced tax-deferred retirement fund for key individuals.

One solution is to offer a safe harbor 401(k) for your small business. A study released in late 2016 by Employee Fiduciary, a 401(k) provider for small businesses, found that 68% of the small firms responding to the survey use a

safe harbor 401(k) plan design to avoid annual nondiscrimination testing. A safe harbor 401(k) allows sponsoring companies to avoid these tests, providing the business makes certain contributions to employees' accounts. The mandatory employer contributions are always 100% vested.

Employer options

Employers have several ways to reach this safe harbor. Many companies prefer the "basic match" approach. Here, the company matches 100% of employee contributions to the 401(k), up to 3% of compensation, plus a 50% match on contributions up to 5% of pay. Thus, the maximum match is 4% of an employee's compensation. (Some companies use an "enhanced match," which might be 100% on the first 4% of pay.)

Alternatively, employers can shelter in a safe harbor with a "nonelective contribution." Here, the company

contributes 3% of compensation to each eligible employee's 401(k) account, regardless of whether a worker is making elective deferrals.

Either way, the safe harbor contributions can be limited to employees earning less than \$120,000 in 2017.

Considering the costs

Safe-harbor 401(k)s might not be a good fit for every small business. The required employer contributions may wind up being extremely expensive. Other efforts, such as employee education that increases contributions from non-highly compensated workers, may be a more cost-effective approach. Also, safe harbor 401(k)s have certain notice requirements. If you are interested in a safe harbor 401(k) for your company, our office can explain the notice requirements and provide an estimate of the cost involved, to help you make an informed decision. ■