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Client Tax Letter

Smart tax, business and planning ideas from your Trusted Business Advisor℠

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Making stock sales less taxing

Patient investors generally have prospered over the long term. Nevertheless, there are many reasons for selling stocks. Knowing the basics can help improve your tax position.

Selling shares held in a taxable account will trigger taxable capital gains or losses, unless the sale proceeds are exactly the same as your basis — your cost for tax purposes. If you are making a complete sale from an investment position, the calculation of basis is fairly simple.

Example 1: Joan Harris has owned shares of ABC Large Company Growth Fund in a taxable account for many years. In March 2019, she sells all of those shares for $42,000. Joan has invested $25,000 in those shares and reinvested $2,800 of dividends from the fund, so her basis is the total: $27,800. Thus, her taxable gain is the $14,200 difference.

Many fund companies will track purchases and dividend reinvestments for shareholders; the companies also will report the amounts of long-term and short-term gains (reflecting whether assets were held for more than a year), which are taxed at different rates. Not all fund companies provide complete records, so it's a good idea to keep careful track of your securities transactions.

Note that Joan will have a tax obligation even if she asks fund company ABC to move all of her money in ABC Large Company Growth Fund to ABC Small Company Value Fund. If this transaction occurs in a taxable account, a gain or loss will be reported.

Partial parting

The situation is different if an investor sells part of a position in a security.

Example 2: Suppose Joan requests a sale of $20,000 from the large company growth fund, out of her $42,000 holding. As noted in example 1, Joan has invested and reinvested in those shares over a period of years. In this case, Joan can choose among multiple options for tax reporting.

- **First in, first out (FIFO).** Assume that this fund's shares are priced at $20 on the date of the sale. Joan will be selling 1,000 shares; with FIFO, that would be the first 1,000 shares that she purchased. As long as fund company ABC keeps track, it will report the amount Joan paid for those 1,000 oldest shares. If Joan paid a total of $11,000 for those shares, her gain will be the $9,000 difference.

In this issue

Plumpest pension

In 2019, the maximum Social Security benefit for someone retiring at full retirement age (now 66) is $2,861 a month, or $34,332 a year.

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Double category averaging

- Another method, "double category" averaging (separate averages for long-term and short-term holdings), was used in the past. That option has been abolished.
- Investors who were using the double category method for stock acquired before April 1, 2011, must figure basis by averaging together all identical shares of stock in the account on that date, regardless of the holding period.
- This applies when an investor sells, exchanges, or otherwise disposes of that stock.

The disadvantage of choosing FIFO is that the taxable gain may be high after a long period of stock market growth. On the other hand, the entire sale may qualify as a favorably taxed long-term capital gain, if all the shares were held for more than a year.

- **Specific identification.** As the name indicates, with this method the investor designates the shares to be sold. To sell 1,000 shares, Joan might indicate the 500 shares bought in January 2016 and the 500 shares bought in April 2017. Assuming those shares were those with the highest purchase prices, Joan may be able to minimize her capital gain or obtain a capital loss, which can provide tax benefits. This method requires careful record keeping, and you will have the burden of proving the basis in the designated shares at the time of the sale.

The preceding choices are available to all investors, whether they hold mutual funds or individual securities. Another method is available only to mutual fund investors and to investors in certain dividend reinvestment plans.

- **Average cost.** With this method, you divide the amount you have invested and reinvested in a given fund, before a sale, by the number of shares you held then. If you choose this method, you must use it for all future sales of that fund's shares.

Example 3: As previously explained, Joan calculates that she has put a total of $27,800 into ABC Large Company Growth Fund. At the time of her sale, she owns 2,100 shares, trading at $20. Dividing her $27,800 investment by her 2,100 shares, Joan calculates the average cost at $13.238 per share.

In our example, Joan sells $1,000 shares at $20, to receive $20,000. With an average cost of $13.238 a share, Joan's basis in the 1,000 shares sold is $13,238. By receiving $20,000, she has a $6,762 taxable gain. Note that some of those gains may be short-term if Joan has bought any shares in the fund within a year or less from the sale date.

Inside a tax favored plan

If you trade shares inside a tax favored plan, such as a 401(k) or an IRA, you won't trigger income tax. That's true no matter how much profit you have on the relinquished shares. Taxes apply only on distributions.

Bond ladders may hedge interest rate hikes

Volatility and high prices might make some investors leery of stocks now. Similarly, the threat of rising interest rates may worry fixed income investors. Rising rates tend to depress bond prices.

Therefore, a time-tested strategy might be useful in the current environment. You could put together a bond ladder to hold the fixed income portion of your asset allocation. A ladder might consist of many individual issues with staggered maturities. As the nearest "rung" on your ladder is redeemed, the proceeds are reinvested in a bond with a longer maturity.

Example 1: Paula Morris decides to allocate $200,000 of her fixed income holdings to a bond ladder. She invests $25,000 in bonds maturing in 2020, $25,000 in bonds expiring in 2021, and so on, out to 2027. Typically, the longer the maturity, the higher the bonds' yields and the greater the exposure to price drops if interest rates rise.

When the bonds that make up Paula's 2020 rung are redeemed at maturity, she invests the $25,000 proceeds in bonds maturing in 2028, and so on, year after year.

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Flex plan

With such a ladder, Paula will have $25,000 worth of bonds maturing each year. If interest rates rise in the future, as many observers expect, Paula will be able to buy higher yielding bonds, raising her periodic cash flow from investment interest.

Conversely, interest rates might surprise the "experts" and move lower. Paula will be re-investing at a lower yield, it's true, but she likely will be glad that she has locked in higher-than-current yields with her bonds on the later rungs.

Ultimately, Paula will wind up with a ladder that comprises bonds that were all bought at 8-year maturities. Historically, that has been a relatively attractive place on what is known as the *yield curve*, a plot of yields and maturities. Eight-year bonds often have yields much greater than those of very short-term bonds as well as moderate exposure to rising rates. That is, a bond issued with an 8-year maturity may not suffer a price drop as steep as a 10- or 20-year bond will experience, if interest rates trend much higher.

Taxable or tax-exempt

Investors often use tax-exempt municipal bonds for their bond ladders. If so, the bond ladder should be held in a regular taxable account to take advantage of the tax break. Bonds issued within the buyer's state of residence often avoid state or local income tax as well as federal tax.

For IRAs and other tax-deferred retirement accounts, bond ladders generally should be constructed from corporate bonds or other taxable issues. Yields generally are higher than they are in comparable municipal bonds, and those yields can compound inside the tax-deferred plan.

Either way, if you are building a bond ladder now, buying existing, rather than newly issued, bonds, be aware that older bonds generally trade at a premium because they have higher yields than today's new issues.

Example 2: When Paula puts together her bond ladder, she pays $27,500 to buy bonds maturing in 2027 with a face value of $25,000. She builds in a $2,500 loss in return for receiving above-market yields for the next eight years, up until maturity.

You shouldn't expect huge profits from a bond ladder. Instead, you should consider a bond ladder as an arrangement that could possibly improve portfolio income and stability over a long period of time. Every year, you can expect an untaxed bond redemption that you can spend or save as you choose.

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Bond premium taxation

- If you pay more than face value to buy tax-exempt bonds, you must amortize the premium each year. The amount of the tax-exempt interest from the bonds that you report on your tax return is reduced by the amortized amount.
- Amortization of the premium reduces your basis in the bond by the amortized amount; the amortized amount is not deductible.
- If you pay more than face value to buy taxable bonds, you can choose to amortize the premium. If you choose to do so, the amortized amount is deductible, and your basis in the bonds is reduced by the amortized amount.
- If you choose not to amortize the premium on taxable bonds, the premium will create a tax loss when the bonds are redeemed at face value.

The SALT deduction limits will affect home sales

The Tax Cuts and Jobs Act (TCJA) of 2017 sharply raised the standard deduction and placed limits on itemized deductions. In particular, no more than $10,000 can be deducted in state and local tax (SALT) payments on a single or joint tax return.

As a result, most people will take the standard deduction now and get no tax benefit from their property tax payments. Even those who itemize may get little or no tax benefit from their property tax payments if they also have ample outlays for state and possibly local income tax. The bottom line is that property tax payments will be fully or mainly out-of-pocket expenses for most homeowners — and for many home buyers — with reduced federal tax savings as an offset.

When the TCJA was passed, some observers predicted that this effective cost increase would significantly bring down home prices.

Example: John and Mary Smithe pay $20,000 a year in property tax. They

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had been in a 28% tax bracket, giving them a $5,600 (28% of $20,000) federal tax saving, resulting in a net cost of $14,400. If this couple sells their home, the buyer could owe the full $20,000 a year in property tax. This might reduce the home's appeal to buyers, who would offer lower bids than would have been offered in the past.

Broadly, such price declines have not happened. The U.S. House Price Index Report from the Federal House Finance Agency shows a 5.8% growth in prices from November 2017 to November 2018. Nevertheless, residential housing markets are very local, and it is likely that the new tax rules are affecting numerous transactions, especially in areas where property taxes are steep.

For sellers

If you are planning to sell a primary residence or second home, be aware that buyers probably will raise questions about the ongoing property tax they will incur. You should know the amount you're paying now and the amounts you have paid in the past. If the growth rate has been modest, or if your home is taxed less than those in your neighborhood, tell your real estate agent. Then, your agent can use this fact as a selling point.

All homeowners, particularly those who plan a sale, should investigate the possibility of reducing their property tax bill. You should find out the procedure for obtaining a lower assessment in your community and see if you might qualify. Any reduction in annual tax obligation may be worth the effort, from increased cash flow today and a potentially higher selling price tomorrow.

For buyers

If you are planning to buy a house, know your tax situation. Will you be taking the standard deduction? Will your itemized SALT deductions be capped? You'll know whether you'll get any tax savings from deducting property tax, so you will know what to expect in after-tax costs from a home purchase. If those costs, which are likely to rise in the future, might strain your budget, you can drop your bid price or look for another place with lower property taxes.

IRS says business meal deductions still apply

The TCJA generally disallowed all deductions for business entertainment, amusement, and recreation. However, the TCJA did not specifically turn thumbs up or down on the deductibility of business meal expenses.

Example 1: Jim Morgan, who owns a roof cleaning business, takes a prospect to lunch and pays the $60 bill. Under the old law, Jim could take a $30 (50%) tax deduction.

Is this still the case? In Notice 2018-76, issued in the second half of last year, the IRS clarified that such business meals generally remain 50% tax deductible. Proposed regulations will be published in the future, but business owners can rely on Notice 2018-76 in the interim.

Essentially, this notice confirms that anything that might be considered entertainment won't be a deductible expense. The IRS's list includes night clubs, theaters, country clubs, sports events, and so on. Regular business meals, on the other hand, may still qualify for the 50% deduction.

Five points

Drilling down, the IRS listed five tests that must be passed in order to support the deduction:

1. The expense must be an ordinary and necessary expense, paid or incurred in carrying on a trade or business.
2. The meal can't be considered lavish or extravagant, considering the business context.
3. The taxpayer (or an employee) must be present.
4. The other party must be a current or potential business customer, client, consultant, or similar business contact.
5. In the case of food and beverages provided during or at an entertainment activity, the food and beverages must be purchased separately from the entertainment, or the cost of the food and beverages must be stated separately from the cost of the entertainment on one or more bills, invoices, or receipts and must be priced reasonably.

Example 2: Carol Clark takes a client to a baseball game, where Carol buys hot dogs and drinks for herself and the client. The cost of the game tickets is not deductible. Carol can deduct 50% of the cost of the food and beverages as long as she can show that these outlays were separate from the ticket cost.

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Note that the IRS uses the expression "food and beverages" in this notice. This may imply that the cost of taking a business contact out for coffee or alcoholic drinks may be 50% deductible, even if no meal was served.

It's also worth noting that activities generally perceived to be entertainment may be deductible business expenses — if you're in an appropriate business. The IRS gives examples of a professional theater critic attending a play and a garment manufacturer conducting a fashion show for retailers. Our office can let you know if some type of entertainment could be considered deductible advertising or public relations for your company.

Supreme Court decision in *Wayfair* affects online sellers

If your company makes sales to out-of-state buyers, do you need to collect state sales tax? Until recently, Supreme Court decisions from the 20th century declared that would not necessarily be the case.

Example 1: ABC Corp., based in Alabama, sends a catalogue to customers and prospects. A consumer who lives in Wyoming places a $100 order.

Assume that ABC has neither employees nor property in Wyoming. ABC would not be required to collect Wyoming sales tax on the $100 purchase price and remit to Wyoming under those Supreme Court decisions because ABC had no "physical presence" in that state. (Wyoming, like most states, requires consumers to pay a use tax instead of a sales tax, but states have found it difficult to enforce compliance with their use taxes.)

Because they must collect sales tax, in-state retailers have been at a significant disadvantage versus out-of-state sellers who don't collect sales tax.

South Dakota v. Wayfair

The 20th century reasoning of the physical presence requirement did not recognize the realities of the 21st century, a divided (5-4) Supreme Court found last year. In *South Dakota v. Wayfair, Inc.*, 6/21/18, the Court held that the physical presence requirement no longer applied, paving the way for enforcement of a South Dakota law that requires many "remote" sellers to collect applicable sales tax on purchases by South Dakota residents.

The majority in the *Wayfair* decision pointed to some favorable aspects of the South Dakota law. For one, it applies only to remote sellers with at least 200 transactions or $100,000 in revenue from South Dakota buyers in a calendar year. Therefore, a company that occasionally ships a few moderately priced items across state lines needn't master all the sales tax rules pertaining to South Dakota buyers and collect the tax and remit it to the state.

In addition, South Dakota is a party to the Streamlined Sales and Use Tax Agreement, which reportedly has 24 member states. This agreement, designed to standardize taxes in order to reduce administrative and compliance costs, provides sellers access to sales tax administration software.

Going forward

After this Supreme Court decision, many (perhaps most) states will consider new legislation that requires out-of-state vendors to collect and forward sales tax, even without a physical presence in the buyer's state. However, Congress might pass a federal law addressing the issue of interstate sales tax collection.

If no federal law is passed, the focus will remain on states' actions. Assuming that states follow the format of the South Dakota law, companies that do a minimum amount of online retailing may not be greatly affected.

Conversely, small businesses that do a great deal of selling online, or plan to do so, might have to make extensive efforts to collect and forward sales tax to multiple states. Our office can help such companies comply with any requirements that arise.

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Tax law enhances the appeal of C corporations

Many owners of private companies have been leery of operating as a regular C corporation. If you make that choice, you will be exposed to double-taxation of business income.

First, a corporate income tax applies to the company's profits. Second, any dividends that pass to you and other shareholders will be subject to personal income taxes. Making matters even more expensive, your C corporation won't get an income tax deduction for the dividends it pays out.

Pain relief

The TCJA has made this tax parlay easier to bear. Personal income tax rates generally have come down: the top federal rate, from now through 2025, has been lowered from 39.6% to 37%, for example.

During these years, corporate income will be taxed at a flat 21%, regardless of the amount. (Formerly, there was a graduated tax schedule, going up to 35%.) These tax rate reductions, combined with the retention of the 15% or 20% tax rates on qualified dividends received (which are based on the capital gains rates), may make it cost effective to operate your business as a C corporation.

Example: Mike Morton owns 100% of a C corporation, which has a $100,000 profit this year. The company pays $21,000 in corporate income tax, at 21%, and pays the $79,000 balance as a dividend to Mike.

Assume Mike and his wife Nora owe the maximum 20% tax rate on the dividend, as well as the 3.8% net investment income tax on that dividend: 23.8% of $79,000, or about $18,800. Altogether, the total tax on that $100,000 of company profits is $39,800, which is much less than it would have been, under the 2017 tax rates.

Pros and cons

Other factors should be weighed when deciding on a business entity. For example, C corporations have some tax advantages, such as the ability to deduct the cost of certain fringe benefits and not pass on imputed income to significant shareholders.

At the same time, C corporations pose other tax perils. Owners may have to contend with possible unreasonable compensation (paying too much in salary and bonus) and excess accumulated earnings (saving too much, rather than paying dividends) issues. Our office can help you put numbers on all of these looming tax traps, so you can make an informed decision.

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