CPA

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

May 2017

Tax-Wise Portfolio Rebalancing

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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What's Inside

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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Trusted Advice

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. ■

Social Security Strategies That Still Work

Recent legislation has reduced Social Security claiming strategies for married couples. For example, if you failed to initiate a "file-and-suspend" plan before April 30, 2016, that opportunity is no longer available.

Still available

Another popular approach for married couples—filing restricted applications for spousal benefits—is still viable, but only for those who reached age 62 on or before January 1, 2016. The people who were grandfathered for this tactic have age 66 as their full retirement age (FRA). At FRA, someone in this age group can apply for Social Security retirement benefits, restricting the claim to a benefit that's based on the other spouse's work record.

Example 1: Nick and Paula Robinson are married. Nick worked for more years than Paula, earning higher pay, so Nick has the larger Social Security benefit.

Suppose Paula is now age 64. She can file a restricted application to get a spousal benefit at age 66, her FRA. Paula's spousal benefit could equal 50% of Nick's benefit. Paula could collect this spousal benefit while her own benefit, based on her work history, continues to grow at 8% a year under current law.

Paula can collect a spousal benefit until age 70, the latest possible starting date. Assuming that Paula's own benefit at some point will exceed the spousal benefit she receives on Nick's work record, Paula would eventually receive her own, larger benefit.

Example 2: Assume the same facts as in example 1. If Nick meets the age requirement, he can file a restricted application to start his spousal benefit at age 66, his FRA. At this time, he could collect a benefit based on Paula's work record. Meanwhile, Nick's own retirement benefit can keep growing at 8% a year until as late as age 70. (A restricted application by one spouse requires the other spouse to be receiving benefits.) If you meet the age requirement for a restricted benefit, our office can help you calculate the method that will likely have the greater payout.

No restrictions

Such restricted applications are available only to certain people who are 63 and older in 2017. Even so, there are other opportunities for all married couples to consider in their planning for Social Security.

Example 3: Steve and Vicki Baker are married, with both reaching age 61 this year. They can't use the restricted application strategy, as explained previously. Suppose both Steve and Vicki have substantial work histories, so they'll both receive sizable Social Security benefits, but Vicki's benefit would be larger. One plan is for Steve to begin his own benefits at age 62, the earliest date possible, while Vicki waits until age 70.

Assuming Steve is retired (so he won't have earnings that reduce his Social Security benefits), Steve's benefits would provide eight years of cash flow while the couple is in their 60s. This would make it easier for the Bakers to wait until Vicki reaches age 70 to start benefits; her larger benefit would increase by approximately 8% a year while she waits to start.

Moreover, if Vicki is the first spouse to die, Steve would receive the amount Vicki was receiving, as a surviving spouse. If Steve dies first, Vicki would continue to receive her larger benefit.

Uneven benefits

Among married couples, there may be one spouse who will get a much larger Social Security retirement benefit, often because the other spouse focused on raising the children and managing the household. How might such couples proceed?

Example 4: Jim Lawson has contributed much more to Social Security than his wife, Marie. Therefore, Jim will be entitled to a $2,600 monthly benefit at his FRA, but Marie's FRA benefit will be only $800 a month. One approach is for Jim to claim benefits at his FRA and begin receiving $2,600 a month. Marie, who is the same age as Jim, also could claim at her FRA. If so, Marie would receive a spousal benefit that's 50% of Jim's benefit—$1,300 a month, in this example—which would be larger than her own. Here, Marie will get a large increase in benefits if she's the surviving spouse.

Another strategy might work for spouses of different ages.

Example 5: Suppose that Marie Lawson is a few years younger than her husband, Jim. If Jim can wait to start benefits until he's age 70, he'll get the maximum monthly benefit. Marie could start at age 62, the earliest possible date, claiming benefits on her own work record. Marie would receive a reduced benefit because she started so early, but she'd still obtain some cash flow.

Marie could wait until Jim is 70 and claims his maximum benefit then claim a spousal benefit, which might increase her Social Security checks. Again, increasing Jim's Social Security benefit will also increase Marie's survivor's benefit, if Jim predeceases her.

Deciding when to start Social Security will depend on many factors, such as health and the need for income. Our office can crunch the numbers for you to help you proceed. ■

With Retirement Plans, SIMPLE May Be Better

In 2017, if a company sponsors a profit-sharing plan, the company could make a contribution on behalf of the business owner of as much as $54,000 (see the ***CPA Client Bulletin, January 2017***). With a SIMPLE IRA, the maximum amount this year is $31,000. If that's the case, why would you consider the latter choice?

One reason can be found in the plan's name; a SIMPLE (**s**avings **i**ncentive **m**atch **pl**an for **e**mployees) IRA has less paperwork as well as lower start-up and operating costs, compared with many other types of retirement plans. As long as your company is eligible (it must have no more than 100 employees and must not sponsor another retirement plan), you can set up the plan by filling out IRS Form 5304-SIMPLE or 5305-SIMPLE.

Subsequently, there is no annual filing requirement and no testing for discrimination in favor of highly-compensated employees. The only other requirement is annual notification, which you can meet by sending each employee a copy of the original 5304-SIMPLE or 5305-SIMPLE.

A SIMPLE IRA also can work if you are just starting a company and have no employees. With other retirement plans, adding workers may require some extensive paperwork. With a SIMPLE IRA, the company just sets up an IRA for each employee who joins the plan. A SIMPLE IRA must be offered to all employees who were paid at least $5,000 in any prior two years and who

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are expected to earn that much in the current year.

Contribution considerations

Eligible employees can defer up to $12,500 of their compensation in 2017, deferring the income tax as well. Those 50 or older can defer up to $15,500.

With a SIMPLE IRA, employers must make certain contributions to employees' accounts. All money that goes into a SIMPLE IRA is totally vested for the employee.

One option is to match each employee's contribution, up to 3% of pay. (An employer may choose to match as little as 1% of employees' contributions, for one or two years during the five-year period that ends with [and includes] the year for which the employer chooses the lower match percentage.)

Example 1: Sue Taylor, who works for ABC Corp., earns $60,000 a year. She contributes $6,000 to her SIMPLE IRA in 2017. ABC, which chose the matching option, contributes $1,800 (3% of $60,000). Therefore, the total amount moving into Sue's account in 2017 is $7,800.

Continuing with the ABC Corp. example, suppose that Richard Palmer, the chief shareholder, is 54 years old. Richard defers the maximum $15,500 of his salary to his SIMPLE IRA. If he earns more than $516,667 in 2017, a 3% match would be another $15,500, bringing Richard the maximum $31,000 SIMPLE IRA contribution this year.

Instead of matching, a company sponsoring a SIMPLE IRA can make non-elective contributions of 2% of pay for each eligible employee, even for those who don't contribute.

Example 2: Walt Vincent works for XYZ Corp., where he earns $50,000 a year. XYZ has chosen to make non-elective contributions to its employees' SIMPLE IRA. Even though Walt does not contribute this year, XYZ must make a contribution of $1,000 (2% of $50,000) to Walt's SIMPLE IRA. These non-elective contributions are capped by an annual compensation limit, which is $270,000 in 2017. As a result, with this method a company's contribution to any employee's SIMPLE IRA can't exceed $5,400 this year (2% of $270,000).

Fine points

During the first two years they are in the plan, SIMPLE IRA participants owe a 25% penalty for in-service withdrawals before age 59½. After two years have passed, the regular 10% early withdrawal penalty applies. During those first two years, rollovers from a SIMPLE IRA to a traditional IRA are prohibited.

Eligible companies generally must establish a SIMPLE IRA by October 1 in order to have the plan in effect for the current year. However, different rules apply to new companies that came into existence after October 1 in a year, and existing companies that previously maintained a SIMPLE IRA plan. ■

TAX CALENDAR

MAY 2017

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2017. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

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

JUNE 2017

June 15

Individuals. If you are not paying your 2017 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2017 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2016. If you want additional time to file your return, file Form 4868 to obtain four additional months to file, then file Form 1040 by October 16.

Corporations. Deposit the second installment of estimated tax for 2017.

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

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