Wagner, Ferber, Fine & Ackerman, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

66 SOUTH TYSON AVENUE
FLORAL PARK, NY 11001
(516) 328-3800

237 WEST 35TH STREET
NEW YORK, NY 10001
(212) 576-1829

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor(sm)

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The Math of Buy and Hold

Many financial advisers warn clients that they should not try to time the stock market. Indeed, research indicates that individuals tend to buy when stocks are going up and sell when stocks have gone down: a buy-high and sell-low approach that reduces long-term returns. Consequently, some investment pros support a strategy known as "buy and hold."

Example 1: Julia Martin consults with a financial planner and agrees to an asset allocation of 60% in stocks and 40% in bonds. Although Julia may periodically change the stocks and stock funds she owns, for specific reasons, she maintains this 60-40 asset allocation for many years. Not until she approaches retirement and desires a more conservative portfolio does Julia trim her stock position to 40% of her holdings.

Patience can be prudent

Assuming that Julia holds well-chosen stocks and funds, this strategy probably will provide Julia with the market's long-term returns, which historically have been excellent. According to Morningstar's Ibbotson subsidiary, through 2014, large-company U.S. stocks have had annualized returns around 8% for the past 10 years, 10% for the past 20 years, 11% for the past 30 years, and 12% for the past 40 years. (Those returns assume dividend reinvestment, no taxes, and no transaction costs.)

Going back nearly 90 years, to the beginning of the Ibbotson data base, U.S. stocks have annualized returns of about 10%. Generally, the numbers for stocks are significantly higher than the returns for bonds or cash equivalents. That's no guarantee of future success, but it's telling that U.S. stocks have been good long-term investments through recessions, depression, wars, turmoil, booms, and busts.

Putting those numbers in perspective, assume that investors in the future net 7.2% a year from stocks, long term. At that rate, money doubles in about 10 years. If that's the case, a $10,000 investment today would grow to $20,000 by 2025, $40,000 by 2035, and $80,000 by 2045. Thus, buy-and-hold investors

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Shopping Spree

Istanbul's Grand Bazaar is the world's most popular tourist attraction, with over 91 million visitors a year.

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can expect to enjoy portfolio growth if they can stomach the price volatility along the way.

Stress test

However, dealing with stock price volatility is not just an emotional matter. There are dollars-and-cents implications as well. In the two bear markets of this century (2000–2002 and 2008–2009), the broad U.S. stock market dropped by about 50% of its value each time.

Example 2: Assume that Julia had $400,000 of U.S. stocks in mid-2008, with a portfolio basically aligned with major indexes. By early 2009, her stocks were worth only $200,000. After that 50% drop in value, Julia needed a $200,000 gain—100% of her early 2009 portfolio—just to get back to the $400,000 she had in mid-2008. Indeed, it wasn't until 2013 that stocks recovered all of their losses.

Such a steep loss and prolonged recovery period can be disheartening. The damage might be especially severe if it occurs just before you need the cash to fund a home purchase or a college education, for example. Retirees who are drawing down their portfolios, without earned income to invest at lower stock prices, may run short of money after an ill-timed bear market.

Tax treatment

Wary investors may want to move out of stocks after years of positive returns. Such a tactic will lock in profits and reduce exposure to a market correction. However, selling stocks at a profit can trigger capital gains tax. The basic tax rate on long-term capital gains (for assets held more than one year) is 15%, but the rate for high-income investors is 20%. The total payment may be increased by state tax, the 3.8% tax on net investment income, and various other tax code provisions.

Example 3: Assume that Julia now holds $500,000 worth of stocks, which she purchased for $280,000, for a $220,000 gain. Also assume a total tax obligation of 25%, federal and state. Julia would owe $55,000 in tax (25% of $220,000) on a sale of all her stocks, leaving her with a net of $445,000. From that point, Julia would need only a 12% gain to get back what she lost in taxes, when she decides that stocks are once again an attractive asset class.

Summing up

All investors should have a plan tailored to their specific needs, perhaps one that was created by a financial adviser. In general terms, though, buy-and-hold investing can be an effective strategy for truly long-term purposes.

Timing the stock market may not work, but reducing stock positions after a long upward surge might result in less exposure to a coming pullback. Even at today's higher tax rates, taking stock market gains can be less expensive than suffering a sharp bear market setback. Indeed, trimming appreciated stock positions in tax-favored accounts such as IRAs will eliminate immediate tax obligations. ■

Passive Activity Losses From Rental Property

In these times of high stock prices and low bond yields, investors might be thinking about rental property. Such investments can pay off, in the right situation. Before you make any decisions, though, you should be aware of the tax implications, especially the passive activity loss rules.

Despite the language, those rules don't apply to familiar investments that might seem passive, such as buying corporate stocks or government bonds. Rental property is deemed to be a passive activity, so the passive activity rules typically apply to individual investors acting as landlords. Investing in real estate may deliver untaxed income, but deducting losses can be challenging. (The rules are different for individuals who are real estate professionals, but specific qualifications must be met.)

Depreciating while appreciating

Investment property owners can take depreciation deductions, even if the property is gaining value. What's more, this deduction requires no cash outlay.

Example 1: Brett Parker buys investment property for $400,000 and collects $1,800 in monthly rent. Thus, his annual income is $21,600. His out-of-pocket expenses (interest, insurance, maintenance) total $12,000, so Brett collects $9,600 in positive cash flow this year, in this hypothetical example.

Suppose that Brett can claim $16,000 of depreciation deductions as well. Now Brett reports $21,600 of income and $28,000 ($12,000 plus $16,000) of expenses from the property, for a net loss of $6,400.

Brett has reported a loss, so no income tax will be due on his rental income. For Brett, this would be $9,600 of tax-free cash flow. If he

Did You Know?

California and Colorado taxpayers had the highest chance of an IRS audit in 2014. Other Western states in the top seven were Nevada, New Mexico, and Arizona. Yet, North Dakota taxpayers were the least likely to be audited.

Source: TaxAudit.com

also can deduct the $6,400 loss from his other income, the tax treatment would be even better.

Loss lessons

In one scenario, Brett has another rental property that generates $7,500 of net income. This passive activity income from Property B can be offset by the $6,400 loss from Property A, so Brett reports a taxable profit of only a net $1,100.

However, many people won't have passive activity income to offset, or their passive activity loss will be greater than that income. In those cases, deducting the loss from other income is possible, if certain conditions are met.

For one, investors must play an active role in managing the property. That doesn't mean you'll have to screen tenants or fix toilets. You can hire a property manager but still play an active role, for this purpose, by making decisions involving the property's operation or management.

Another condition of deducting losses from a rental property relates to your adjusted gross income (AGI). A deduction as great as $25,000 per year is permitted, but the deduction phases out as your AGI climbs from $100,000 to $150,000. That phaseout range is the same for joint or single filers.

Example 2: Joan, Janice, and Jennifer Smith are sisters; they each own rental property that shows a loss this year, after deducting depreciation. Joan's AGI is $95,000, so she can deduct her rental property loss this year, up to the $25,000 maximum. Janice's AGI is $155,000, so she can't deduct any loss from her rental property. (However, because Janice reports a loss, she also won't owe tax on the cash flow she receives.)

Suppose that Jennifer's AGI is $130,000. She is 60% ($30,000/$50,000) through the phaseout range, so she'll lose 60% of her maximum loss deduction. Jennifer can deduct rental property losses up to $10,000 (40% of the $25,000 maximum) but won't be able to deduct larger losses.

Keep in mind that rental property losses you can't deduct currently are not gone forever. Unused losses add up, year after year, to offset future passive activity income. If you have unused losses from prior years, you can use them when your future AGI permits. Moreover, when you sell the property, you can use all of your banked losses then to reduce the tax you'll owe on the sale.

Trusted Advice

Passive procedures

- Passive activities include trade or business ventures in which you do not materially participate; that is, you are not involved in the operation of the activity on a regular, continuous and substantial basis.
- Rental activities such as rental real estate ventures generally are passive activities for the rules on passive activity losses.
- The passive activity rules apply to individuals, estates, trusts (other than grantor trusts), personal service corporations, and closely held corporations as well as to the owners of grantor trusts, partnerships, and S corporations.

Nevertheless, a tax deduction you can take immediately is more valuable than a deduction years in the future. If your AGI is between $100,000 and $150,000, actions such as taking capital gains or converting a traditional IRA to a Roth IRA can raise your AGI and reduce current deductions for rental property losses. ■

Succession Planning for a Family Business

If you intend to name a family member to succeed you in running your company, you have some advantages. The person you'll name (probably your son or daughter, son- or daughter-in-law) is someone you can identify easily, without an extensive search. You know that person's capabilities and shortcomings; he or she likely works for the company now, so you have a good idea of how well the future owner will do.

That said, passing on your company to a family member can pose problems. Intra-family dynamics should be considered, which may not be the case if your successor is an outsider. Moreover, there are several methods of relinquishing ownership, all of which may be closely scrutinized by the IRS.

Seeing things clearly

Designating a family member as your successor can raise emotional issues. Does your son really want to run your business, working the long hours you've always put in? Is your

daughter truly eager to jump off the partner track at her law firm to take charge of your company? Be honest with yourself, even if it leads to painful conclusions.

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Example: Donna Allen realized that her two sons did not get along with each other, but she thought that would change as they grew older. Instead, their mutual animosity continues, and they're competing with each other to replace their mother as CEO of Allen Enterprises. Facing reality, Donna concluded that a 50-50 ownership solution would ruin her successful company. Thus, she is dividing the company into two firms, along product lines, so each son can be the sole owner of his own business in the future.

Playing fair

If you have more than one child, it's often the case that one will be the obvious successor. Passing on ownership to all the children and leaving one to run the company can lead to strife: The operator may feel like he or she is working to enrich siblings, and the outside owners might second-guess business decisions.

Naming the child who will manage the company as the sole owner may make sense, from a business perspective, but it also can deprive the others of a valuable asset. In such cases, it may be desirable to equalize the inheritances. (If you're married, your estate plan also should provide for a surviving spouse.)

Situations differ, but life insurance might offer a way to compensate family members who won't wind up with your valuable business.

Transfer tactics

Your estate plan also should focus on the method you'll use to keep your company in the family. Broadly, here are your options:

- **Sell it.** This mode has the obvious benefit of providing you with income in retirement, enabling you to enjoy the fruits of building the business. Coming up with enough cash for the buyout may be difficult for your younger successor, so it might be necessary to arrange financing or an installment sale so payments will come from future company earnings, in some manner.
- **Give it.** Another option is to transfer some shares to your successor during his or her lifetime. Gift tax may be avoided or minimized by using discounts for fractional interests in the company while ownership might be motivational. On the downside, such gifts can reduce the income you'll get from the business and you should have a strategy for dealing with other children.
- **Leave it.** You can simply hold onto the company until you die and bequeath it to your successor. This approach allows you to remain in control and perhaps receive income from dividends once you stop working. A lack of ownership, though, might discourage your chosen successor and lead to that person's leaving for another opportunity.

No matter which of these methods you choose, the IRS may challenge the valuation involved. A below-market sale, for example, could be recast as part sale and part taxable gift. Thus, having a reliable valuation of the company should be part of your all-in-the-family succession plan.

A sophisticated approach might involve a mix of selling, giving, and leaving your business to a younger relative. Tactics such as retaining income-producing shares while transferring operational control may be appropriate. Our office can help you put together a tax-effective strategy. ■

TAX CALENDAR

JULY 2015

July 15

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

July 31

Employers. For Social Security, Medicare and withheld income tax, file Form 941 for the second quarter of 2015. Deposit any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2014.

AUGUST 2015

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2015. This due date applies only if you deposited the tax for the quarter in full and on time.

August 17

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

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