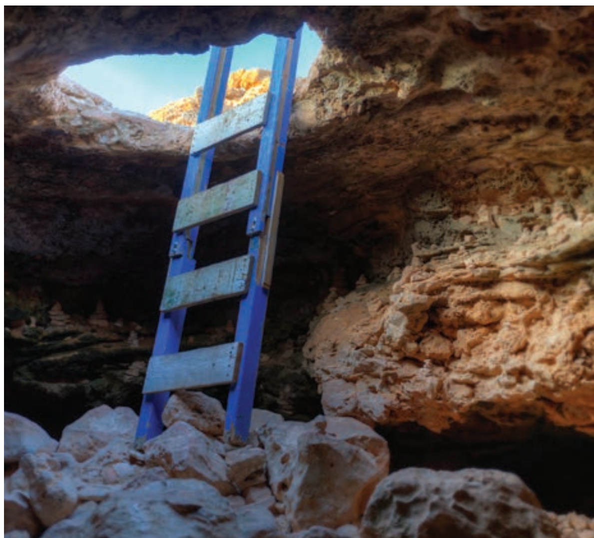
CPA
# Client Tax Letter
Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

January/February/March 2016

## Past Losses Offer Winning Opportunities



For nearly two decades, investors have been riding a stock market roller coaster. The late 1990s tech stock boom turned into a bust in the early years of this century, as the Dow Jones Total Stock Market Index fell by nearly 45%. After a real estate-led recovery pushed stocks to new highs, a real estate collapse dropped that index more than 50% from 2007 to 2008. Since then, the index has nearly tripled; as of this writing, U.S. stocks have gone through some down months but are still not far from record levels.

Despite this seeming up-and-down symmetry, stock market gains and losses are not taxed equally. When you file your annual income tax return, all of your net capital gains are taxed. That's true whether you have $1,000 of gains or $100,000 of gains. Moreover, you'll owe tax on gains taken by your mutual funds, even if you have all of your gains reinvested. (Gains in tax-favored retirement accounts aren't taxed currently.)

**Example 1:** Ann Baldwin executes trades in her taxable investment account in 2016 and reports $50,000 of long-term capital gains and no capital losses. Ann also owns mutual funds in that account, which report $10,000 of long-term capital gains distributions this year, which Ann has reinvested. Ann owes tax on the entire $60,000 gain.

**Example 2:** Carl Davis executes trades in his taxable investment account during the year and reports $50,000 of capital losses and no capital gains. Carl, too, owns mutual funds in his taxable account that report $10,000 of long-term capital

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### Knot Again

*In the latest year on record (2013), 4 out of 10 weddings included at least one person who had been married before.*

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gains distributions this year, which Carl has reinvested.

In example 2, Carl reports a net loss of $40,000 for the year (netting the $50,000 loss and the $10,000 fund distribution). However, the maximum annual net capital loss deduction is limited to $3,000 per year on a single or a joint income tax return.

## Carrying over

Therefore, Carl can deduct only $3,000 of his $40,000 net capital loss from the income on his 2016 tax return. What happens to the other $37,000 of Carl's net capital loss in 2016? It's a capital loss carryover, which Carl can use in the future. Such losses can offset net capital gains, dollar for dollar. Loss carryovers that aren't used this way can be deducted each year, up to $3,000.

**Example 3:** Carl carries over a $37,000 net capital loss from 2016. In 2017, he has a net capital gain of $11,000. Carl can completely offset that gain with his loss carryover, so he owes no tax on his gains that year. He still has a net loss of $26,000, so he deducts $3,000 from other income on his 2017 tax return. Going into 2018, Carl has a $23,000 net capital loss carryover.

**Example 4:** In 2018, Carl executes no taxable trades. On his tax return for that year, he takes a $3,000 net capital loss deduction from his carryover. Going into 2019 Carl will have a $20,000 net capital loss carryover. And so on, year after year.

As you can see, taking capital losses can save taxes, now or in the future.

## Using carryovers

It may make sense to use loss carryovers as soon as possible. If you have carryover losses from the 2008 financial crisis—or even from the bursting of the tech bubble eight years earlier—the long-running bull market in stocks might provide opportunities to use them up.

**Example 5:** Erica Foster has a total of $120,000 in loss carryovers, mainly from 2000 and 2008. At present, most of the stocks Erica owns have gained value since the purchase date. Erica is concerned that her exposure to the stock market is too high.

Thus, Erica sells the stocks of seven different companies she owns, for a total gain of $105,000. Using her loss carryovers, Erica will report no taxable gains for 2016. She'll still have a $15,000 loss carryover, so Erica can take a $3,000 deduction on her 2016 tax return, reducing her loss carryover still further, to $12,000.

Suppose, in our example, Erica is extremely concerned about a stock market pullback. She could use all the money from her stock sales to diversify away from the stock market and increase her holdings of bonds, commodities, cash equivalents, and so on. By such a move, Erica may have substantially reduced her risk in case of another stock market crash.

## Building basis

Liquidating stocks is not the only move you can make when you use up loss carryovers.

**Example 6:** Erica takes gains on seven stocks to use up most of her loss carryovers, as explained in example 5. In this scenario, though, Erica is only moderately worried about a future market crash. She uses the money from selling three of her stocks to buy bonds and increase her holdings of money market funds, reducing her stocks.

The money from selling the other four stocks is used the next day to buy back those stocks, which Erica believes have excellent future prospects. This buyback will raise Erica's basis in those stocks, reducing the taxable gain or increasing the capital loss on a future sale.

Suppose Erica invested $25,000 in ABC Corp. in 2009. This year, she sells those shares for $40,000. As explained, Erica will owe no tax on the $15,000 gain because of her loss carryovers. After the buyback, Erica will have a $40,000 basis in ABC, not a $25,000 basis, so she'll have improved her tax position without paying any tax.

## Unwashed

If Erica were to sell shares at a loss and buy them back any time in the next 30 days, the wash sale rules would prevent her from using the loss on her tax return. The wash sale rules don't apply to capital gains, though, so Erica is allowed to boost her basis in this manner. Our office can help determine if this tactic will be tax-effective for you.

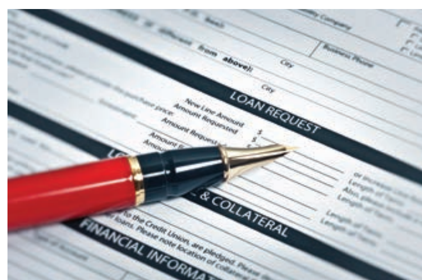
If you don't have loss carryovers from prior years, you still can benefit from knowing the tax treatment of capital gains and losses. Take losses regularly, as long as the trades fit in with your investment strategy. Use the capital losses to offset gains and take annual losses up to $3,000, whenever the losses you take during the year exceed the gains you take. Larger net losses can be carried over into future years and play a valuable role in your investment tax planning. ■

## Did You Know?

The current 10 best-selling cars in the United States range in basic price from $17,250 (Hyundai Elantra SE) to $24,300 (Hyundai Sonata SE Sport 2.4L 6-Speed Automatic). The top seller, the Toyota Camry L, costs $22,970 with basic features. Average annual insurance costs for all 10 models range from $2,551 to $2,862.

*Source:* WalletHub

# What You Should Know About Student Loans




Recently, concerns about student loans have been in the headlines. In 2015, the Federal Reserve Bank of New York put total student loan debt at $1.16 trillion, greater than outstanding auto loans or credit card balances. Publications such as the *New York Times* have published articles about "A Generation Hobbled by the Soaring Cost of College."

The reason for the growth in student loan debt is straightforward: Many families need to borrow money in order to cover the expense of higher education. If you're in that situation, knowing your choices can help you make practical decisions.

Today, most higher education loans come from the U.S. Department of Education. Broadly, they fall into one of two categories: student loans or parent loans.

## Student loans

The most common federal loans, formerly known as Stafford loans, are now called Direct Loans. Students are the borrowers; in order to be eligible for these loans (in fact, for any federal education loans), the student must fill out the Free Application for Federal Student Aid (FAFSA). There is no credit check, but there are limits on how much students can borrow. Typically, annual loans to undergraduate students who are parents' dependents can be as large as $5,500 for freshmen, $6,500 for sophomores, and $7,500 for others.

Besides an origination fee of approximately 1% of the amount borrowed, Direct Loans have fixed rates, set each summer, based on then-current interest rates. From July 2015 through June 2016, the fixed rate for Direct Loans is 4.29%.

Direct Loans are either subsidized (for students who demonstrate financial need) or unsubsidized. If a student has an unsubsidized loan, payments are due after the funds are disbursed. Borrowers can choose not to make payments until six months after leaving school, but all unpaid interest will be added to the loan balance. With subsidized Direct Loans, the federal government pays the interest until six months after the borrower leaves school.

Students with exceptional financial need may qualify for a federal Perkins Loan. If so, no interest will be charged until nine months after leaving school. The fixed interest rate is 5%, and loans to undergraduates go up to $5,500 a year.

For federal student loans, the standard repayment period is 10 years, but there are various extension, deferral, and even loan forgiveness opportunities. For example, some loans can be forgiven if a borrower teaches full time for at least five consecutive years in a school classified as "low-income" by the Department of Education.

## Parent loans

Formerly known as Parent Loans to Undergraduate Students, federal Direct PLUS Loans are offered to parents of undergraduates. (PLUS Loans also are available to graduate students.) Again, a student must fill out the FAFSA in order for a parent to get a PLUS Loan.

## Trusted Advice

### *Deducting Student Loan Interest*

- To deduct interest paid for education loans, you must have borrowed solely to pay qualified education expenses for yourself, your spouse, or a dependent.
- Loans from a related person or a qualified employer plan don't qualify.
- The maximum annual student loan interest deduction is $2,500.
- To get the maximum tax deduction, your modified adjusted gross income (MAGI) must be not more than $65,000 for a single filer, or $130,000 on a joint return. Reduced deductions are allowed with MAGI up to $80,000 or $160,000.

PLUS Loans can be as large as the total amount of college costs, minus any financial aid.

**Example:** Dave Evans attends a college where the posted cost of attendance is $40,000 for this academic year. Including a student Direct Loan, Dave receives financial assistance that totals $16,000. Thus, Dave's parents can borrow up to $24,000 ($40,000 minus $16,000) with a PLUS loan for that year.

The origination fee for a PLUS Loan is 4.272%, and the fixed interest rate is 6.84% for the 2015–2016 academic year. In order to receive a PLUS Loan, a parent must pass a credit check. If the parent's application is rejected, the child may be able to receive larger student loans.

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## Private loans

Although most student loans come from the federal government, some banks, credit unions, and other lenders offer education loans as well. Private loans can supplement or even replace federal education loans. Interest rates on private loans can be lower than federal rates for creditworthy borrowers—some are in the 3% range now.

However, private loans often have variable rates, which can rise if prevailing interest rates move higher. Private education loans may have relatively high fees, so borrowers should read all the fine print before making any decisions. Our office can help you determine the true cost of a private student loan you're considering.

Keep in mind that any loan can be an education loan, if the proceeds are used to help pay college bills. You might use a home equity loan or a home equity line of credit, for instance. Besides a relatively low interest rate, home equity debt may offer more opportunities to take a tax deduction for the interest you pay. Of course, you always should use home equity debt with caution because your home might be at risk if you default. ■

# Passive Activity Losses From Rental Property

In these times of still-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 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

## 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.

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.

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. ■

# Supreme Court Decision May Affect State Taxes

In May 2015, the Supreme Court decided a case involving Maryland state personal income taxes (*Comptroller of the Treasury of Maryland v. Wynne* [No. 13-485]). The narrow 5-4 outcome in favor of the taxpayers, in which the Court held that Maryland's personal income tax system violates the Constitution, could have far-reaching effects.

Maryland's state personal income tax has two components: a "state" income tax, imposed at graduated rates, and a "county" income tax, imposed at a single rate depending on an individual's county of residence. At the time of the dispute, Maryland offered a credit against the state tax for taxes paid to other states but not against the county tax.

Brian Wynne, a Maryland resident, was a part-owner of a health care company that operated nationally, filing income tax returns in 39 states. Because the company is an S corporation, its income flowed through to Brian and his wife, Karen, on their joint tax return. For the year in question, the Wynnes paid thousands of dollars in income tax to other states where the company operated. The Wynnes claimed a credit for the taxes paid to other states against their state and county income taxes. (A tax credit is a dollar-for-dollar reduction in tax owed.)

Maryland allowed the tax credit against the 5.75% state income tax but not against the county income tax. The couple challenged this determination administratively and in the courts, with the case eventually going to the Supreme Court, which held for the Wynnes. The Supreme Court held that Maryland's personal income tax system was invalid because it led to some income being taxed twice, by Maryland and the state in which it was earned. This favored intrastate over interstate commerce, which the Court found violated the dormant Commerce Clause of the U.S. Constitution.

## Gauging the impact

The decision will affect many Maryland taxpayers. According to some reports, about 8,000 residents have filed "protective refund" claims relating to this issue. Such claims preserve taxpayers' rights in case of a favorable turn of events. Based on these numbers, $200 million of refunds could be triggered. This could help the individuals and companies that paid tax to other states but strain revenues in Maryland going forward.

The issue may reach beyond the borders of Maryland as well. Across the United States, many cities, counties, and other local entities tax residents' income. If there are situations where business or individual taxpayers do not receive an offsetting tax credit, such laws might be invalid, in light of the Supreme Court decision.

**Example:** Bob Reynolds resides in a city with an income tax. Bob sells investment property in another state and incurs a taxable gain, thus requiring tax payments to the out-of-state jurisdiction as well as to his hometown. Unless Bob is entitled to an offsetting tax credit under his home state's law, he may want to pay both the out-of-state and the local income tax and then file a refund claim, mentioning the *Wynne* decision.

Our office can help you determine whether any out-of-state income is being taxed twice, and help you to file a refund claim, if appropriate. ■

# SIMPLE 401(k) Plans May Appeal to Employees

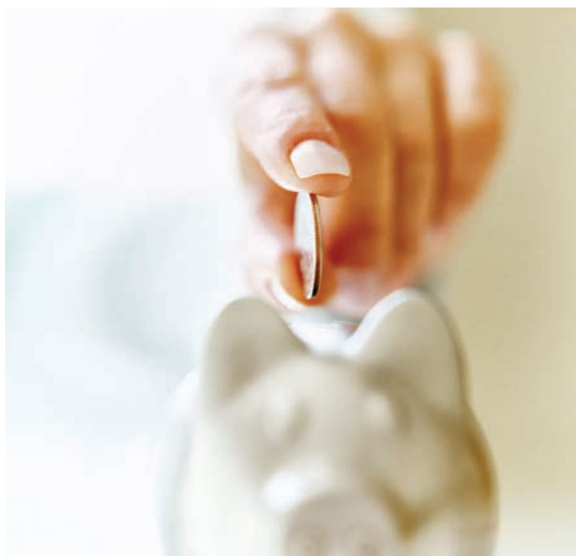
Many workers value employer-sponsored 401(k) retirement plans. Consequently, offering a 401(k) may help a small company attract and retain high-quality employees. Offering a standard 401(k) plan can involve considerable administrative time and expense, but business owners with fewer than 100 employees may find a practical solution in a SIMPLE 401(k).

SIMPLE 401(k) plans are very similar to the traditional 401(k)s from major employers. Eligible employees can contribute part of their compensation to the plan; workers owe no income tax on the contributed amount and can choose how the money is invested, picking from a menu of choices.

## Describing the differences

There are differences between SIMPLE 401(k) plans and the traditional version. In 2016, the maximum employee contribution to a SIMPLE 401(k) plan is $12,500, or $15,500 for those 50 or older. (In a traditional version, those numbers are $18,000 and $24,000.) In a traditional 401(k), employer matching is optional, but SIMPLE 401(k) plans require a match.

The required SIMPLE 401(k) match can be dollar-for-dollar, up to 3% of compensation for all participating employees. Alternatively, employers can contribute 2% of compensation for all eligible employees, regardless of whether they contribute to the SIMPLE 401(k). All SIMPLE 401(k) contributions, from employers and employees, are fully vested.



## Assessing the advantages

Why would you offer a retirement plan that requires an employer match? Especially a plan with lower contribution limits than a traditional 401(k)?

For one reason, the 401(k) label can help send the message that your company provides excellent employee benefits. Pointing out the required employer match can emphasize that idea, as some traditional 401(k) plans don't have matching contributions.

In addition, SIMPLE 401(k) plans live up to their names because they don't require discrimination testing. In the traditional version, employers must go to considerable lengths to show their plan doesn't favor highly-paid executives. If lower-paid workers fail to participate adequately in a traditional 401(k), key employees may find their permissible contributions reduced. That won't be an issue with a compliant SIMPLE 401(k).

## Simple selections

Compared with SIMPLE IRAs (which are similar in many respects), SIMPLE 401(k) plans require more administration. You must file IRS Form 5500 each year, for example. Still some employees and prospective employees may respond more favorably to the 401(k) label, which might sound more like a workplace plan and may offer plan loans, which SIMPLE IRAs don't have. That flexibility can add to a plan's appeal to workers (but may add to an employer's paperwork burden).

If this type of simple retirement plan might work for your company, you have until October 1 to decide on establishing a plan for 2016. ■

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