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CPA

Client Bulletin

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

April 2014

Is It Time to Trim Stocks?

In 2013, the benchmark Standard & Poor's 500 Index returned more than 32%, and the average domestic stock fund was up more than 31%, according to Morningstar. Major domestic stock market indexes are at or near record levels, as of this writing. Since the nadir of the financial crisis in early 2009, stocks have enjoyed a powerful five-year run.

Is it time to move out of stocks, or at least trim your holdings? Most commentators advise against trying to time the market. There's no way of knowing if we're at the top of the market, as we were in 2000 and 2007, or if we're just beginning an 18-year bull run like the one we enjoyed from 1982 to the 2000 peak.

Rebalancing act

Market timing may not be recommended, but many financial advisers favor the concept of rebalancing your portfolio. Here, you determine an asset allocation to suit your investment goals and your risk tolerance. If your actual allocation departs from the plan, you'll act to get your investment mix back on the chosen path.

Example 1: Megan Harris has a basic asset allocation of 65% stocks and 35% bonds. After a few years of a bull market, Megan's $400,000 portfolio is $300,000 in stocks (75%) and $100,000 (25%) in bonds. To rebalance, Megan would sell $40,000 of stocks and buy $40,000 of bonds. This would bring her to $260,000 in stocks (65%) and $140,000 in bonds (35%).

Note that Megan will still have a substantial amount invested in stocks, so she will continue to profit if stocks perform well. At the same time, she will have less exposure to a possible stock market reversal.

The Megan Harris example is extremely simplified. Today, many financial advisers advocate a portfolio that's diversified among multiple asset classes. Megan might hold international and domestic equities, large company and small company stocks, high grade and lower quality bonds, real estate securities, commodities and so on. Each asset class will have an allocation, and periodic rebalancing can keep the mix on track.

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What's Inside

Risks Rewarded

Leveraged equity mutual funds, which use derivatives such as futures and options to turbocharge stock market gains, have led Morningstar's mutual fund categories from 2009—2013 with annualized returns over 23%.

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Tax tactics

One advantage of continual rebalancing is that it encourages investors to sell after assets have appreciated and buy other assets that are currently out of favor. Long term, that can be a formula for successful investing. It's also a formula for realizing taxable gains. Some astute planning can reduce the tax bill, though.

One approach is to rebalance by executing your asset sales in a tax-favored retirement plan such as a 401(k) or an IRA. Then, any gains on the sale won't be taxed right away. By building up a substantial amount in such an account and holding a blend of asset classes in there, you'll increase your ability to rebalance without triggering taxes.

Another tax reduction method is to sell assets from a large holding within your portfolio, acquired at different times. Specify the shares you'd like to sell, choosing those with the least tax impact.

Example 2: As in our previous example, Megan Harris wants to rebalance her portfolio by selling $40,000 of stocks. She sells $15,000 of stock funds held inside her 401(k), avoiding a current tax bill, but Megan would like to sell another $25,000 of stocks in her taxable account.

Megan holds a large position in mutual fund ABC, which she has amassed over several years. She wants to reduce her exposure to this fund, so she sells $25,000 worth of fund ABC in her taxable account. When instructing her broker to make this sale, Megan specifies which shares to sell, choosing those that (*a*) have declined since her purchase or (*b*) have relatively small paper profits. Among the gainers, Megan focuses on the shares that have been held more than one year and, thus, qualify for the favorable tax rate on long-term capital gains.

Yet another way to reduce the tax on rebalancing gains is to build up a bank of capital losses by periodically selling assets that lose value after you buy them. (See the January 2014 *CPA Client Bulletin*). Such capital losses can offset taxable capital gains.

Our office can help you find the right tax reduction strategy if you are interested in rebalancing. ■

Supreme Court Bolsters Beneficiary Rights

A 2013 decision by the U.S. Supreme Court illustrates the importance of updating beneficiary forms regularly. If you don't, your desired heirs can lose a valuable asset.

This case, *Hillman vs. Maretta*, had its genesis in 1996, when Warren Hillman married Judy Maretta. Warren was a federal employee, so he named Judy as the beneficiary of his group term life insurance policy. The couple was divorced after two years, and Warren subsequently married Jacqueline. Warren and Jacqueline were still married in 2008 when Warren died; that life insurance policy's death benefit was nearly $125,000.

As it turned out, Warren had never changed the beneficiary designation on the policy. Thus, Judy received the death benefit, and Jacqueline went to court to get the money from Judy.

State versus federal

The case took place in the state of Virginia, which has passed a state law saying that a divorce or annulment revokes a beneficiary designation relating to death benefits. That sounds like it should have settled the matter, but Warren's life insurance policy was created under the Federal Employees' Government Life Insurance Act (FEGLIA), a federal law, and the U.S. Constitution states that federal law will trump state law when there's a conflict.

Nevertheless, Jacqueline still had a card to play. Virginia has another law saying, in essence, that if death benefits are turned over to a former spouse because of such a conflict, that former spouse is liable for the amount in question, payable to the person who otherwise would have collected. Thus, Jacqueline (Warren's widow) sued Judy for the amount of the insurance proceeds.

Court conflicts

Did federal law override state law, giving the life insurance benefits to Judy? All parties agreed that was the case. But did the second Virginia law prevail, allowing Jacqueline to ultimately collect the death benefits from Judy? That was the question dividing the Virginia courts and bringing the matter to the U.S. Supreme Court.

In 2013, the Supreme Court decided *Hillman vs. Maretta* in favor of Judy, the former spouse and the designated beneficiary. "FEGLIA establishes a clear and predictable procedure for an employee to indicate who the intended beneficiary shall be," the Supreme Court noted, so federal employees have an "unfettered freedom of choice in selecting a beneficiary and to ensure the proceeds actually belong to that beneficiary."

Did You Know?

Last year was the best year for the U.S. IPO market since 2000. A total of 222 companies went public, raising $55 billion, including recognizable names such as Hilton, Twitter, and Coty.

Source: Renaissance Capital

State law can't overturn that federal law's intent, the Court ruled.

Not every case will come down in favor of a former spouse. ERISA, a federal law covering retirement plans, gives a current spouse certain rights to death benefits from an employer's retirement plan, unless that right has been formally waived. Nevertheless, beneficiary conflicts can be time consuming, expensive, and stressful, especially if large amounts are at stake. Regularly updating all beneficiary forms can spare your loved ones from fighting what might wind up being a losing battle. ■

Business Owners Get More Bang From Flex Plan Bucks

Although all the effects of the Affordable Care Act (ACA) are still unclear, it's likely that health insurance costs will continue to increase in the future. Business owners may require greater health plan contributions from participating employees. In addition, this health care law already has made it more difficult for individuals to deduct medical outlays: For most taxpayers, only expenses over 10% of adjusted gross income (AGI) are tax deductible, versus a 7.5% hurdle under prior law. (The 7.5% rule remains in place through 2016 for individuals 65 and older and their spouses.)

In this environment, business owners stand to benefit substantially by offering a health flexible spending account (health FSA). These plans allow employees to set aside up to $2,500 per year that they can use to pay for health care expenses with pretax dollars.

Example 1: XYZ Corp. offers a health FSA to its employees. Harvey James, who works there, puts $2,400 into the plan at the beginning of the year. Each month, $200 will be withheld from Harvey's paychecks, and he'll owe no income tax on those amounts.

Going forward, Harvey can be reimbursed for his qualified medical expenses that are not covered by his health plan at XYZ. Possible examples include health insurance deductibles, copayments, dental treatments, eyeglasses, eye surgery, and prescription drugs. Such reimbursements are not considered taxable income. Thus, Harvey will pay those medical bills with pretax rather than after-tax dollars.

Health FSAs and the Affordable Care Act

Under the ACA, there are limitations on an employer offering a health FSA to their employees. Standalone health FSAs can only be offered to provide limited scope dental and vision benefits. An employer can only offer a health FSA that provides more than limited scope dental and vision benefits to employees if the employer also offers group major medical health coverage to the employees.

Additionally, an employer can make contributions to an employee's health FSA. However, under the ACA, the maximum employer contribution the plan can offer is $500 or up to a dollar-for-dollar match of the employee's salary reduction contribution.

Ultimately, these additional new rules can affect whether an employer can offer a health FSA and the amount of any optional employer match; our office can provide guidance for your specific situation.

Employer benefits

A health FSA's benefits to participating employees are clear. What will the business owner receive in return? Chiefly, the same advantages that come from offering any desirable employee benefit.

Trusted Advice

Paired Plans

- In most 401(k) and similar plans, an amount left by a participant who has not received benefits will automatically go to the surviving spouse.
- If a participant wishes to select a different beneficiary, the spouse must consent by signing a waiver.
- This waiver must be witnessed by a notary or a plan representative.

Recruiting may be strengthened, employee retention might increase, and workers' improved morale can make your company more productive.

There's even a tax benefit for employers, too. When Harvey James reduces his taxable income from, say, $75,000 to $72,600 by contributing $2,400 to a health FSA, he also reduces the amount subject to Social Security and Medicare withholding by $2,400. Similarly, XYZ Corp. won't pay its share of Social Security or Medicare tax on that $2,400 going into the health FSA.

Counting the costs

However, drawbacks to offering an FSA to employees do exist. The plan, including reimbursements for eligible expenses, must be managed. Many companies save headaches by hiring

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a third-party administrator to handle a health FSA, but there will be a cost for such services.

In addition, companies offering health FSAs to employees should have enough cash to handle a large demand for reimbursement, especially early in the year.

Example 2: Kate Logan also works for XYZ and she chooses to contribute $1,800 to her health FSA at the beginning of the year: $150 a month, or $75 per each semimonthly paycheck. Just after her first contribution of the year, Kate submits paperwork for a $1,000 dental procedure. XYZ might not have trouble coming up with $1,000 for Kate, but there could be a problem if several employees seek large reimbursements after making small health FSA contributions.

Using It, Losing It

Employers also should be sure that employees are well aware of all the implications of health FSA participation. For years, these plans have been "use it or lose it." Any unused amounts would be forfeited at year end.

Example 3: Mark Nash participated in an FSA offered by XYZ several years ago. He contributed $2,000 but spent only $1,600 during the year. The unspent $400 went back to XYZ.

In 2005, the rules changed. Now, if the FSA permits, participants have until mid-March of the following year to use up any excess. If XYZ had adopted this optional grace period, Mark Nash would have had an extra 2½ months to spend that leftover $400 on qualified medical costs.

Yet another change occurred in late 2013—a $500 option. Under this provision, FSA plans can be amended to allow each employee a carryover of up to $500, from one year to the next. Plans with this $500 carryover provision cannot allow a grace period as well. If your company now has an FSA with this optional grace period, it will have to amend the FSA to eliminate the grace period in order to add the $500 carryover provision. Our office can help with the necessary paperwork.

In addition to explaining all the rules on possible forfeitures, employers offering an FSA should be sure their employees know about a possible impact on Social Security benefits. As mentioned, FSA contributions aren't subject to Social Security; those contributions aren't included in official compensation, for Social Security purposes. Employees should know that reduced compensation today might reduce Social Security benefits tomorrow. Companies that spell out all the FSA implications to workers may reduce misunderstandings and future complaints. ■

TAX CALENDAR

APRIL 2014

April 15

Individuals. File a 2013 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, "Application for Automatic Extension of Time To File U.S. Individual Income Tax Return." Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2014 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2014 estimated tax. Use Form 1040-ES.

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

Household employers. If you paid cash wages of $1,800 or more in 2013 to a household employee, file Schedule H (Form 1040). If you are required to file a federal income tax return, file Schedule H with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2012 or 2013 to household employees. Also, report any income tax you withheld for your household employees.

Partnerships. File a 2013 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), "Partner's Share of Income, Deductions, Credits, etc.," or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2013 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2014.

MAY 2014

May 12

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2014. 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.

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