

CPA Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business AdvisorSM

Financial Resolutions for the New Year



With the calendar turning to 2010 and the winter holidays past, now is a great time to create a to-do list of financial steps to take this year. Here are some suggestions.

Make a plan

In fact, make three plans: with short, intermediate, and long-term goals.

- Your short-term plan can cover what you'd like to do this year, such as maximize contributions to your company's retirement plan.
- An intermediate term plan might set out what you hope to do over the next three to five years, such as buy a primary residence or a second home.
- For the long term, your goal might be to retire at age 62, with enough money saved for a comfortable retirement.

With these plans in place—and, ideally, in writing—you can track your progress every month or quarter and make adjustments to your personal money management if necessary.

Get matching contributions

If your employer offers a retirement plan such as a 401(k) with an employer match,

contribute at least as much of your 2010 salary as required to get the maximum match. If you don't get your full employer match, you're forfeiting free money.

Build a cash reserve

Financial advisors often tell clients they should keep three to six months' worth of expenses in cash to handle unexpected expenses. If you have ample home equity and a home equity line of credit that you can access easily, three months' worth of spending money may be adequate. If you do not have ready access to a line of credit, you may prefer to have six months of expenses in your emergency fund.

Here's one way to determine how much you should keep in cash:

Example: Matt Bernard decides to maintain a six month cash reserve. In 2009, his gross income was \$100,000; Matt paid \$20,000 in total taxes and saved \$10,000. Therefore, Matt calculates he spent \$70,000 last year: \$100,000 minus \$30,000. If he spent \$70,000 over the past 12 months, he'll need \$35,000 in cash to provide a six month cushion.

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Your cash reserve should be accessible. Thus, you should be able to obtain that money quickly, without paying taxes or penalties. A one year certificate of deposit may not be a good choice because you'll lose interest if you make a premature withdrawal. Instead, you generally should hold cash in a money market fund or bank account that permits penalty free withdrawals.

In addition, you should not hold your cash reserve in an IRA or similar tax-advantaged retirement account. You'll probably owe tax (and perhaps a 10% surtax if you're under age 59½) on withdrawals, so a \$10,000 cash reserve might be worth only \$7,000 or \$7,500 in spendable dollars.

Pay down debt

If you pay down the balance on a credit card that charges a 12% interest rate, for example, you will effectively earn 12%, after tax, with no investment risk. You also may do well to pay off other types of debt, depending on the interest you're paying and whether it is tax deductible. Our office can help you calculate your after-tax return if you prepay a home mortgage, student loans, or other outstanding debt.

Protect yourself and your family

You probably have many insurance policies—in fact, you may not be aware of all the coverage you have. At the same time, you may lack some vital types of insurance. Therefore, you should promise yourself to review your current insurance. Include any policies you have acquired on your own as well as benefits provided by your employer.

Once you know what you have, you can decide whether to add missing coverage. Alternatively, you might be able to cut back on unnecessary insurance and save money on future premium payments. Generally, insurance falls into one of two categories.

Property/casualty: This category includes homeowners' and auto insurance. You probably will want enough coverage for losses or damages to these valuable assets. Just as important, you should have adequate liability coverage to protect your personal net worth if someone is injured in a home or auto accident. In fact, you may decide you need an "umbrella" policy for extended liability coverage.

Life and health: These coverages include health, life, disability, and long-term care insurance. Many employers provide some coverage and offer

employees the chance to buy more at favorable rates.

To see whether you have enough coverage, you may want to schedule two meetings with insurance professionals: one who specializes in property/casualty and one who deals with life and health policies. After these meetings, you may decide you should have more coverage. More coverage, however, means higher costs. Indeed, you may be surprised to discover how much you're paying for all of your insurance. If you'd like to cut insurance costs without increasing your risk of financial catastrophe, you might be interested in assuming higher deductibles for some coverage.

Our office can help you evaluate the tradeoff between paying lower premiums and assuming responsibility for uninsured outlays. ■

Your CPA Client Bulletin Has a New Look!

Welcome to the inaugural issue of the redesigned *Client Bulletin*. Please enjoy its contemporary look and full color images. We're happy to hear your feedback!

Making Sense of Mutual Funds' Returns

If you decide to invest through mutual funds, you'll have literally thousands of funds to choose among. Hoping that your fund will do well in the future, you'll likely look for a fund that has done well in the past. You'll have to go over a great deal of data in order to make an informed decision.

Set your sights

Your fund choice may partially depend on how long you intend to keep it. Some investors buy mutual funds in the hope of catching hot sectors.

Example 1: Alicia Warren allocates 10% of her investment portfolio

to trend spotting. She knows that emerging markets stock funds will have some high return time periods; high yield bond funds also have their quarters or even years of superior performance. Alicia aims to catch such trends and ride them until she takes profits and moves her money elsewhere.

Alicia may decide to focus on results from the past few months. If a fund's share price starts to move up rapidly, she might decide to investigate that fund more closely. Alicia could, for example, look at previous periods when that category of fund did

well and see if a particular fund outperformed the category average. (Mutual fund data is available at the sponsoring company's website as well as research sites such as www.morningstar.com.)

Other investors may view mutual funds as long-term holdings. Indeed, investors who buy some funds for short-term results also might hold others for years.

Example 2: While Alicia Warren allocates 10% of her portfolio to short-term mutual fund purchases, she invests the other 90% in funds that she expects to hold for the long term. For

these selections, she pays less attention to recent results. Instead, Alicia looks at fund performance for the previous 5 years and 10 years. If a fund has been around long enough, she will evaluate the results of the past 20 years, which cover several bull and bear markets in stocks and bonds.

Drilling down

If you take this long-term view, you might see that Fund ABC's average return was 9% per year for the past 10 years, while Fund XYZ, which is in the same category of stock funds, had an average return of 7%. Does that mean ABC had the better record? Not necessarily.

Looking at the calendar year results for the past 10 years, you might see that ABC had greater gains than XYZ in 2003–2007, when stocks enjoyed steady gains, and also in the rebound year of 2009. XYZ had lower returns in those years but smaller losses in 2002 and 2008. In 2000 and 2001, XYZ had modest gains; ABC had losses. Therefore, ABC's long-term superiority stemmed from some

outstanding years, but XYZ generally gave investors less year-to-year volatility.



From such a pattern, you might infer that ABC is likely to be more aggressive in its investment strategy than XYZ. Depending on how long those funds have been in existence, with the same management, you might go back even further and try to detect similar patterns. If returns patterns are indeed similar, you might decide to invest in ABC for the long term because you can live with volatility in pursuit of higher returns. If you'd prefer a less nerve-racking mutual fund, you may choose XYZ instead. ■

Trusted Advice

According to the Employee Benefit Research Institute:

- ❖ After rising each year from 2003 through 2007, the average 401(k) retirement account fell by 24.3% in 2008.
- ❖ Even after that decline, the median (mid-point) 401(k) account balance increased at an average annual growth rate of 11.4% over the six-year period.
- ❖ The median 401(k) account balance was \$43,700 at the end of 2008.

Therefore, the best way to build a retirement fund is to make regular contributions, good years or bad.

Selecting a Structure for Your Small Business

If you decide to go into business, you must choose how to structure the business. Operating as a sole proprietorship is the easiest approach: you don't have to fill out any startup forms, and you'll have little ongoing paperwork to handle. However, sole proprietors are personally liable for claims against the business. Furthermore, raising capital for a sole proprietorship can be difficult; thus, most business owners who envision a growing company choose another form of business entity.

C corporations

This structure is also known as a "regular" corporation because it has been the norm. If you hold shares of a publicly traded company, you

probably are part owner of a C corporation.

Business owners may have many reasons for incorporating, including limited liability. That is, shareholders generally are not personally liable for the company's debt. If the company is sued or files for bankruptcy, the owners' personal assets are not at risk.

There are drawbacks to operating a company as a C corporation, however. You must comply with requirements for filings, corporate minutes, and so forth. Perhaps most important, C corporations are subject to the corporate income tax. Your C corporation may be taxed on its net income for the year. In addition, if the company passes out some of those profits to you, you'll

owe tax on that dividend income. Therefore, some dollars will be subject to double taxation. On the other hand, if your C corporation has a loss, you'll receive no direct tax benefit.

S corporation

With an incorporated business, you also may be able to elect S corporation status. In order to make this election, your company must meet certain requirements. It must have no more than 100 shareholders, for example, and none of those shareholders can be other corporations or nonresident aliens. In addition, an S corporation cannot have more than one class of stock.

If your company qualifies for S corporation status, you will enjoy the same limited liability granted to C

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corporation shareholders. In addition, S corporations can deliver tax benefits. Losses are passed through to individual shareholders (and can be deducted to the extent of their bases in the corporation), and the company owes no corporate income tax on any profits.

Example 1: Bill Benson and Sarah Sanders form a corporation and elect S corporation status. They each own 50% of the shares. In the first year of operation, the company loses \$30,000. Bill reports a \$15,000 loss on his personal income tax return, which he can deduct from other income. Sarah also reports a \$15,000 loss.

Example 2: In the following year, their S corporation reports a \$200,000 profit. Bill and Sarah each report \$100,000 of profits on their personal income tax return, but their

company does not have to pay any corporate income tax. Thus, Bill and Sarah avoid the double taxation that C corporations and their owners may have to pay.



Limited liability company

These entities, commonly known as limited liability companies (LLCs), have gained popularity recently among small business owners. In some ways,

LLCs offer S corporation advantages without the disadvantages.

Like S corporations, LLCs offer limited liability to the business owners, known as members. LLCs also avoid corporate income tax while allowing members to deduct their share of any losses incurred by the business (to the extent of their bases in the LLC). What's more, you don't have to meet the S corporation requirements to form an LLC. You can organize your LLC to have more than one class of membership, for instance.

Because LLCs are relatively new, investors and lenders may be more comfortable with businesses structured as corporations. Our office can help you decide which business structure is most suitable for your company. ■

TAX CALENDAR

JANUARY 2010

January 15

Individuals. Make a payment of your estimated tax for 2009 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2009 estimated tax. However, you don't have to make this payment if you file your 2009 return and pay any tax due by February 1, 2010.

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

FEBRUARY 2010

February 1

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2009. Payments that are covered include: (1) compensation for workers who are not considered employees; (2) dividends and other corporate distributions; (3) interest; (4) rents; (5) royalties; (6) profit-sharing distributions; (7) retirement plan distributions; (8) original issue discounts; (9) prizes and awards; (10) medical and health care payments; (11) debt cancellations (treated as payment to debtor); and (12) cash payments over \$10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2009.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2009 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2009.

For all taxes, deposit any undeposited tax. If the total is less than \$2,500 and not a shortfall, you can pay it with the return. If you deposited the tax for the year in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2009. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

February 15

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2009, but did not give you a new Form W-4 to continue the exemption for 2010.

February 16

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2009. Payments that are covered include: (1) amounts paid in broker and barter exchange transactions; (2) amounts paid in real estate transactions; and (3) payments to attorneys.

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