Delman & Company
Certified Public Accountants
336-540-1990

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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

September 2015

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 are near 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 2015 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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What's Inside

Coverage for Care

Medicaid, a program for low-income individuals that is jointly funded by the federal and state governments, pays at least 40% of total nursing home costs in the United States.

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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 2015 tax return. What happens to the other $37,000 of Carl's net capital loss in 2015? 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 2015. In 2016, 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 2016 tax return. Going into 2017, Carl has a $23,000 net capital loss carryover.

Example 4: In 2017, 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 2018, 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 current 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 2015. She'll still have a $15,000 loss carryover, so Erica can take a $3,000 deduction on her 2015 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

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. ■

Ongoing Responsibility for Retirement Plans

Another May 2015 Supreme Court decision may affect business owners. In *Tibble v. Edison International* (No. 13-550), the Court unanimously held that there is no statute of limitation on fiduciary responsibility for 401(k) plans.

In this case, employees of a utility company filed suit, alleging that the company had added some relatively high-fee mutual funds to the 401(k) plan's menu of investment choices. In 1999, the plan added three funds that were sold to ordinary investors; another three similar funds were added in 2002. According to the complaint from plan participants and beneficiaries, versions of the same funds, with lower fees, were available to institutional investors, yet these versions were not in the Edison 401(k) plan. Thus, the plaintiffs said they paid higher fees than necessary, reducing investment returns.

In the Supreme Court, the case revolved around the funds added in 1999. The company said that such disputes related to employer-sponsored retirement plans have a six-year statute of limitation based on when the funds were selected for the plan. As the action was begun in 2007, the employees' complaint regarding the funds added 8 years earlier was untimely. A district court and the Ninth Circuit generally agreed with this argument.

The Supreme Court reversed, siding with the employees. The high court found that the fiduciary of an employer retirement plan has responsibilities similar to those of a trustee: not only to exercise prudence in selecting investment options but also

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to continually monitor those options, removing those now deemed to be imprudent. Fiduciaries should exercise "care, skill, prudence, and diligence," as the Court put it.

The Court further found that as long as the actions upon which the employees based their claim of a breach of this continuing duty was filed within six years of their occurrence, the employees' claim was timely filed. Thus, the Court sent the case back to the U.S. 9th Circuit Court of Appeals to review whether the employer had breached its continuing duty of prudence within the relevant six-year period with respect to the 1999 funds. (Earlier, the district court had decided for the employees in regard to the 2002 funds, where the statute of limitation was not an issue.) Despite what may have been reported, the Supreme Court did not address the substance of the employees' complaint about high plan fees and their impact on long-term investment returns.

Eternal vigilance

Apparently, based on the Supreme Court's holding in this case, fiduciary responsibility for investment choices in employer sponsored retirement plans lasts as long as the investment choices are offered by the plan. If you offer your employees a defined contribution plan, such as a 401(k), investment choices should be well considered, and fees should be part of that consideration. Going forward, menu options that no longer pass muster should be replaced or dropped.

Employer responses

Business owners who sponsor retirement plans should take heed of the Supreme Court's message. Meet with the advisers who help with your plan to make sure investments are chosen carefully and scrutinized regularly. Get formal reports supporting those efforts, review them to see if you're comfortable with what you read, and maintain the reports in a secure location.

You also might want to meet with an attorney familiar with securities law to get a knowledgeable opinion. Would it make sense to limit plan choices to a few low-cost stock funds and high-quality bond funds? Are there ways to reduce fiduciary responsibility by outsourcing? Ultimately, the most important question might be whether all the benefits of sponsoring a retirement plan for employees are worth the time and expense involved in reducing perpetual liability for possible missteps. ■

TAX CALENDAR

SEPTEMBER 2015

September 15

Individuals. If you are not paying your 2015 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2015 estimated tax. Use Form 1040-ES.

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

Corporations. File a 2014 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2015. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2014 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

OCTOBER 2015

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2014, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

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

Electing large partnerships. If you were given an additional six-month extension, file a 2014 calendar year tax return (Form 1065-B).

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