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JUNE 2022

STAY THE COURSE

"For as long as I can remember, I've used the phrase "stay-the-course" to urge investors to invest for the long term and not be diverted by the daily sound and fury of the stock market."

John C. Bogle

In John C. Bogle's book, *The Little Book of Common Sense Investing*, he writes:

> "Remember the unfailing principle . . . : in the long run it is the reality of business – the dividend yields and earnings growth of corporations – that drives the returns generated by the stock market."
>
> "My advice to investors is to ignore the short-term noise of the emotions reflected in our financial markets and focus on the productive long-term economics of our corporate businesses. . . . The way to success is to get out of the expectations market of stock prices and cast your lot with the real market of business."
>
> "In our foolish focus on the short-term stock market distractions of the moment, we, too, often overlook this long history. We ignore that when the returns on stocks depart materially from the long-term norm, it is rarely because of the economics of investing – the earnings growth and dividend yields of our corporations. Rather, the reason that annual stock returns are so volatile is largely because of the emotions of investing."

Mr. Bogle's last quote referred to a stock's volatility, which is often confused by some with "risk." Market volatility often prompts some investors and advisors, during a declining stock market, to sell the more "risky" equities and buy "less risky" bonds. However, investment "risk" can be defined as the possibility or likelihood of a lower than expected return on an investment, which suggests to us that, for the long-term investor (i.e., those not depending significantly on their investment accumulation for current living costs), investing in bonds (with historically lower returns than equities) is generally more risky than investing in a broad-based equity portfolio or index fund.

Our August 2021 newsletter listed the average 30-year, 20-year, and 10-year returns on large cap stocks (S&P 500) from 1926 through 2020 as 11.16 percent, 10.83 percent, and 10.43 percent, respectively. The S&P 500

(*Continued on the reverse*)

Index annual increases for 2019, 2020, and 2021 were considerably higher than those averages at 28.88 percent, 16.26 percent, and 26.89 percent, respectively.

The downward "correction" on stocks that we are experiencing in 2022 following such market returns that well exceeded real economic gains was to be expected. The correction preference would have been a below-average, but positive, annual return over a period of time rather than a steep or extended crash. Nevertheless, our overall economic well-being continues to be, directly or indirectly, dependent on the long-term success of our nation's businesses, which suggests a steady course in a broad-based equity investment, rather than attempting to chase some short-term solution to current market declines.

THE HOBBY TRAP

Taxpayers with small, sideline, or start-up businesses operating at a loss have long been vulnerable to an assertion by the Internal Revenue Service (IRS) that the activity was not an activity engaged in for profit but was instead a "hobby." When a taxpayer with a loss from such an activity is audited, the IRS will often assert that the activity is a hobby and disallow the loss deduction. Under the law prior to the Tax Cuts and Jobs Act (effective for 2018), the disallowance of the loss generally resulted in increasing taxable income by the excess of the activity expenses over the activity income. For example, assume a taxpayer has an activity of raising race horses with $20,000 of sales revenue and $52,000 of expenses resulting in a loss and a reduction in net taxable income of $32,000. If, on examination, the activity was ultimately determined to be a "hobby," the taxpayer's income would, under prior law, only increase by the $32,000 net loss. Now, if such an activity is adjusted on audit, the results are different. The $20,000 of sales revenue will be fully included in taxable income, but none of the $52,000 of deductions will be allowed. Thus, the taxpayer's income increases after audit not by the net loss of $32,000, but by the disallowance of the expenses of $52,000. In other words, the "hobby" resulted in an economic (net-of-tax) loss of $32,000 plus the tax on $20,000 revenue ($8,000 for a 40 percent taxpayer), or $40,000. If the activity was not a hobby but was a business, the net-of-tax loss would be $19,200 ($32,000 x .60 = $19,200), which is less than one-half as much as "hobby" treatment.

Under the prior law, the deductible expenses were limited to the revenue from the activity and were deductible as other itemized deductions – that is, prior law allowed deductions sufficient to offset the included income. Now, with the disallowance of virtually all miscellaneous itemized deductions (which includes hobby expenses), the income tax consequence of an activity that is ultimately determined to be a hobby is extreme – that is, taxpayers must include their hobby gross income but may not deduct any of the expenses necessary to produce the included income.

The law continues to include a safe harbor rule for determining whether or not an activity is a for-profit business.

> An activity is presumed to be a for-profit business if it produces positive taxable income (revenues in excess of deductions) for at least three out of every five years. Losses from the other years can be deducted because they are considered to be business losses as opposed to hobby losses. A

(*Continued on page 3*)

horse racing, breeding, training, or showing activity is presumed to be a for-profit business if it produces positive taxable income in two out of every seven years.

Even if the safe harbor rule is not met, a taxpayer might successfully treat the activity as a for-profit business and rightfully deduct the losses. The applicable regulations provide that the taxpayer must demonstrate an intent to make a profit. Factors that indicate the intent of the taxpayer include the following:

- Conducting the activity in a business-like manner with accurate books and records
- Having (or hiring people with) expertise in the activity
- Spending enough time to justify the idea that the activity is a business and not just a hobby
- An expectation of asset appreciation (this is probably why the IRS will almost never assert that owning rental real estate is a hobby even when tax losses are incurred for many years) (Note: IRS will generally consider owning farm land to be a separate activity from the farming activity itself (cattle, crops, etc.), and will not usually consider farm land appreciation in this factor.)
- Success in other ventures, which indicates business acumen
- History and magnitude of losses from the activity – that is, occasional large profits carry more weight than frequent small profits. Losses caused by unusual events or bad luck are seen by the IRS as more justifiable than ongoing losses the IRS will assert only a hobbyist would be willing to accept
- The taxpayer's financial status – high income taxpayers might be considered by the IRS as able to afford the hobby while lower income taxpayers are less likely to continue at a loss
- Elements of personal pleasure – that is, IRS agents tend to view raising, racing, or showing horses as more likely to be a hobby than a vegetable or chicken farming activity

Taxpayers with losses from activities vulnerable to the "hobby loss" treatment will want to carefully maintain all available records documenting their intent to make a profit in the activity. Taxpayers with good facts have successfully defended against hobby loss attacks in cases involving part-time ranching, auto restoration, a hair braiding salon, and a horse training and breeding operation. The Tax Cuts and Jobs Act has significantly increased the potential adverse consequences of the business versus hobby issue. It is now even more important for taxpayers to be prepared to defend their intent to make a profit.

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Tax & Business Alert

JUNE 2022

CAN YOU DEDUCT THE COSTS OF A SELF-MANAGED PORTFOLIO?

Do you have significant investment-related expenses, including payment for financial service subscriptions, home office maintenance and clerical support? Under current tax law — specifically the 2017 Tax Cuts and Jobs Act — these expenses aren't deductible through 2025 if they're considered investment expenses to produce income. But they are deductible if they're considered trade or business expenses.

For years before 2018, production-of-income expenses were deductible, but they were included in miscellaneous itemized deductions, which were subject to a 2%-of-adjusted-gross-income floor. (Unless Congress acts to extend them, these rules are scheduled to return after 2025.) If you do a significant amount of trading, you should know which category your investment expenses fall into, because qualifying for trade or business expense treatment is more advantageous now.

To be able to deduct your investment-related expenses as business expenses, you must be engaged in a trade or business. The U.S. Supreme Court held many years ago that an individual taxpayer isn't engaged in a trade or business merely because the individual manages his or her own securities investments — regardless of the amount or the extent of the work required.

A TRADER VS. AN INVESTOR

However, if you can show that your investment activities rise to the level of carrying on a trade or business, you may be considered a trader, who is engaged in a trade or business, rather than an investor, who isn't. As a trader, you're entitled to deduct your investment-related expenses as business expenses. A trader is also entitled to deduct home office expenses if the home office is used exclusively on a regular basis as the trader's principal place of business. An investor, on the other hand, isn't entitled to home office deductions since the investment activities aren't a trade or business.

Since the Supreme Court decision, there has been extensive litigation on the issue of whether a taxpayer is a trader or investor. The U.S. Tax Court has developed a two-part test, both parts of which must be satisfied for a taxpayer to be considered a trader.

PROFIT IN THE SHORT TERM

A taxpayer's investment activities may be regular, extensive and continuous. But that itself isn't sufficient for determining that the taxpayer is a trader. To be considered a trader — and therefore entitled to deduct investment-related business expenses — you must show that you buy and sell securities with reasonable frequency with the goal of making a profit on a short-term basis.

In one U.S. Tax Court case, a taxpayer made more than 1,000 trades a year with trading activities averaging about $16 million annually. Even so, the individual was deemed to be an investor rather than a trader, because the holding periods for stocks sold averaged about one year.

1. The taxpayer's trading is substantial (in other words, sporadic trading isn't considered a trade or business), and

2. The taxpayer seeks to profit from short-term market swings, rather than from long-term holding of investments.

Again, to pass this test, a taxpayer's investment activities are considered a trade or business only if *both* parts one and two are satisfied.

Contact us if you have questions or would like to figure out whether you're an investor or a trader for tax purposes. ■

HOW START-UP COSTS OF A NEW BUSINESS AFFECT YOUR TAX RETURN

Despite the COVID-19 pandemic, government officials are seeing a large increase in the number of new businesses being launched. The latest data available from the U.S. Census Bureau shows that for the period of June 2020 through June 2021, business applications were up 18.6%. The Bureau measures this by the number of businesses applying for an employer identification number.

Entrepreneurs often don't know that many of the expenses incurred by start-ups can't be currently deducted. You should be aware that the way you handle some of your initial expenses can make a large difference in your federal tax bill.

HOW TO TREAT EXPENSES FOR TAX PURPOSES

If you're starting or planning to launch a new business, keep these three rules in mind:

1. Start-up costs include those incurred or paid while creating an active trade or business — or investigating the creation or acquisition of one.

2. Under the tax code, taxpayers can make a special election to deduct up to $5,000 of business start-up and $5,000 of organizational costs in the year the business begins. As you know, $5,000 doesn't go very far these days! And the $5,000 deduction is reduced dollar-for-dollar by the amount by which your total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized over 180 months on a straight-line basis.

3. No deductions or amortization deductions are allowed until the year when "active conduct" of your new business begins. Generally, that means the year when the business has all the pieces in place to start earning revenue. To determine if a taxpayer meets this test, the IRS and courts generally ask questions such as: Did the taxpayer undertake the activity intending to earn a profit? Was the taxpayer regularly and actively involved? Did the activity commence?

Be sure to keep detailed records and receipts for these costs, so that nothing falls through the cracks.

ELIGIBLE EXPENSES

In general, start-up expenses are those you make to:

- Investigate the creation or acquisition of a business,
- Create a business, or
- Engage in a for-profit activity in anticipation of that activity becoming an active business.

To qualify for a special election, an expense also must be one that would be deductible if it were incurred after a business began. One example is money you spend analyzing potential markets for a new product or service.

To be eligible as an "organization expense," an expense must be related to establishing a corporation or partnership. Examples of organization expenses include legal and accounting fees for services related to organizing a new business and filing fees paid to the state of incorporation.

PLAN NOW

If you have start-up expenses that you'd like to deduct this year, you need to decide whether to take the election described above. Recordkeeping is critical. Contact us about your start-up plans. We can help with the tax and other aspects of your new business. ■

NONWORKING SPOUSES MAY STILL CONTRIBUTE TO AN IRA

Married couples may not be able to save as much as they need for retirement when one spouse doesn't work outside the home — perhaps so that spouse can take care of children or elderly parents. In general, an IRA contribution is allowed only if a taxpayer earns compensation. However, there's an exception involving a "spousal" IRA. It allows contributions to be made for nonworking spouses.

For 2022, the amount that an eligible married couple can contribute to an IRA for a nonworking spouse is $6,000, which is the same limit that applies for the working spouse.

IRA ADVANTAGES

As you may know, traditional IRAs offer two types of advantages for taxpayers who make contributions to them:

1. Contributions of up to $6,000 a year to an IRA may be tax deductible, and

2. The earnings on funds within the IRA aren't taxed until withdrawn. (Alternatively, you may make contributions to a Roth IRA. There's no deduction for Roth IRA contributions, but if certain requirements are met, distributions are tax-free.)

As long as the couple together has at least $12,000 of earned income, $6,000 can be contributed to an IRA for each, for a total of $12,000. (The contributions for both spouses can be made to either a regular IRA or a Roth IRA, or split between them, if the combined contributions don't exceed the $12,000 limit.)

BOOST CONTRIBUTIONS IF 50 OR OLDER

In addition, individuals who are age 50 or older can make "catch-up" contributions to an IRA or Roth IRA in the amount of $1,000. Therefore, for 2022, for a taxpayer and his or her spouse, both of whom will have reached age 50 by the end of the year, the combined limit of the deductible contributions to an IRA for each spouse is $7,000, for a combined deductible limit of $14,000.

There's one catch, however. Suppose in 2022, the working spouse is an active participant in one of several types of retirement plans. In that case, a deductible contribution of up to $6,000 (or $7,000 for a spouse who will be 50 by the end of the year) can be made to the IRA of the nonparticipant spouse, only if the couple's AGI doesn't exceed $129,000.

Contact us if you'd like more information about IRAs or you'd like to discuss retirement planning. ■

HELP PREVENT FINANCIAL SCAMS AIMED AT OLDER PEOPLE

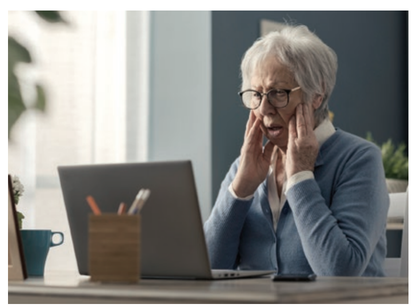
In any season, scam artists are on the lookout for ways to steal financial data and money from vulnerable people. Such fraudulent activities often target older adults. Whether you're in this age bracket or worry about senior parents and other relatives, here are seven ways to help prevent elder financial abuse and fraud:

1. Keep both paper and online financial documents in a secure place. Monitor accounts and retain statements.

2. Exercise caution when making financial decisions. If someone exerts pressure or promises unreasonably high or guaranteed returns, walk away.

3. Write checks only to legitimate financial institutions, rather than to a person.

4. Be alert for phony phone calls. The IRS doesn't collect money this way. Another scam involves someone pretending to be a grandchild who's in trouble and needs money. Don't provide confidential information or send money until you can verify the caller's identity.



5. Beware of emails requesting personal data — even if they appear to be from a real financial institution. Remember, your banker or financial professional already has these things. Ignore contact information provided in the email. Instead, contact the financial institution through a known telephone number.

6. As much as possible, maintain a social network. Criminals target isolated people because often they're less aware of scams and lack trusted confidants.

7. Work only with qualified professionals, including accountants, bankers and attorneys.

Most important, never let your guard down. Thieves are on the lookout for vulnerable people, so you need to be on the lookout for thieves. ■