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MARCH 2019

WHAT IS THE OBJECTIVE?

The accompanying *Tax & Business Alert* includes as the lead article, *Weigh the Tax Impact of Income vs. Growth When Investing*. The article compares the income tax aspects of dividend paying stocks (or mutual funds that invest in dividend paying stocks) with growth stocks (or mutual funds that invest in growth stocks). In a short "side-bar" article at the top of page 2, the question "*What Are Your Investment Objectives?*" is asked. We believe that your answer to the question of your investment objectives will probably render a comparison of the income tax aspects of income and growth stocks moot.

Prudent investing generally limits investment in equities (stocks) to long-term commitments. Transaction costs (commissions, fees, income tax consequences of trading) significantly reduce investment returns and long-term investment accumulation and cause many prudent investors (and non-commission compensated investment advisors) to conclude that individual stocks or managed mutual funds, hedge funds, private equity funds, etc. are not the best available choice for a long-term equity investor.

The "magic of compound interest" is greatly magnified when applied over long periods of time and to investments with total returns diminished only by the minimum required cost and minimum income taxes. For example, as Warren Buffett points out in his 2019 letter to the Berkshire Hathaway shareholders, the average annual return on the S&P 500 Index for the last 77 years (his years as an equity investor) is 11.78 percent. This annual rate-of-return compounds $1,000 into an accumulation after 77 years of $5,297,075. If, however, the annual rate of return is diminished by only one percent to 10.78 percent by payments to various "helpers" such as investment managers and consultants, the accumulation is cut in half to $2,651,702. At lesser rates and shorter times, the magic is, of course, much less dramatic. Nonetheless, $1,000 over 35 years at eight percent grows to an accumulation of $14,785. Reducing the compounding rate by one percent to seven percent results in an accumulation of $10,677 or only 72 percent of the eight percent accumulation. In other words, cutting the rate-of-return by one-eighth (12½ percent) reduced the accumulation by 28 percent. At 20 years decreasing an eight percent average annual return by one percent (to seven percent) decreases the accumulation of $1,000 from $4,661 to $3,870, a 17 percent reduction.

(Continued on reverse)

Numerous academics and investment professionals, endowment managers, etc. have reached, based on a pre-tax analysis, the conclusion that, after fees, commissions, etc., but before income taxes, managed stock investing, whether in mutual funds, hedge funds, or individual stocks, is less effective than investing in a broad-based diversified index of common stocks, for example, an S&P 500 Index fund. For equity investments outside of tax-sheltered accounts (IRAs, 401(k)s, etc.), the case for indexing becomes even more compelling.

Those choosing passive, index investment in taxable accounts will currently pay income tax only on the dividend income and will defer the tax on appreciation. The dividend return on an S&P 500 Index fund is less than $2 per $100 of investment value and is taxed at favorable rates (generally about 20 percent – that is, 40 cents (20 percent of $2) per $100 of investment value). The annual cost and expense for an S&P Index fund per $100 of investment value can be 4 cents per year or less. Accordingly, current taxes and expenses consume about 44 cents per year of the total return from an investment value of $100. Assuming an eight percent average annual total return, the investor would be left with a long-term compounding rate of 7.56 percent after paying taxes only on the dividend income and is deferring the tax on the unrealized appreciation. If the passive investment (index fund) is held until death (or the death of a community property spouse), the appreciation will be income tax free to the heirs (and the surviving community property spouse) because the tax basis of the investment will increase to its fair market value. An investor willing to accept the pre-tax average return of the S&P 500 Index can receive that annual return diminished only by four one-hundredths of one percent or less for expenses and approximately four tenths of one percent for income taxes.

Where the objective of an equity investor is to maximize average annual total return and thereby maximize financial security and long-term accumulation, the major decision is the choice between active management or a broad-based, passive index. An investor choosing a broad-based passive index fund has increased the probability of maximizing long-term accumulation while minimizing the required time and effort. Such a long-term investor (buy and hold) has made investing less complex and does not need to consider differences between income and growth stocks or any other stock selection or market timing issues.

TAX SEASON REMINDERS

Tax Return Data – Soon. As always, tax preparers will appreciate and benefit from receiving complete (or nearly complete) individual income tax data as early as possible. Early receipt of all data (or all but a missing Schedule K-1, etc.) allows time for more thoughtful preparation and diminishes the hazards of the rush to completion of the last days of the season. Many taxpayers with complex returns, brokerage accounts with histories of corrected information forms, late K-1s, etc. will be well served by an extension of time to file until October 15, 2019. Extensions of time to file do not, in our experience, prejudice the return in any way. An extension, however, does not extend the time to pay. Accordingly, early submission of the data for computation of the estimated amount to be paid, if any, with the automatic extension will be helpful. For most individual income tax returns, the furnishing of all or almost all of the data by mid-March will allow the orderly

(Continued on page 3)

preparation of a well-considered return. In instances where almost all of the data is not available by mid-March and for most complex returns, automatic extensions are often the best choice.

IRA and HSA Contributions – April 15, 2019. Taxpayers making individual retirement account (Roth IRA and traditional IRA) or health savings account (HSA) contributions for 2018, and who have not already done so, will need to make the contributions on or before April 15, 2019. April 15, 2019 is the last available date for a 2018 contribution even if the taxpayer obtains an extension of time to file the 2018 individual income tax return.

The maximum contribution to an IRA (Roth or traditional) for 2018 is $5,500 for those below age 50 and $6,500 for those age 50 or above at December 31, 2018. We, of course, encourage early contributions to tax-deferred accounts for those certain of their eligibility. For 2019, the maximum IRA contributions are $6,000 for those below age 50 and $7,000 for those age 50 or above at December 31, 2019.

The maximum HSA contribution for a single person for 2018 is $3,450 and for a family is $6,900. Those 55 or older can add, for 2018, an additional $1,000. For 2019, the maximum for a single person increases $50 to $3,500. For a family for 2019, the maximum is $7,000. For those 55 and over, the 2019 limits are increased by $1,000 for both single and family.

Charitable Contribution Receipt – Return Due Date. Please remember that a taxpayer with charitable contributions should be sure to obtain properly worded receipts for contributions (cash, check or property) of $250 or more before filing the federal tax return. The written acknowledgement must state whether or not the organization provided any goods or services in consideration for the contribution.

Qualified Plan Distribution – April 1, 2019. Participants in qualified retirement plans, tax-sheltered annuities, or IRAs (other than Roth IRAs) are generally required to begin withdrawals of minimum annual amounts from the plan no later than April 1 following the year in which they reach age 70½. This rule generally applies to all such tax-favored plans. Individuals who are still employed at age 70½ and are not five percent owners of their employer, however, are not required to begin receiving distributions from their employer's qualified plan until April 1 following the year in which they terminate employment. Distributions from traditional IRA accounts must begin by April 1 following the year in which the account holder attains age 70½. Distributions are not required from Roth IRAs until after the death of the owner.

Although the first required distribution may be deferred until April 1 of the year following the year in which the account owner becomes 70½, it is likely that the distribution should be taken in the year of becoming age 70½ to avoid taxing two years' distributions in one year, possibly causing the recipient to be in a higher tax bracket or become subject to increased phase-outs of deductions, credits, etc.

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Tax & Business Alert

MARCH 2019

WEIGH THE TAX IMPACT OF INCOME VS. GROWTH WHEN INVESTING

As the 2018 tax-filing season heats up, investors have much to consider. Whether you structured your portfolio to emphasize income over growth — or vice versa, or perhaps a balance of the two — will have a substantial impact on your tax liability. Let's take a look at a couple of the most significant "big picture" issues that affect income vs. growth.

DIFFERING DIVIDENDS

One benefit of dividends is that they may qualify for preferential long-term capital gains tax rates. For the 2018 tax year, the top rate is 20% for high-income taxpayers (income of $425,800 or more). For those with incomes between $38,601 and $425,800, the rate is 15%. Individuals with incomes of $38,600 and below pay 0% on long-term capital gains.

Keep in mind, however, that only "qualified dividends" are eligible for these rates. Nonqualified dividends are taxed as ordinary income at rates as high as 37% for 2018. Qualified dividends must meet two requirements. First, the dividends must be paid by a U.S. corporation or a qualified foreign corporation. Second, the stock must be held for at least 61 days during the 121-day period that starts 60 days before the ex-dividend date and ends 60 days after that date.

A qualified foreign corporation is one that's organized in a U.S. possession or in a country that has a current tax treaty with the United States, or whose stock is readily tradable on an established U.S. market. The ex-dividend date is the cutoff date for declared

dividends. Investors who purchase stock on or after that date won't receive a dividend payment.

TIMING IS EVERYTHING

One disadvantage of dividend-paying stocks (or mutual funds that invest in dividend-paying stocks) is that they accelerate taxes. Regardless of how long you hold the stock, you'll owe taxes on dividends as they're paid, which erodes your returns over time.

When you invest in growth stocks (or mutual funds that invest in growth stocks), you generally have greater control over the timing of the tax bite. These companies tend to reinvest their profits in the companies rather

WHAT ARE YOUR INVESTMENT OBJECTIVES?

When re-evaluating your investment portfolio, it's important to consider whether your objectives have changed. There are many factors to consider, both tax and nontax. Some investors seek dividends because they need the current income or they believe that companies with a history of paying healthy dividends are better managed. Others prefer to defer taxes by investing in growth stocks. And, of course, there's something to be said for a balanced portfolio that includes both income and growth investments. When preparing to file your 2018 taxes, take a moment to identify your objectives and determine if you met them or fell short.

than pay them out as dividends, so taxes on the appreciation in value are deferred until you sell the stock.

KEEPING AN EYE OUT

Regardless of your investment approach, you need to understand the tax implications of various investments so you can make informed decisions. You should also keep an eye on Congress. As of this writing, further tax law reform beyond the Tax Cuts and Jobs Act of 2017 isn't on the horizon — but it's being discussed. Contact our firm for the latest news and to discuss your tax and investment strategies. ■

DEDUCTING CHARITABLE GIFTS DEPENDS ON A VARIETY OF FACTORS

Whether you're planning to claim charitable deductions on your 2018 return or make donations for 2019, be sure you know how much you're allowed to deduct. Your deduction depends on more than just the actual amount you donate.

WHAT YOU GIVE

Among the biggest factors affecting your deduction is what you give. For example:

Cash or ordinary-income property. You may deduct the amount of gifts made by check, credit card or payroll deduction. For stocks and bonds held one year or less, inventory, and property subject to depreciation recapture, you generally may deduct only the lesser of fair market value or your tax basis.

Long-term capital gains property. You may deduct the current fair market value of appreciated stocks and bonds held for more than one year.

Tangible personal property. Your deduction depends on the situation. If the property isn't related to the charity's tax-exempt function (such as a painting donated for a charity auction), your deduction is limited to your basis. But if the property is related to the charity's tax-exempt function (such as a painting donated to a museum for its collection), you can deduct the fair market value.

Vehicle. Unless the vehicle is being used by the charity, you generally may deduct only the amount the charity receives when it sells the vehicle.

Use of property or provision of services. Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. When providing services, you may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.

OTHER FACTORS

First, you'll benefit from the charitable deduction only if you itemize deductions rather than claim the standard deduction. Also, your annual charitable deductions may be reduced if they exceed certain income-based limits.

In addition, your deduction generally must be reduced by the value of any benefit received from the charity. Finally, various substantiation requirements apply, and the charity must be eligible to receive tax-deductible contributions.

PLANNING AHEAD

For 2018 through 2025, the Tax Cuts and Jobs Act nearly doubles the standard deduction — plus, it limits or eliminates some common itemized deductions. As a result, you may no longer have enough itemized deductions to exceed the standard deduction, in which case your charitable donations won't save you tax.

You might be able to preserve your charitable deduction by "bunching" donations into alternating years, so that you'll exceed the standard deduction and can claim a charitable deduction (and other itemized deductions) every other year.

THE YEARS AHEAD

Your charitable giving strategy may need to change in light of tax law reform or other factors. Let us know if you have questions about how much you can deduct on your 2018 return or what's best to do in the years ahead. ■

DID YOU REPAIR YOUR BUSINESS PROPERTY OR IMPROVE IT?

Repairs to tangible property, such as buildings, machinery, equipment or vehicles, can provide businesses a valuable current tax deduction — as long as the so-called repairs weren't actually "improvements."

The costs of incidental repairs and maintenance can be immediately expensed and deducted on the current year's income tax return. But costs incurred to improve tangible property must be capitalized and recovered through depreciation.

BETTERMENT, RESTORATION OR ADAPTATION

Generally, a cost must be depreciated if it results in an improvement to a building structure, or any of its building systems (for example, the plumbing or electrical system), or to other tangible property. An improvement occurs if there was a betterment, restoration or adaptation of the unit of property.

Under the "betterment test," you generally must depreciate amounts paid for work that is reasonably expected to materially increase the productivity, efficiency, strength, quality or output of a unit of property or that is a material addition to a unit of property.

Under the "restoration test," you generally must depreciate amounts paid to replace a part (or combination of parts) that is a major component or a significant portion of the physical structure of a unit of property.

Under the "adaptation test," you generally must depreciate amounts paid to adapt a unit of property to a new or different use — one that isn't consistent with your ordinary use of the unit of property at the time you originally placed it in service.

SAFE HARBORS

A couple of IRS safe harbors can help distinguish between repairs and improvements:

1. Routine maintenance safe harbor. Recurring activities dedicated to keeping property in efficient operating condition can be expensed. These are activities that your business reasonably expects to perform more than once during the property's "class life," as defined by the IRS.

Amounts incurred for activities outside the safe harbor don't necessarily have to be depreciated, though. These amounts are subject to analysis under the general rules for improvements.

2. Small business safe harbor. For buildings that initially cost $1 million or less, qualified small businesses may elect to deduct the lesser of $10,000 or 2% of the unadjusted basis of the property for repairs, maintenance, improvements and similar activities each year. A qualified small business is generally one with gross receipts of $10 million or less.

MORE TO LEARN

To learn more about these safe harbors and other ways to maximize your tangible property deductions, contact us. ■

THERE MAY BE UNCLAIMED PROPERTY WITH YOUR NAME ON IT

It may sound too good to be true, but there may be valuable unclaimed property out there with your name on it. The term generally refers to financial assets being held for owners who haven't been found. Just a few examples include uncashed dividend and payroll checks; unclaimed tax refunds; and insurance payments, refunds or policies with cash value.

If you're interested in looking, there are search databases maintained by the state or states where you live and work, as well as states where you (or a deceased relative) previously lived and worked. Unclaimed property is sent to the state of the owner's last known address.

Most states participate in MissingMoney.com, a free, national unclaimed property database. For states that don't participate, you can find links to every state's unclaimed property database on unclaimed.org, the website of the National Association of Unclaimed Property Administrators. You can also use this site to find links to relevant federal programs.

If you discover unclaimed property in your name, follow the instructions on the website where you found it. Typically, you'll need to provide proof of ownership or, in the case of a deceased owner, a death certificate and proof that you're entitled to the assets (such as a will).

Finally, be wary of companies that offer to locate and obtain property for a fee. Some of these offers are scams. But even if they're legitimate, in most cases you can find and claim assets yourself for free or by paying a nominal handling fee. ■