

Client Bulletin

Smart tax, business and planning ideas from your Trusted Business AdvisorSM

February 2019

Putting stock market volatility in perspective



As of this writing, in late 2018, the U.S. stock market has been extremely volatile. By the time you read this article, in February 2019, stocks may have stabilized, may have risen, or may have dropped dramatically. The last stunning market retreat, which made tumultuous news in late 2008, reached its bottom in February 2009.

Future stock prices are unknown. That said, a knowledge of history may help you invest prudently. Over time, staying the course has largely paid off for patient investors.

Looking back

Perhaps the most traumatic day for stocks in the last half-century was October 19, 1987. In a single day, the benchmark S&P 500 Index fell by more than 20%. An investor who went to sleep on Sunday night with \$100,000 in stocks and stock funds may well have seen

that balance drop below \$80,000 by Monday afternoon.

Moreover, Black Monday was hardly a one-day pullback. In August 1987, the S&P had peaked at 337 index points. After Black Monday, that index was down to 225, a drop of more than 33%. Even after Black Monday, however, the S&P regained its peak value by 1989.

Similar events have occurred in this century. After a long bull market fueled largely by tech stocks, the S&P peaked at 1,527 in 2000. That bubble burst, and a long decline lasted until 2002, when the S&P bottomed at 777. The stock market recovered, but the following financial crisis took the S&P from a peak of 1,565 in 2007 to a trough of 677 in 2009, which was also followed by a lengthy rebound. After flirting with 3,000 in September 2018, the index was over 2,700 two months later.

Successful strategies

One key takeaway from this history lesson is that the broad U.S. stock market, measured by the S&P, has gone from 337, shortly before the 1987 meltdown, to a value that's more than 8 times as great in about 3 decades. Every market stumble, correction, or crash in this time period has proven to be a buying opportunity for investors who buy and hold stocks.

Such returns in the future aren't guaranteed, but this prior experience is encouraging. Two proven investment methods are suggested.

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Plumpest pension

In 2019, the maximum Social Security benefit for someone retiring at full retirement age (now 66) is \$2,861 a month, or \$34,332 a year.

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Trusted advice

Double category averaging

- Another method, "double category" averaging (separate averages for long-term and short-term holdings), was used in the past. That option has been abolished.
- Investors who were using the double category method for stock acquired before April 1, 2011, must figure basis by averaging together all identical shares of stock in the account on that date, regardless of the holding period.
- This applies when an investor sells, exchanges, or otherwise disposes of that stock.

For one, periodic investing has paid off. If you participate in a retirement plan such as a 401(k) and you direct some of your contributions into the stock market, money is coming out of each paycheck into equities. You're buying during market lows as well as during highs, which may lower your cost per share and raise your return from long-term gains.

The second tactic involves what to buy, rather than when to invest. Despite the long-standing strength of equity markets, many investors have lost money in stocks. Often, the reason is buying the wrong stocks and suffering from problems or unrealized expectations at the chosen companies.

You can reduce company-specific risk and increase your chances of participating in any broad market gains by buying multiple stocks with various attributes. Many investment advisers recommend some form of diversification within the equities markets: foreign as well as domestic companies, small firms as well as large ones, a mix of industry sectors

in your portfolio. Blending stocks with other holdings, such as bonds, can dampen overall volatility and provide valuable comfort when equities plunge.

A matter of time

The preceding statistics paint a rosy picture, but there is a major caveat. Markets always have rebounded to the benefit of those buying when stocks go "on sale." That's not the case, however, if you are not able to keep investing regularly. Once you stop working and the paychecks stop, you might be taking dollars out of your portfolio, rather than investing at possible bargain prices.

Therefore, as you approach retirement, a steep decline in the value of your holdings can imperil your future lifestyle. Regardless of whether stocks are soaring or sinking, shifting assets to less volatile investment categories might be considered.

Did you know?

In 2019, the standard premium for Medicare Part B (covering medical bills) is \$135.50 per enrollee a month. However, seniors who had modified adjusted gross income (MAGI) over \$85,000 in 2017 (over \$170,000 on joint tax returns) will pay more. Monthly costs go as high as \$460.50 per enrollee with 2017 MAGI of at least \$500,000 or \$750,000 on joint returns.

Source: medicare.gov

Making stock sales less taxing

As explained in the article, "Putting stock market volatility in perspective," patient investors generally have prospered over the long term. Nevertheless, there are many reasons for selling stocks. Knowing the basics can help improve your tax position.

Selling shares held in a taxable account will trigger taxable capital gains or losses, unless the sale proceeds are exactly the same as your basis — your cost for tax purposes. If you are making a complete sale from an investment position, the calculation of basis is fairly simple.

Example 1: Joan Harris has owned shares of ABC Large Company Growth Fund in a taxable account for many years. In March 2019, she sells all of those shares for \$42,000. Joan has invested \$25,000 in those shares and reinvested \$2,800 of dividends from the fund, so her basis is the total: \$27,800. Thus, her taxable gain is the \$14,200 difference.

Many fund companies will track purchases and dividend reinvestments for shareholders; the companies also will report the amounts of long-term and short-term gains (reflecting whether assets were

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held for more than a year), which are taxed at different rates. Not all fund companies provide complete records, so it's a good idea to keep careful track of your securities transactions.

Note that Joan will have a tax obligation even if she asks fund company ABC to move all of her money in ABC Large Company Growth Fund to ABC Small Company Value Fund. If this transaction occurs in a taxable account, a gain or loss will be reported.

Partial parting

The situation is different if an investor sells part of a position in a security.

Example 2: Suppose Joan requests a sale of \$20,000 from the large company growth fund, out of her \$42,000 holding. As noted in example 1, Joan has invested and reinvested in those shares over a period of years. In this case, Joan can choose among multiple options for tax reporting.

- **First in, first out (FIFO).** Assume that this fund's shares are priced at \$20 on the date of the sale. Joan will be selling 1,000 shares; with FIFO, that would be the first 1,000 shares that she purchased.

As long as fund company ABC keeps track, it will report the amount Joan paid for those 1,000 oldest shares. If Joan paid a total of \$11,000 for those shares, her gain will be the \$9,000 difference.

The disadvantage of choosing FIFO is that the taxable gain may be high after a long period of stock market growth. On the other hand, the entire sale may qualify as a favorably taxed long-term capital gain, if all the shares were held for more than a year.

- **Specific identification.** As the name indicates, with this method the investor designates the shares to be sold. To sell 1,000 shares, Joan might indicate the 500 shares bought in January 2016 and the 500 shares bought in April 2017. Assuming those shares were those with the highest purchase prices, Joan may be able to minimize her capital gain or obtain a capital loss, which can provide tax benefits. This method requires careful record keeping, and you will have the burden of proving the basis in the designated shares at the time of the sale.

The preceding choices are available to all investors, whether

they hold mutual funds or individual securities. Another method is available only to mutual fund investors and to investors in certain dividend reinvestment plans.

- **Average cost.** With this method, you divide the amount you have invested and reinvested in a given fund, before a sale, by the number of shares you held then. If you choose this method, you must use it for all future sales of that fund's shares.

Example 3: As previously explained, Joan calculates that she has put a total of \$27,800 into ABC Large Company Growth Fund. At the time of her sale, she owns 2,100 shares, trading at \$20. Dividing her \$27,800 investment by her 2,100 shares, Joan calculates the average cost at \$13.238 per share.

In our example, Joan sells \$1,000 shares at \$20, to receive \$20,000. With an average cost of \$13.238 a share, Joan's basis in the 1,000 shares sold is \$13,238. By receiving \$20,000, she has a \$6,762 taxable gain. Note that some of those gains may be short-term if Joan has bought any shares in the fund within a year or less from the sale date.

New tax law enhances the appeal of C corporations

Many owners of private companies have been leery of operating as a regular C corporation. If you make that choice, you will be exposed to double-taxation of business income.

First, a corporate income tax applies to the company's profits. Second, any dividends that pass to you and other shareholders will be subject to personal income taxes. Making

matters even more expensive, your C corporation won't get an income tax deduction for the dividends it pays out.

Pain relief

The Tax Cuts and Jobs Act (TCJA) of 2017 has made this tax parlay easier to bear. Personal income tax rates generally have come down: the top federal rate, from now through 2025,

has been lowered from 39.6% to 37%, for example.

During these years, corporate income will be taxed at a flat 21%, regardless of the amount. (Formerly, there was a graduated tax schedule, going up to 35%.) These tax rate reductions, combined with the retention of the 15% or 20% tax rates on qualified dividends received (which are based

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on the capital gains rates), may make it cost effective to operate your business as a C corporation.

Example: Mike Morton owns 100% of a C corporation, which has a \$100,000 profit this year. The company pays \$21,000 in corporate income tax, at 21%, and pays the \$79,000 balance as a dividend to Mike.

Assume Mike and his wife Nora owe the maximum 20% tax rate on the dividend, as well as the 3.8%

net investment income tax on that dividend: 23.8% of \$79,000, or about \$18,800. Altogether, the total tax on that \$100,000 of company profits is \$39,800, which is much less than it would have been, under the 2017 tax rates.

Pros and cons

Other factors should be weighed when deciding on a business entity. For example, C corporations have some tax advantages, such as the ability to deduct the cost of certain fringe benefits and not pass

on imputed income to significant shareholders.

At the same time, C corporations pose other tax perils. Owners may have to contend with possible unreasonable compensation (paying too much in salary and bonus) and excess accumulated earnings (saving too much, rather than paying dividends) issues. Our office can help you put numbers on all of these looming tax traps, so you can make an informed decision.

Tax calendar

February 2019

February 15

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2018. Payments that are covered include (1) amounts paid in real estate transactions; (2) amounts paid in broker and barter exchange transactions; and (3) substitute payments and gross proceeds paid 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.

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.

February 16

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2018 but did not give you a new Form W-4 to continue the exemption for 2019.

February 28

All businesses. File paper versions of most annual information statements (Forms 1098, 1099, and others) for certain payments you made during 2018 (due date is April 1 if you are filing electronically).

March 2019

March 15

Partnerships. File a 2018 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 (Form 1065). If you want an automatic six-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 and provide each partner with a copy of their final or amended (if required) Schedule K-1 by September 16.

S corporations. File a 2018 calendar-year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), *Shareholder's Share of Income, Deductions, Credits, etc.*, or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe. Then, file Form 1120S and provide each partner with a copy of their final or amended (if required) Schedule K-1 by September 16.

S corporation election. File Form 2553, *Election by a Small Business Corporation*, to choose to be treated as an S corporation beginning with calendar year 2019. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2020.

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



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