Meisel, Tuteur & Lewis, P.C.
Certified Public Accountants
Management Consultants

Thoughts from Outside the Box

OUR PERSPECTIVES

3rd Quarter 2016

Volume 15 Issue 3

Dear Clients and Friends,

At the national level, it's been hard to ignore the drama surrounding this presidential election. The year has been full of surprises and all eyes are on both candidates as pundits attempt to guess how each will impact our country. I will make no projections here. What I will say is that we here at MT&L will continue to monitor policy changes and will communicate relevant ones to you when we believe they may impact your personal and/or business finances.

On a personal level, as we wrap up the third quarter of the calendar year, I encourage you to begin thinking about year-end planning. And not just year-end tax planning; schedule time to evaluate your business plans, marketing plans, and financial plans as well. Doing so in the next couple of months gives you plenty of time to meet with your advisors and implement changes, if necessary.

Enjoy the fall weather and holidays. And, as always, please do not hesitate to contact us if you have any questions.

Very truly yours,

Michael S. Lewis, CPA
Managing Partner

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Cancellation of Debt Income and Exclusion from Income

Thomas Stickle, CPA

Fortunately for most individuals and businesses, the thought of being faced with Cancellation of Debt (COD) Income is an item rarely experienced. When faced with such a situation, it is usually the direct result of being overburdened with debt and a lack of ability to repay that debt. This was, unfortunately, a more prevalent occurrence during the economic crisis of the "great recession" in 2008 and 2009. Even though the economy is in a much stronger state at the present time, there are still those who may be faced with the potential of having to renegotiate or restructure debts, which could result in an individual or business taxpayer being faced with COD income.

Pursuant to the Internal Revenue Code, COD income is generally included as taxable income and is subject to tax at ordinary tax rates. There are exceptions to the inclusion of COD income and Code Section 108 provides for the exclusion of income under the following eight categories:

1. Bankruptcy
2. Insolvency
3. Qualified Real Property Business Indebtedness (Non-corporate taxpayers only)
4. Purchase Money Debt Reduction
5. Lost Deductions through Non-payment
6. Qualified Farm Indebtedness
7. Qualified Personal Residence (before 2013)
8. Special Deferral Election (for 2009 and 2010)

Categories 1 and 2 noted above are somewhat self-explanatory, however certain steps need to be followed when, and if, a taxpayer falls into either of these categories and is faced with COD income. The basic parameters for exclusion under Bankruptcy and Insolvency are outlined below, but more specific analysis will likely be required.

For Bankruptcy, the taxpayer must be part of a formal Title 11 Bankruptcy proceeding to qualify for taxable income exclusion of COD income.

In order to have COD income excluded through the Insolvency category, a taxpayer must be insolvent before

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Inside this Issue

Avoiding Mutual Fund Pitfalls

Shane Orbach, CPA, MST

Mutual funds are regulated investment companies under Internal Revenue Code Subchapter M. Under this subchapter, the mutual fund itself does not pay taxes on investment income, dividends, and capital gains, but instead serves as a pass-through to the investors. In order to qualify, the fund must distribute all, or substantially all (deemed to be 90%) of its net investment income to the shareholders. If a mutual fund distributes less than 98% of its net investment income, the Internal Revenue Code imposes a 4% excise tax on any amount that falls short of this 98% limit. For this reason, mutual funds establish required minimum distributions each year to meet the 98% threshold. Further, 90% of the fund's income must be derived from dividends, interest, and capital gains from their portfolio's securities and at least 50% of the fund must be invested in diversified securities.

Though this rule prevents double taxation of the investment income, it may cause significant issues for shareholders based upon the type of account which holds the mutual fund and the timing of purchases and sales of shares. Distributions made on mutual fund shares owned within tax-advantaged accounts, such as 401(K), 403(b) and IRAs, are deferred until earnings are withdrawn, usually at retirement. Thus, these investors do not pay taxes each year on distributions of capital gains and dividends. However, shareholders who own mutual funds outside of tax-advantaged accounts are taxed each year on two types of transactions: distributions of net investment income from the fund and the sale of the fund's shares.

> *Efforts and courage are not enough without purpose and direction.*
>
> \- John F. Kennedy

The payout of income is determined by a shareholder's ownership on a specific date of record, regardless of how long those shares were owned. This results in the inequity of a shareholder purchasing shares of a mutual fund just prior to the aforementioned date of record and being taxed on the full amount of the distribution as if they owned the shares during the entire appreciation. This inequity can be demonstrated with a simple example:

If Warren buys 100 shares of Mutual Fund Z at a cost of $50 per share, the day prior to the date of record related to its $5 per share annual distribution, the value of their shares would be $5,000. Since assets of the fund are used to pay the distribution, the value of the mutual fund shares would immediately go down by an equivalent amount. Thus, once the $500 distribution is made, the value of Warren's interest in Mutual Fund Z is now $4,500. Your first thought might be, Warren is whole since he is left with Mutual Fund Z with a net asset value of $4,500 and cash of $500, but Uncle Sam would beg to differ. That $500 would be subject to Federal and State income tax. If we assume a 30% tax rate, the after-tax value of the $500 distribution is only $350. Thus, Warren has lost $150 simply because he bought the mutual fund the day prior to the date of record related to its annual distribution.

Thus, don't invest in a fund just before a distribution. Since most funds distribute towards the end of the calendar year and/or the end of each calendar quarter, you should be wary of making investments prior. Income funds, such as bond funds, may even make distributions at the end of each month. Most funds provide a schedule of their distribution dates to prevent this scenario.

Additionally, a mutual fund's turnover rate should be reviewed prior to investment. This reflects the rate at which it buys and sells investments. A fund with 100% turnover sells its entire portfolio and purchases other investments within a year. This is important because only realized capital gains and other investment income is distributed. A fund with a lower

turnover rate buys stocks and holds them for a longer period of time. As the stock appreciates it is also appreciating the value of the mutual fund. However, since the shares are not sold, the fund would not have to make a distribution and in turn shareholders would not have to pay taxes, thus increasing the tax deferred compounding of the investment return. The other downside to high turnover funds is that most of the gains tend to be short-term in nature because they held the shares for less than one year. Consequently, these gains are not offered the preferential tax rates offered to long-term gains. Funds with the lowest turnover rates are typically index funds.

Furthermore, it is important to check a mutual fund's prospectus for loss carryforwards. Mutual funds don't pass through their realized losses. Moreover, when a fund sells an investment at a loss, the loss can offset gains realized during the year and reduce the gains passed through to the shareholders. When a fund's losses exceed its gains for the year, the losses are carried forward and can offset future gains. Thus, this scenario would help the fund's tax deferred compounding of these future gains.

In addition, index funds must be examined just as carefully as active funds before investing. An index fund is a type of mutual fund with a portfolio constructed to match or track the components of a market index, such as the Standard & Poor's 500 Index. So in theory, all index funds created to mimic a particular market index should be almost identical. However, this has proven not to be the case. Items such as expense ratios, distribution histories, and performance relative to the particular index can vary significantly between fund families, subsequently affecting after-tax returns.

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Cancellation of Debt Income and Exclusion from Income

being faced with the debt cancellation. Insolvency is determined by offsetting the liabilities of the taxpayer by the fair market value of the assets at the date of measurement. Another important aspect of insolvency is that for partnerships, the insolvency test or insolvency measurement takes place at the partner level and not the entity level. For S-Corporations, the insolvency measurement is at the entity level and not the shareholder level.

Both bankrupt and insolvent taxpayers who are able to exclude COD income through Section 108 must utilize various tax attributes in a specific order. Any COD income over and above the utilization of the tax attributes will be excluded from taxable income. Tax attributes that must first be utilized are listed, in order, as follows:

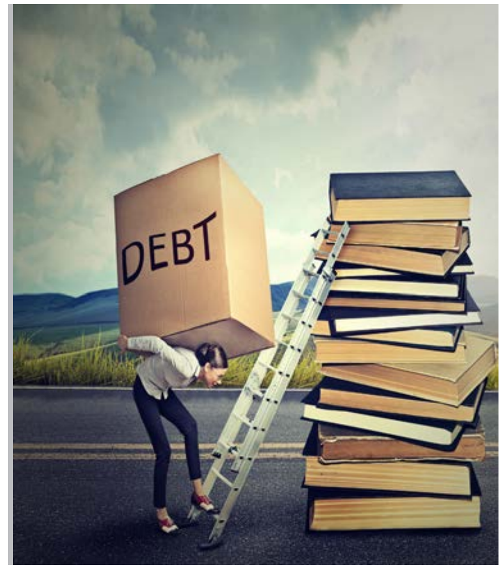
1. Net operating loss carryforwards
2. General business credits
3. Minimum tax credits
4. Capital loss carryovers
5. Income tax basis reduction
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers

The taxpayer also has the option to reduce the basis of its depreciable property prior to reducing the above attributes. This option must be formally elected by the taxpayer on their tax return in the year the COD income was realized.

Other than bankruptcy and insolvency, perhaps the most utilized COD income exclusion category is the relief of debt from the reduction of Qualified Real Property Business Indebtedness (QRPI). This exclusion, which allows taxpayers to reduce basis in depreciable real property instead of recognizing COD income, is available to solvent non-corporate taxpayers. To qualify under this exclusion the debt must meet the following parameters:

1. The debt instrument must have been incurred in connection with real property used in a trade or business;
2. The debt must be secured by the real property; and
3. The debt must be qualified acquisition indebtedness.

In order to claim the exclusion, the taxpayer is required to make an election on their tax return in the year in which the COD income was recognized. In the case of a partnership, the determination



of whether the debt is considered QRPI is made at the partnership level. The election to apply the provision to reduce basis in depreciable real property is made at the partner level in the year in which the COD income was incurred.

The guidelines in determining whether or not a taxpayer is eligible to exclude COD income under any of the exclusion categories noted above can be complex and often require additional evaluation and research. Should you be faced with the possibility of COD income, contact your MT&L advisor to help you plan accordingly. ■

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Avoiding Mutual Fund Pitfalls

When it is time to sell your mutual fund shares it is important to plan your sales. If you are not selling all of your holdings, a choice can be made as to which shares are being sold in order to achieve the best tax results. This analysis must be done in synchrony with your overall tax picture. The amount of gain or loss on the sale of fund shares is determined by the difference between the "cost basis" of the shares (generally, the original purchase price) and the sale price. If you have chosen to reinvest your distributions throughout your investment, this exercise could get challenging. Each time a distribution is reinvested, your basis in the new shares is the value on that date. Consequently, if distributions are reinvested over a number of years, you have a number of shares bought at different times at different prices. For newer investments, Congress made this analysis a bit easier when they passed legislation that required brokers and mutual funds to report the cost basis when shares are redeemed to shareholders and the IRS. This rule is effective for mutual fund shares acquired on or after January 1, 2012. Further, beginning in 2012, brokers and funds were required to ask their shareholders to choose a basis determination method and to use that method to calculate basis when shares are redeemed. If shareholders fail to choose a method, the broker or fund would apply its default method.

Since mutual funds on the whole make their investment decisions on the basis of maximizing before-tax returns, it is up to you to monitor your mutual fund's activities in order to maximize your after-tax dollars. According to a study by Joel Dickson and John Shoven, as much as a quarter of a mutual fund investor's annual returns are consumed by the taxes payable on dividend and capital gain distributions. Over time, the compounding effects of an average equity return of 10% being reduced by 25% are staggering. Over the course of 30 years, an initial $10,000 investment with 10% annual returns will compound to nearly $175,000. At 7.5% annual return, the same $10,000 investment will compound to only $87,500, or half. Thus, any pitfall avoided means more money in your pocket. ■

An Inside Look

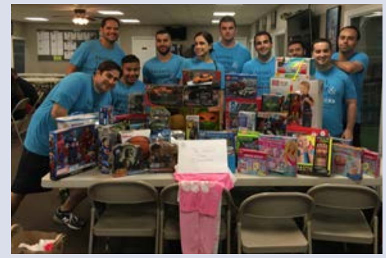
Employee News

Congratulations to **Anthony Piccininni** and his wife, Kristin, on the birth of their baby girl, Aria Faith. She was born on June 8th and weighed in at 8 lbs. 1 oz. and 21-¼" long.

Congratulations to **Ryan McElwaine** for passing all four parts of the CPA Exam.

We are pleased to announce that **Alexandra Laschuk** and **Stephen Andolena** have been promoted to Senior Accountant.

Firm News



MT&L welcomes the following new employees:

- **Tim Sweeney** – Staff Accountant
- **Kathy Sandello** – Bookkeeper
- **Kim Sarno**, CPA, MST

MT&L sponsored a team for the 2016 Young CPAs Kickball Tournament for the second year in a row. This charity tournament, held on July 14, benefited The Valerie Fund, which supports comprehensive health care services for children with cancer and blood disorders. In addition to the tournament, the firm assisted the NJSCPA in collecting toy donations for Gifts for the Children. ■

Using Non-Financial Incentives to Retain Employees

Katie Bewalder, CPA, MST

Most employees expect an employer to provide certain benefits: a competitive salary, raises, health insurance, and retirement accounts (i.e., 401(k)). While these financial benefits may be the key to attracting new employees, recent surveys have shown that non-financial incentives may be the secret to retaining them. Today's professionals desire non-financial incentives such as flex time, a compressed work week, work-from-home options, professional growth opportunities, tuition assistance, as well as other types of non-financial perks. If you are considering implementing some non-financial incentives in your business, read below to learn about some of the top non-monetary benefits that employees are interested in.

Flex Time

Many employees would prefer more flexibility in their work hours over a raise or promotion. According to studies, employees with flexible hours who are given the option to arrive earlier and leave earlier, or to arrive later and stay later, tend to be more motivated. Since personal schedules vary, the flexible schedule option gives them the ability to alter their work hours to their individual needs, keeping the total hours worked the same but significantly increasing job satisfaction. While it is harder for smaller employers to provide flex time while maintaining full staff coverage, these employers should consider implementing core hours that employees are expected to be in the office, such as 9:00 AM to 3:00 PM. Even the flexibility of one or two hours can make a big difference to a person.

Compressed Work Week

A compressed work week allows an employee to work a traditional 40-hour work week in less than five work days. For example, if someone works four 10-hour days during a week instead of the traditional five 8-hour work days, they could have each Friday off. Or some companies offer the option of working nine 9-hour days with every other Friday off. Many appreciate having three-day weekends and find a compressed work week to be a very attractive option.

Work-From-Home Options

If your employees have job functions that they are able to perform at home, you may want to consider offering a work-from-home option. Some of the benefits to employees include avoiding traffic and gas expenses as well as being able to spend more time with their family. There are also many benefits for employers, including increased productivity, reduced turnover, and improved morale. If it isn't practical to offer this option once a week, even offering the ability to work from home on occasion, whether every other Friday or on an as needed basis, can have a significant impact on an employee's attitude and motivation.

Empower Them

Employees value the freedom and independence to get their job done as they choose. Most employees agree that it's harder to focus and do their job when someone is continually checking on them and directing how they should perform their job. While it is hard to step back and give your employees greater responsibility, doing so can greatly benefit you. Be clear about what your employees need to do and the time frame in which it needs to be done, and then grant them the freedom and independence to get the job done on their own.

Professional Growth

Some employees are happy to stay in the same position for decades, doing the same work over and over again. However, ambitious employees generally want growth and the opportunity to take on new responsibilities and challenges. In addition to offering opportunities for employees to attend conferences or take courses and continuing education in their field, making work interesting and offering new opportunities will lead to a more knowledgeable and more satisfied employee.

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Tax Update

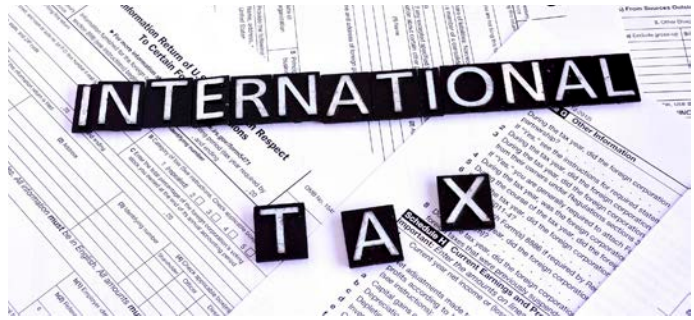
William Schwarz, CPA, MST

The following is a summary of recent tax developments that may affect you, your family, or your business.

- **Final Regulations on Foreign Financial Asset Reporting by Domestic Entities:** Since 2011, U.S. citizens and resident aliens, with an interest in a specified foreign financial asset, have been required to include Form 8938 with their income tax return. The form discloses the taxpayer's interest in such foreign assets and is required for any year in which the total value of the assets is greater than $50,000 on the last day of the year or $75,000 at any time during the year. Since the inception of this reporting requirement, the Internal Revenue Service (IRS) has also issued Proposed Regulations stating when a domestic corporation, partnership or trust would also be required to report their holdings of specified foreign financial assets.

These Proposed Regulations have now been finalized and "specified domestic entities" will have to include Form 8938 with their returns for tax years that begin after December 31, 2015. A "specified domestic entity" is now defined as a domestic corporation, partnership or trust if at least 50% of the entity's gross income or assets are passive.

- **IRS Lowers Fee for Streamlined Application for Tax Exempt Status:** U.S. organizations wishing to apply for tax exempt status under Internal Revenue Code Section 501(c)(3), that generally will have less than $50,000 in gross receipts and less than $250,000 of gross assets, can file a form 1023-EZ, a streamlined version of the full application Form 1023. Effective July 1, 2016, the user fee required to process the application has been reduced from $400 to $275.
- **President Signs Bill that Allows Use of Taxpayer Information to Find Missing Children:** On June 30, President Obama signed into law the "Recovering Missing Children Act" which allows for the disclosure of tax returns and tax return information to state and local law enforcement agencies that are working in collaboration with a Federal agency to investigate cases of missing or exploited children.
- **Final Regulations Eliminate the Need to Attach Code Section 83(b) Election to Tax Return:** In general, if property is transferred to a taxpayer in connection with the performance of services, the excess of the fair market value of the property over the amount paid for the property (if



any), is included in the taxpayer's gross income. This occurs in the first tax year in which the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture. However, under IRC Section 83(b)(1), a taxpayer may elect to include the income in the year of transfer rather than the year that the property vests. This election can be very beneficial as any increase in the value of the property after the time it is received will be taxed as a capital gain rather than ordinary income.

The election is made by filing one copy of a written statement with the IRS office where the taxpayer files his return, within 30 days of the date of transfer. Previously, a copy of the statement was also required to be submitted with the taxpayer's income tax return for the year of transfer. Effective for property transferred on or after January 1, 2016, a copy of the election is no longer required to be attached to the tax return.

- **IRS Sent Out Erroneous Penalty Notices:** The IRS has announced that it erroneously sent out notices indicating that taxpayers made late deposits of employment taxes that were due around Memorial Day. The IRS has also stated that any impacted taxpayer account will be corrected and taxpayers need not take any further action.
- **New Jersey Lottery Withholding Rules:** The New Jersey Division of Taxation has updated its publication that discusses withholdings from New Jersey lottery winnings. For tax years beginning on or after January 1, 2009, New Jersey Lottery winnings from prize amounts exceeding $10,000 are taxable for New Jersey gross income tax purposes. Specifically, the prize amount is the determinative factor of taxability, rather than the total amount of lottery winnings over the year. For example, if a person won the New Jersey Lottery two times in the same year and the winning prize amounts were $5,000 and $6,000, these winnings are not subject to New Jersey gross tax.

If you have any questions about these or other tax laws, please don't hesitate to reach out to your MT&L tax professional. ■

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What You Need to Know About Nanny Taxes

Ryan McElwaine

Now that summer is over and the kids are back in school full-time, many parents are relieved of the burden of who is going to take care of their kids during the day while they are at work. But what about those whose children are not enrolled in full-time school yet? Some will rely on family to be the child's caregiver, while others will hire a nanny or babysitter. It's important to be aware that your nanny is considered a household employee, and, depending on their income level, you might be required to withhold and pay taxes for them. These are known as **Nanny Taxes**.

Nanny Taxes are taxes the employer (you) withholds and pays for a household employee (in this case, the nanny) who earns more than $2,000 in a calendar year (or $1,000 or more in any calendar quarter). You, the employer, are required to withhold Social Security and Medicare (also known as FICA) taxes from the nanny's paycheck every pay period and also pay a matching portion of these FICA taxes yourself. Also, depending upon which state you reside in, you may have to pay federal and/or state unemployment taxes as well. If the nanny wishes to withhold federal and state income taxes from their paycheck, they must fill out and provide you with a Form W-4.

So, if you have a nanny or household employee who meets the annual $2,000 earned income threshold, there are a couple of things you will need to do to set up the proper payroll system. First, in order to report nanny taxes, you need to obtain both federal and state tax identification numbers, which you can get from the IRS and tax agency in your state of residence, respectively. Next, put a system in place that will allow you to properly calculate their gross pay, withhold the correct amount of taxes, and determine the taxes that you, as the employer, must pay. There are free online calculators to assist you with this, as well as service providers who take care of the entire process for a fee. These service providers can perform the necessary payroll tasks, create the required tax forms you will need at year-end, and also prepare and file the appropriate schedules on your federal and state income tax return on a quarterly basis (quarterly is recommended, not required).

With so many required tax forms and schedules to be filed, many individuals ask "why can't I just pay my nanny cash and take my chances with the IRS?" Unfortunately, should the state find out, disregarding nanny taxes could lead to a state audit and potential tax evasion charges, as well as owing back taxes with penalties. This scenario could become a very real possibility if a former nanny ever applies for federal and state unemployment benefits and lists you as former employer.

The benefits of paying nanny taxes outweigh the negatives:

1. If you have a **Flexible Spending Account (FSA)** with your employer, you can set aside up to $5,000 of pre-tax dollars for dependent care expenses. Paying childcare expenses with pre-tax dollars reduces your overall taxable income, effectively lowering your total income tax bill.
2. If you do not have an FSA, the **Child Care Tax Credit** provides individuals with a credit to their taxable income of up to $3,000 per child per year for child care expenses, with the maximum allowable being $6,000. There are Adjusted Gross Income limitations to this option which may cause a decrease in the overall credit.

In summary, nanny taxes are an obligation if the nanny earns the above stated income levels. This comes with the responsibility of running payroll, providing tax forms to the nanny, and filing tax returns on a more consistent basis than one might normally do. If this seems overwhelming, look for a service provider that can perform all of these responsibilities for you. In the end, ensuring your children are well taken care of while fulfilling your financial obligations is the ultimate goal. ■

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Using Non-Financial Incentives to Retain Employees

Tuition Assistance/Expense Reimbursement

Many employees would like to pursue an advanced degree or a professional license, but may have trouble bearing the cost on their own. Offering tuition assistance or an expense reimbursement program can greatly impact whether or not an employee chooses to stay with your company. Not only do advanced degrees benefit the individual, but they will also benefit the employer with a more educated employee.

Recognition

Employees who feel appreciated are more likely to stay. Recognition and praise are powerful motivators and are not utilized by employers as often as they should be. Recognition can be as simple as a "thank you" for a job well done or can be implemented through an Employee of the Month or similar program. Everyone likes to be appreciated and expressing your appreciation to your employees is a simple and effective way of motivating them.

Other Incentives

The above non-financial incentives are desired by many employees, but not all people are the same. Therefore, you should talk to your people to find out what is important to them and what kind of incentives they may be looking for. It could be something little that will make a huge difference. From personal experience, there is nothing better to boost employee morale than a late night ice cream run for all of the staff working long hours during tax season.

Happy employees provide better output. And while most people value competitive salaries, raises, and promotions, non-financial benefits also play a large role in whether or not your employees will stay. In today's competitive marketplace, employers should seriously consider using non-financial incentives and rewards to keep their employees engaged, satisfied, and loyal. ■