CPA

Client Bulletin

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

December 2017

Pros and Cons of Asset Management Fees

A transition is underway within investment firms. Increasingly, the people you hire to manage your money don't refer to themselves as *brokers* or *stockbrokers*. Instead, they're now *financial advisers, financial planners*, or *financial consultants*.

The titles may not be important, but the method of compensation can be crucial. Traditionally, brokers were paid by commissions. When you bought or sold stocks or certain mutual funds, you paid money to the broker. That's still true for some investment professionals.

However, many financial advisers are reducing or eliminating commission income in favor of fees; therefore, the money you pay these advisers does not depend on the trading you do. Various types of fees may apply, but an "assets under management (AUM)" approach is probably the most common.

With AUM, you pay a fee to the adviser that's based on your portfolio value.

Example 1: Nora Collins has a $500,000 portfolio that's managed by a financial adviser. The adviser has a 1% AUM fee. Thus, Nora pays $5,000 (1% of $500,000) a year to the adviser. If her portfolio increases to $550,000, Nora's annualized fee would increase to $5,500; if her portfolio drops to $450,000, the fee would be $4,500, and so on. (Many advisers reduce AUM percentages as portfolio size increases.)

Common interest

Advisers who favor the AUM method may contrast it with the traditional way of paying commissions on trades. Some brokers have been charged with "churning" clients' accounts—trading heavily to boost their income, even if there was no good reason to do so. With AUM, churning isn't an issue; Nora will pay the 1% fee no matter how many or how few trades are made.

Instead, AUM supporters assert they are on "the same side of the table" as investors. The better these advisers perform, the more money clients will have and the more fees advisers can collect. Investment losses, on the other hand, will decrease AUM fees. So, advisers charging this way have ample incentive to perform well.

After all, if Nora sees her account grow by $50,000, she probably won't mind

continued on page 2

What's Inside

1 Pros and Cons of Asset Management Fees

2 Win With a Roth IRA Reversal

3 Year-End Thank You Gifts From Business Owners

4 Tax Calendar

Pet Purchases

Pet industry spending in the United States during 2016 set a record high at $66.75 billion, led by food ($28.23 billion), veterinary care ($15.95 billion), and supplies and over-the-counter medicine ($14.71 billion).

continued from page 1

paying an extra $500 to her adviser, will she?

Getting your money's worth

Those reasons have merit, but there are possible drawbacks to paying AUM to an adviser. For instance, the amounts involved may not be inconsequential. Nora might be paying $4,000–$6,000 a year to her adviser, depending on investment results.

Will Nora be getting value for her money with a truly personalized investment plan? Will her adviser help her reduce the tax impact on her investment activity? Will he or she advise her on which investments go inside her 401(k) plan and which go into taxable accounts? Ultimately, it's up to Nora and other clients paying advisers by AUM to decide if the investment advice they're receiving, perhaps supplemented by other financial planning, is worth the money they pay every year.

In addition, some investors may not have easy access to advisers who charge AUM fees.

Example 2: Mark Lane invests largely in real estate and has relatively little in stocks, bonds, or mutual funds. Advisers who work on an AUM basis may have a minimum portfolio size for clients, so Mark won't qualify.

The same is true for Mark's sister, Kathy, who runs a small business and puts most of her spare cash back into the company. However, Mark and Kathy both have some investment assets that could benefit from astute advice, as well as a substantial need for personal financial guidance.

Other options

Besides AUM, what alternatives do you have for investment management? You can do it yourself, if you have the time and inclination, by choosing no-load mutual funds and perhaps paying discount brokerage commissions for selected securities transactions. Another possibility is to work with an adviser who still charges commissions, if the total of those commissions is less than an AUM fee.

Some financial advisers work on a retainer basis for clients such as Mark and Kathy, who have significant net worth but relatively little in the way of liquid assets to manage. The retainer typically is based on the adviser's estimate of the time necessary for financial planning. The retainer might be high for a new client, reflecting considerable planning, but then drop in subsequent years until an event such as a business sale requires more effort again.

Hourly fees and flat fees for an upfront financial plan also may be among possible modes of compensation for financial advice. Some advisers will offer a combination of compensation arrangements to suit a client's needs. For investors, the key is to get complete disclosure of an adviser's compensation method and periodically confirm that you're getting value for the amount you pay. ■

Win With a Roth IRA Reversal

IRAs mainly come in two broad categories: traditional and Roth.

Traditional IRAs may be funded with pre-tax or after-tax dollars and are often funded largely with pre-tax dollars. Withdrawals of pre-tax money and earnings from the IRA are taxed at ordinary income rates. Once the IRA owner reaches age 70½, required minimum distributions (RMDs) from the account begin and last as long as there is money in the account. Any shortfall in a taxpayer's RMDs for a year is subject to a 50% penalty.

Roth IRAs are always funded with after-tax dollars. Account owners never have RMDs. Once a Roth IRA has been in place for five years and the account owner reaches age 59½, distributions are tax-free.

Astute combining of these two IRA varieties can result in a substantial stream of cash flow, moderately taxed, for you or your beneficiaries, or both.

Conversion calculation

IRA contributions are now capped at $5,500 per year ($6,500 for those 50 or older). In addition, many people roll over large amounts into IRAs from a 401(k) account when they leave a job.

Example 1: Sue Baker leaves her long-time employer at age 55 to start a consulting business. While employed, Sue accumulated $400,000 in her 401(k) account, all pre-tax. She rolls the entire amount into a traditional IRA, maintaining the tax deferral.

At this point, Sue does not expect to heavily depend on her IRA for retirement spending. However, Sue realizes that she eventually will face RMDs. After more than 15 years of tax-deferred buildup, the RMDs could be substantial, generating sizable tax bills for withdrawals that Sue might not need.

Sue naturally would prefer to have her money in an RMD-free, potentially tax-free, Roth IRA. However, a complete Roth IRA conversion of her $400,000 traditional IRA would add $400,000 to her taxable income this year and trigger a six-figure tax obligation. Considering that her RMDs might last for many years, Sue would be vulnerable for future tax rate increases. Therefore, Sue decides to execute a partial Roth IRA conversion. The next step is determining the amount to convert.

continued on page 3

continued from page 2

Partial projection

One way to approach a partial Roth IRA conversion is to estimate an amount that will keep taxable income in the current tax bracket.

Example 2: Sue, who is unmarried, reported taxable income of about $75,000 in 2016. She expects her 2017 income to be about the same. This year, the 25% tax bracket for single taxpayers goes up to $91,900. Thus, Sue converts $15,000 of her traditional IRA to a Roth IRA in 2017. She believes that will keep her in the 25% tax bracket and generate $3,750 of added federal income tax (25% of $15,000), which Sue feels is reasonable.

If Sue makes similar partial Roth IRA conversions for the next 15 years, she probably will convert over half of this traditional IRA to a Roth IRA. Her RMDs will be reduced, and she'll have access to a substantial amount of untaxed cash flow.

Looking back

A more precise method of implementing Roth IRA conversions is to use *recharacterization*, an IRS-approved method of reversing Roth IRA conversions, in full or in part. A Roth IRA conversion can be recharacterized up to October 15 of the following year, regardless of whether a taxpayer has requested an extension of time to file his or her return.

Example 3: Sue converts $100,000 of her traditional IRA to a Roth IRA in December 2017. When her 2017 tax return is prepared in early 2018, she discovers that her taxable income would be $73,200 without her Roth IRA conversion. Therefore, Sue recharacterizes enough of her 2017 conversion to wind up with an $18,700 conversion (the $91,900 upper limit of the 25% tax bracket minus Sue's $73,200 of other taxable income).

Sue uses the full amount of the 25% tax bracket, moving as much money as possible from the traditional to the Roth side without moving into a higher bracket. Our office can help you calculate the amount to recharacterize and the amount to leave in the Roth IRA if you are interested in this strategy.

Once money is in the Roth IRA and the qualifications are met, Sue can withdraw as much or as little as she needs tax free. Amounts still in the account at Sue's death usually can be withdrawn by her beneficiaries tax free, although RMDs will be in effect. ■

Trusted Advice

Roth IRA Conversions

- You can convert a traditional IRA to a Roth IRA in three ways:
  - **Rollover.** You can receive a distribution from a traditional IRA and contribute that amount to a Roth IRA within 60 days. Here, the distribution check is payable to you.
  - **Trustee-to-trustee transfer.** You can ask the financial institution holding your traditional IRA to transfer an amount directly to the trustee of your Roth IRA at a different financial institution. The distribution may be issued to you, payable to the new trustee.
  - **Same trustee transfer.** To keep your Roth IRA with your traditional IRA custodian, you can tell the trustee to transfer an amount from your traditional IRA to your Roth IRA.
- A conversion to a Roth IRA results in taxation of any untaxed amounts transferred or rolled from the traditional IRA.
- The conversion is reported on Form 8606, Nondeductible IRAs.

Year-End Thank You Gifts From Business Owners

During the holiday season, it's natural for business owners to think about giving something to key individuals. On your list might be your employees, customers, suppliers, or others who helped your business during 2017. If you haven't already made plans, do so quickly so the gifts may be distributed before year-end.

Lavish gifts may make an excellent impression, but you probably don't want to go overboard by spending too much. You should have a budget for these gifts and stick to it. You also should know the tax consequences of your generosity.

Employee gifts

Amounts you spend on gifts to your workers probably will be tax deductible for your company. However, the key question for employees is whether the gifts will be treated as taxable income.

Generally, a cash gift or anything that looks like cash, such as a gift card or gift certificate, will be taxable. The amount will be subject to federal and any state or local income tax withholding as well as unemployment tax and FICA taxes.

Non-cash gifts will be untaxed if they fall under the de minimis classification, meaning that the value is so low that it would not be reasonable for an employer to bother with record keeping, withholding, and so forth. The IRS has not spelled out an upper limit for spending on tax-exempt gifts. That said,

continued on page 4

continued from page 3

you're probably safe giving away hams or turkeys during the holidays.

If you wish to give other types of gifts, our office can advise you of the tax consequences. (More expensive gifts probably will generate taxable income.) In all price ranges, choices are vast and variable, from smartphone accessories (photo tripods, waterproof cases, and so on) to tickets to local entertainment.

Your gift will be even more meaningful if it's accompanied by a thoughtful letter of thanks and wishes for good health in the coming year.

Business gifts

Instead of or in addition to employee gifts, you may want to give something to selected outsiders who helped your company during 2017. In this case, the issue is not whether the gift will be taxable income for the recipient, but whether you can deduct the cost of gifts to clients, vendors, and so on.

A business may deduct no more than $25 for business gifts per recipient. You can't exceed this limit by making indirect gifts to a customer's family member. Therefore, if you give a $200 sweater to the husband of a key customer, it will be considered an indirect gift over the $25 limit, and the excess amount will not be tax deductible. However, this rule does not apply if you have a bona fide, independent business connection with the family member receiving the gift, and it is not intended for the customer's eventual use.

For this purpose, a partnership and its partners are treated as one taxpayer. Similarly, a married couple will be treated as one taxpayer subject to the $25 limit. It doesn't matter whether the spouses each have their own company, are employed at different places, or have independent connections with the recipient.

Example: Steve Harrison's company does business with ABC Corp., which is a valued customer. Steve and his wife Tina give four baskets of wine to ABC as a holiday gift.

The Harrisons paid $100 apiece for these baskets, for a $400 total. Four ABC executives each took a gift basket home for their personal use. The Harrisons have no independent business relationship with any of the executives' other family members. They can deduct only $100 (4 times the $25 limit) of the cost of the gift baskets.

Incidental costs, such as engraving on jewelry, packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit. That's true, as long as the incidental cost doesn't add substantial value to the gift.

Beyond $25

The following items aren't considered gifts for purposes of the $25 limit:

- An item that costs $4 or less that has your name clearly and permanently imprinted on the gift and is one of many identical items your company widely distributes. Such items might include pens, desk sets, plastic bags, and cases.
- Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Keeping good records can enable you to support deductions for business gifts, if those deductions are challenged. ■

TAX CALENDAR

December 2017

December 15

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

Corporations. Deposit the fourth installment of estimated income tax for 2017.

January 2018

January 16

Individuals. Make a payment of your estimated tax for 2017 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2017 estimated tax. However, you don't have to make this payment if you file your 2016 return and pay any tax due by January 31, 2018.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2017 if the monthly rule applies.

The *CPA Client Bulletin* (ISSN 1942-7271) is prepared by AICPA staff for the clients of its members and other practitioners. The *Bulletin* carries no official authority, and its contents should not be acted upon without professional advice. Copyright © 2017 by the American Institute of Certified Public Accountants, Inc., New York, NY 10036-8775. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service, call 888.777.7077 or visit *www.aicpastore.com*.

CPA **Client Bulletin**

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

December 2017

Citation and Resource Guide

Sidney Kess, CPA, JD, Editor

Pros and Cons of Asset Management Fees

- The American College of Financial Services compares advisory fee methods at **http://knowledge.theamericancollege.edu/blog/pros-and-cons-of-6-fee-based-options-for-financial-advisors.**

Win With a Roth IRA Reversal

- The IRS explains the rules on Roth IRA conversions at **www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-rollovers-and-roth-conversions.**

Year-End Thank You Gifts from Business Owners

- The IRS explains the rules on the taxation of business gifts at **www.irs.gov/publications/p463#en_US_2016_publink100033905.**

Practice Development Tip

Help Clients Help Hurricane Victims

As of this writing, the hurricane season is in full swing. Texas, Florida, and nearby states have suffered enormous losses; rebuilding in some areas will be long and costly. In addition, other hurricanes are being tracked now that could potentially bring even more devastation.

During the holiday season, the news will still be vivid in the minds of many clients. Some will be eager to help those who have been severely affected.

You can help clients to help others via e-mail, through your website, or by other means of communication. To do so, you should have one or more recipients in mind. A nursing home on the west coast of Florida, for instance, might have a need for quilts, blankets, and other bedding for residents.

To prescreen potential recipients, you or others at your firm may know someone in an area affected by these hurricanes or know someone who knows someone there. If a recipient group or organization is vouched for by someone trustworthy, direct clients to them to donate cash or property contributions. This type of effort can involve everyone at your firm, from partners to staffers, and demonstrate the firm's values to the workforce as well as to clients.

If you're a CPA in an area that was in a hurricane's path, and you're reading this practice development tip, we wish you good fortune in rebuilding your health and property as well as your practice—and a much better year in 2018!

Practice Development and Management Resources

from the AICPA

For more information or to order, log on to *www.aicpastore.com* **or call 888.777.7077.**

Fundamentals of Estate Planning, 15th edition

- This publication provides a complete overview of the main topics of estate and gift tax planning. Learn about the various aspects of estate and gift tax planning, including the nature, valuation, transfer, and administration and taxation of property; the estate and gift tax system, including strategies of estate planning; gratuitous transfers of property; and the client interview.
  [Item no. PPF1603P—AICPA Member $149.00, Nonmember $169.00]

continued on next page

CPA Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

December 2017

Planning for Retirement Needs, 13th edition

■ Learn about individual retirement planning, including IRAs and Roth IRAs, Social Security benefits, and saving and planning for retirement. Know how to help your business owner clients make decisions about qualified plans, SEPS, SIMPLEs and 403(b) plans, and nonqualified deferred compensation plans. Retirement planning covers accumulating and preparing for retirement, as well as making decisions during retirement. This publication covers the basic concepts needed to discuss your client's retirement planning needs.

[Item no. PPF1507P—AICPA Member $149.00, Nonmember $169.00]

AICPA PCPS/CPA.com MAP Survey National Summary

■ AICPA's Private Companies Practice Section (PCPS) partnered with CPA.com on the National MAP (Management of an Accounting Practice) Survey, which was fielded from mid-May through July 2016. This summary provides financial and other key benchmarking data from the survey. This product will provide you with comparative benchmarking data relative to firm size and region that can help you create strategic goals and maximize your firm's performance.

[Item no. PCPSSUR03—AICPA Member $200.00, Nonmember $300.00]

Management of an Accounting Practice eHandbook

■ This is your go-to resource for all things practice management. Streamlined online guidance for easy reading and quick reference on the topics you care about: employee compensation and benefits, staffing, disaster recovery, firm organization, benchmarking, strategic planning, and more!

[Item no. MAP-XX—AICPA Member $149.00, Nonmember $189.00]

MAP On Track

■ Often, practitioners and small- to medium-sized firms find it challenging to stay on top of firm management responsibilities. The new Management of an Accounting Practice On Track (MAP On Track) will help keep you organized. This new scheduler is easy to download and functions as an add-in to Microsoft Outlook, adding tasks to keep your firm running throughout the year. As an added bonus, within the automatically scheduled tasks, you'll find useful links to relevant content within the comprehensive MAP eHandbook as well as PCPS tools that can inform your next steps.

[Item no. MAPTKD—AICPA Member $229.00, Nonmember $289.00]

CPA Client Bulletin Select

■ Do you ever wish you had more flexibility with your CPA Client Newsletter content? Now you can with this new monthly offering from the AICPA. Optimize your client and prospect communications with the AICPA's trusted CPA Client Newsletter content, now available in a flexible, editable MS Word format for use in your firm blog, social media outlets, traditional client newsletter communications, and beyond.

[Item no. PCN1301W—AICPA Member $549.00, Nonmember $689.00]

Need help with your subscription?

Contact our Member Service Center at 888.777.7077 or *service@aicpa.org*.

Questions or comments about the content?

Contact Whitney Woody, Managing Editor, at 919.402.4857 or *CBeditor@aicpa.org*.