CPA

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Client Bulletin

BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

Investment Outlook 2007: Slow but Steady

As you plan your investments for 2007, here's what forecasters are expecting:

Economic growth

There is no recession in sight, according to most predictions, but growth is expected to slow. The White House Council of Economic Advisers sees U.S. gross domestic product rising by 2.9% in 2007. Other forecasters see slower growth, in the 2% to 2.5% range. (The final number for 2006 probably will be around 3%.)

The main reason for the expected slowdown this year is weakness in housing. According to the National Association of Realtors and the U.S. Department of Commerce, new home sales fell by more than 25% in 12 months, existing home sales were down 11.5%, median home sales prices fell a record 3.5%, and the inventories of unsold homes increased to the highest level since 1993.

Consumer spending also may be less exuberant this year, as gasoline prices remain high and homeowners pay more interest on adjustable-rate mortgages. Again, a slowdown in consumption is likely to restrain economic growth.

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Did You Know?

Housing prices may have leveled off in 2006, but real estate mutual funds were up 34.63% for the year through November, tops of all domestic fund categories. The ten-year annualized return for the real estate category was 15.19%, double the 7.60% return for all domestic equity funds.

***Source:* Morningstar**

Inflation

If there is a bright side to a slower economy, it may be the forecasts of lower inflation. According to the latest report, the core personal consumption expenditure price index (the Federal Reserve Board's favorite inflation measure) rose by 2.4% in the latest 12 months.

In a slower economy, this inflation gauge could fall to 2%, or even lower.

Bond market outlook

In this environment, where should investors be in the bond market?

Generally, high-quality bonds are recommended. That means government issues and investment-grade corporate bonds. A slowing economy will raise the prospects for defaults and might cause investors to suffer losses in lower rated bonds.

Short-term issues, with maturities from two to five years, are recommended by fixed-income analysts. Going longer may not pay off; currently, two-year Treasuries actually pay more (4.5%) than 10-year Treasuries (4.4%).

Municipal bonds (munis) look attractive, especially if you are in a high tax bracket.

Top-quality, five-year corporate issues, for example, now yield around 5%. If you are effectively in a 40% tax bracket (including state and local taxes), you'd lose 2 percentage points, or 40% of 5%. Thus, you'd net only 3%, after taxes.

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AAA-rated, five-year municipal bonds yield around 3.5%, so you'd wind up ahead with munis. Buying local issues can help you avoid state and local as well as federal income tax on the interest.

Stock market outlook

The so-called "Goldilocks" economy (not too hot, not too cold) expected for 2007 should be favorable for stocks. The broad market has posted gains in each of the past four years and that streak may continue. (Even after this extended runup, the benchmark Standard & Poor's 500 Index [S & P 500] is still nearly 10% below the peak reached in early 2000, so valuations are not irrational.)

If there is a chance for a pullback, it might be in small-capitalization stocks. The Russell 2000 Index of small-caps is up nearly 14% a year for the past five years, almost double the return of the S&P 500.

Therefore, you might want to look over your portfolio with an eye towards rebalancing. Trim your small-cap positions, if they've gone beyond your allocation, and put money into underperforming large-caps.

Similarly, foreign stocks (especially companies based in emerging markets) have been far ahead of domestic equities over the past five years. Since no trend lasts forever, this might be the time to take some profits on international stocks and funds while shoring up your stake in U.S. companies.

Prepare to Meet Your Preparer

As the filing deadline for your 2006 Federal income tax return approaches, you probably are rounding up the paperwork necessary for a meeting with our office. The more advance preparation you do, the more value you're likely to get from your tax preparer—for a lower fee.

Many people schedule a preliminary consultation at this time of year. However, taxpayers vary tremendously as to how they use that meeting.

Access to expertise

Some people pull out a folder and use the meeting to open up envelopes and hand over pieces of paper. If that's your approach, you're wasting valuable time.

Other taxpayers organize in advance. They make a list of all their income and expenses, with backup documentation, which means that this material can be gone over quickly.

If you take the latter approach, you can devote more of the meeting to asking questions. Thus, you can get a consultation on tax and financial matters.

In addition, organizing your records before meeting with your tax professional will result in the added benefit of lower costs; the less time your CPA has to spend straightening out your records, the less time you'll have to pay for.

Letter perfect

When you get ready to meet with us, organize your receipts by category. Also bring your W-2 forms, 1099s, bank statements, investment records, and so on. If you aren't sure whether certain documents are necessary, bring them to the meeting anyway, just to make sure you're don't overlook anything that turns out to be important.

One technique for organizing your records is to have one envelope for charitable contributions, another for travel and entertainment expenses, etc. Add up all the expenses (without double counting) and put the sum of that category on the outside of the envelope.

Those will be the numbers you give to your tax preparer. This approach saves accounting time (and fees) while providing supporting documents for easy retrieval.

Out of harm's way

Being well organized also can reduce your chance of attracting the attention of the Internal Revenue Service (IRS). For example, misreporting the amount of estimated taxes paid by only a few dollars can result in an IRS notice.

In this situation, the amount of extra taxes that have to be paid may be insignificant, even if interest and penalties are involved. However, you probably will not enjoy receiving a letter from the IRS. In addition, it may take a few hours of a CPA's time to respond to the IRS notice, and that will result in additional fees.

When it comes to minimizing the chance of an IRS examination, keep in mind that the IRS devotes a tremendous amount of effort to document matching. Make sure that your tax return reflects all income reported on all the W-2 and 1099 statements you receive for 2006. Any discrepancies are likely to get an unwelcome response from the IRS.

Track your trades

Avoiding discrepancies in reporting income is especially important when it comes to securities transactions. Suppose, for example, you sold some stocks last year. Go over your records to be sure you know your cost basis and the length of your holding period.

The same is true if you moved

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money among mutual funds last year. Any mutual fund transaction is a reportable sale, even if you moved money between funds in the same "family."

Most mutual fund companies and brokerage firms provide basis information after year-end. However, some investors throw away those statements before filing their tax returns. Without those records, you may have a hard time putting together the necessary information.

If you file your return without reporting all your securities transactions, the IRS may ask for more information. Eventually, your entire tax return may be examined.

In 2007, Cut Your 2006 Tax Bill

Even though the calendar says that it's 2007, it may not be too late to cut the tax you owe on your 2006 return. If you had self-employment income last year or if you run a small company, you may be able to get "look-back" deductions with a simplified employee pension (SEP) plan.

Retroactive tax relief

A SEP will be effective for a calendar or a fiscal year if it's adopted by the time that year's tax return is due, including extensions. Therefore, if you have not yet created a SEP for 2006, you can set one up by April 16, 2007, when your tax returns are due.

You can get even more time by requesting a filing extension. Then, you'll have until next October 15 to establish a SEP, fund it, and get tax deductions for 2006.

Simple does it

To establish a SEP, an employer need only fill out IRS Form 5305-SEP, which is not as demanding as the lengthy plan and trust documents required by qualified plans. If you set up a SEP with a financial institution, you likely will be provided with the necessary paperwork, which is minimal.

In fact, your SEP form does not have to be filed with the IRS and no annual reports need be filed, either. Essentially, the only ongoing condition is that a copy of the SEP form must be provided to any covered employee.

Upper limits

A SEP may be called a SEP-IRA because of the insignificant paperwork involved. As for an individual retirement account (IRA), all participants choose their own investments, which allows you to keep control of your retirement planning.

However, contributions to a traditional or a Roth IRA are limited to $4,000 per year for 2006 and 2007 ($5,000 for those 50 or older). Tax-deductible contributions to a SEP-IRA can be much greater.

For someone on a company payroll, contributions can be up to 25% of employee's compensation. The calculation is more complicated for self-employed individuals, though. Once all the numbers are crunched, you can contribute (and deduct) about 20% of your gross self-employment income.

Either way, for 2006, the maximum contribution to a SEP plan is $44,000, the same as for some types of qualified plans. (That ceiling rises to $45,000 in 2007.)

Thus, in order to make the maximum $44,000 contribution to a SEP for 2006 account, you must earn at least $220,000 as a self-employed individual. If you're an employee, your salary must be at least $176,000 to qualify for a $44,000 contribution.

Paying the price

For self-employed individuals, a SEP may be ideal. However, consider the costs if you run a small company or professional practice. All eligible employees must receive the same SEP contribution, as a percentage of compensation.

Suppose, for example, you earned $176,000 in 2006 as an employee of your corporation. You direct your company to contribute $44,000 (25%) to your SEP account.

In this situation, the company also must contribute 25% of pay to the SEP accounts of all eligible employees. You even may have to contribute on behalf of part-timers and workers who have left the company.

The tax code requires that employers with SEP plans must contribute to the account of each employee who has—

- Attained age 21;
- Worked for your company in at least three of the last five years; and
- Received at least $450 in compensation from you in 2006 ($500 in 2007).

If you wish, you can use less restrictive requirements to determine an eligible employee.

The three-year hitch

Why would you want to use less restrictive requirements?

Suppose, for example, you had a 24-year-old assistant who worked for you in 2005 but left your company in mid-2006. Technically, this employee worked in only two preceding years, so he need not be included in your SEP plan. You don't have to make a 25%-of-pay contribution for a departed worker you probably will never see again.

However, if you exclude some workers because of the three-year rule, all workers who fail this test must be excluded. For instance, you won't be able to include the well-paid sales manager you just hired and she will be unhappy about being excluded.

The bottom line is that SEPs may not work well if you have many employees, some of whom are highly compensated. SEPs are most appropriate if you have few employees and they don't draw huge paychecks.

The more people on your payroll, the more carefully you need to work with your CPA to decide whether the simplicity of a SEP justifies the expense.

Tax Calendar

FEBRUARY 2007

February 12

Employees who work for tips. If you received $20 or more in tips during January, report them to your employer. You can use Form 4070.

February 15

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 2006, but did not give you a new Form W-4 to continue the exemption for 2007.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2006. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is April 2.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2006. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is April 2.

MARCH 2007

March 12

Employees who work for tips. If you received $20 or more in tips during February, report them to your employer. You can use Form 4070.

March 15

Corporations. File a 2006 calendar-year income tax return (Form1120 or 1120-A), and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2006 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.

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 2007. If Form 2553 is filed late, S treatment will begin with calendar year 2008.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date is effective for the first March 15 following the close of the partnership's tax year. The due date of March 15 applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

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

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose. For any entries in the Tax Calendar that refer to other IRS publications, visit *www.irs.gov* for more information.