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

January 2018

Investing In 2018: Dividend Stocks

As of this writing, it appears that 2018 may be a difficult year for investors. Yields on bonds, bank accounts, money market funds, and other savings vehicles are extremely low, with questionable prospects for substantial increases. Stock market indexes, on the other hand, are at or near record levels.

In essence, relatively low-risk places to put your money this year appear to offer scant returns. Equity markets have been rising since early 2009, so the chance of a pullback may be just as great as the possibility of solid gains.

Given this environment, where might investors go for opportunities for respectable returns with some protection against a steep decline? One possibility is in the stock market.

Paying dividends

Equity markets are notoriously difficult to predict. Nevertheless, dividend paying stocks might tilt the risk-reward odds in your favor. During recent bear markets, dividend payers generally fared better than those that didn't pay dividends.

This seems reasonable because dividend paying companies may be enterprises that generate ample cash flow—enough to distribute some profits to investors. Companies in strong financial condition could be favored by investors in stormy economic weather, and the prospect of ongoing dividend payouts might stem panicked selling.

Floor and ceiling

Whereas dividend paying stocks may offer some protection during down markets, they also might deliver solid returns. The yield on the benchmark Standard & Poor's 500 Index currently is nearly 2%. That's the yield for the broad index, so some of the large companies included in the index have dividend yields of 3% or more. When an investment starts with such a payout, it's less likely to fall into negative territory and is already on the way to possible robust returns.

Dividends can grow, too. Indeed, many public companies have long histories of raising their payouts.

Example: Nancy King is a widow who depends on investment income for her lifestyle. She invests $50,000 in shares of GHI Corp., currently paying a 4% dividend, or $2,000 a year. If GHI raises its annual dividend to $2,500 over the next few years, Nancy will collect a 5% return on her initial investment.

In addition, *qualified dividends* (see **Trusted Advice** box) receive favorable tax treatment. Nancy, in a low tax bracket in our example, could owe 0% on qualified dividends. Other taxpayers owe 15% or,

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What's Inside

Slippery Slope

From late 2007 to late 2017, oil prices fell from over $100 a barrel to under $50 a barrel.

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Trusted Advice

Qualified Dividends

- Most stock dividends paid to U.S. investors are qualified dividends that are subject to the low 0%, 15%, and 20% tax rates.
- To be qualified dividends, the dividends must be paid by a domestic corporation or a foreign corporation that meets certain requirements (a qualified foreign corporation).
- To get the low rates, investors must hold onto a stock for more than 60 days during the 121-day period, which begins 60 days before the ex-dividend date.
- The ex-dividend date is the first day of trading when the buyer of a stock is no longer entitled to the most recently announced dividend payment. If the ex-dividend date is December 12, a December 11 buyer would receive the latest dividend, but a December 12 buyer would not receive it.

for those in the highest ordinary tax bracket, 20%. These rates are lower than ordinary income tax rates. The Trump Administration's tax reform framework, released in the fall of 2017, does not mention the possibility of ending this tax break.

Go with a pro

It's true that dividend paying stocks can offer many advantages. However, investing in equities carries risks; even the most established company, with excellent management, can see its share price tumble in a broad selloff. Selecting individual dividend paying stocks can require thorough research and portfolio monitoring.

Therefore, many investors prefer to invest in mutual funds or ETFs that focus on dividend stocks. There are dozens of such funds available, with portfolio managers who are responsible for stock selection. Other funds track a custom index of dividend paying stocks. Dividend stock funds tend to fall into two broad categories:

- **High payout.** Some funds are designed to pay higher yields than the S&P 500, perhaps 3% or 4%. They may use "dividend capture" strategies, buying funds just before a dividend payout. High dividends may be appealing, but a robust payout can indicate a relatively low share price due to concerns about the company's growth prospects.
- **Dividend growth.** These funds may have yields similar to the S&P 500 or lower. However, the stocks they hold are chosen because the companies have enjoyed growing earnings along with rising dividends and are considered likely to continue such profitability.

Quality counts

Dividend oriented investors may hold individual stocks, specialized funds, or a combination. They aim to own successful, profitable companies that will provide a steady stream of cash flow, bull market or bad. There's no magic about dividend paying stocks and there have been instances in which a dividend cut has been followed by a plunging stock price. Still, buying successful companies that pay appealing dividends is one way to approach equity investing this year, with current prices at lofty levels. ■

Investing In 2018: Defensive Funds

As the previous article suggests, 2018 might be a difficult year for stock market investing. Yes, a 9-year bull market could stretch to 10 years. However, the longer the bulls keep running, the greater the chance that they'll have to pause for breath, and an exhausted equities market will sag. Risk reduction can be just as important as profit potential at current stock values.

One approach to risk reduction is to sell stocks and put the proceeds into cash. That may turn out to be a good move now, but it's also possible that you'll miss another good year in the market while earning virtually nothing in cash.

Another way to play defense is to review your asset allocation. If your investment plan is to have a 60/40 portfolio, stocks to bonds, equity gains might have moved that ratio to 70/30, for example. Trimming stocks and increasing bonds to get back to 60/40 probably would make your portfolio less volatile.

Safety in numbers

One additional defensive tactic could be to reduce your holdings of individual stocks, then shift some assets into mutual funds and ETFs. A fund with 50 holdings is not as likely to be decimated as a portfolio with only 2 or 3 stocks. Funds often are managed by experienced professionals, backed by analysts who spend considerable time seeking desirable issues.

That said, there are many thousands of stock funds from which to choose. There is no certain way to predict results of a given fund, but some strategies might boost the likelihood of finding one that can provide some cushion in a down market.

Crafty capturing

One possible approach is to use "capture ratios" to evaluate funds that you're considering. There are two types of ratios: downside capture and upside capture. The downside capture ratio shows a fund's losses in relation to a relevant market benchmark during downturns. The upside capture ratio shows a fund's gains in relation to a relevant market benchmark during upturns. This information can be found online on Morningstar.com.

Example 1: XYZ Fund's 10-year downside capture ratio shows that it held losses to about 80% of its benchmark's decline during market drops, while its 10-year upside capture ratio reports that it's returning about 90% of the market's gains during upward moves. This positive spread indicates the fund has held down losses while delivering largely positive results.

Comparing capture ratios can be useful but it's not a guarantee of success. If it were, everyone would simply look up capture ratios online, invest in the funds with the best positive spread, and mint money.

Nevertheless, the idea of comparing upside with downside performance can be useful. A fund that has done relatively well—that is, limiting losses—during the bear markets of 2000-2002 and 2008-2009 may be a fund that could do the same in the bear market of 2018 or 2019, or whenever the Ursidae family comes out of hibernation. If a fund that has done well defensively also has registered strong growth in rising markets, it may be a fund worth further evaluation.

Winning the numbers game

Underlying the approach of investing defensively is some basic math that investors may overlook.

Example 2: John Lucas holds $100,000 in XYZ Fund. The market drops 25% in the next year, but XYZ only falls by 20% to $80,000.

At the same time, John's cousin Linda James holds $100,000 of ZYX Fund, which drops the full 25% to $75,000.

Going forward, John needs a 25% gain to get back to $100,000, and Linda needs a 33.3% gain to recoup her losses. It's certainly possible that Linda's fund will outperform John's in the recovery, but it has significantly more ground to make up.

Carrying this example further, investors need a return over 40% to recover from a 30% loss, a 67% return after a 40% loss, and so on. Holding down losses can put you in a better position to build wealth when market cycles turn bullish, as you'll have more assets left to participate in future growth.

Stress reduction, too

Defensive funds may have non-mathematical attributes as well. Historically, bear markets have proven to be buying opportunities. Stock prices are "on sale," after steep declines. Yet, many investors sell during downturns and subsequently are late to get back in, forgoing potential profits. This sort of selling may be less likely after, say, a 10% decline in asset values than with a 20% drop.

If you decide to seek a fund with a good record of playing defense, see if the manager or managers who held down losses during bear markets are still in place. Read the fund's materials to find out if its investment philosophy meshes with yours, or discuss the fund's approach with your investment adviser. When stock market records are falling regularly, patience and prudence can pay off. ■

Small Companies Need Plans for Natural Disasters

From East Coast to West Coast, hurricanes and wildfires recently created huge losses of lives, property, and emotional wellbeing. In the middle of the United States, crippling natural disasters can range from blizzards to river flooding to tornadoes. News reports naturally focus on homes and families, but local businesses also are among the victims.

There may be little a small company can do when it's in the path of record winds or a wall of flames. However, there are steps a business owner can take when things are calm to reduce the impact of catastrophic conditions in the future.

Be sure about insurance

For example, relevant insurance should be in place. Whether you rent or own the facilities you use, you should have adequate property insurance from a well-established company. Business interruption coverage may provide cash if revenue producing operations are curtailed for any length of time. Your firm also may obtain special flood or earthquake insurance (or both) if that's deemed necessary.

You probably won't have the time or the inclination to evaluate all the coverage you might need. Therefore, you should work with an experienced agent or insurance consultant who can provide expertise. This professional also can suggest the scope of personal insurance needed by you and your employees, payable after a natural disaster. In the wake of a dreadful event, the less time people spend worrying about personal losses, the sooner your firm can get back to operating at full speed.

Staying online

Business interruption policies may or may not cover problems that disable information technology systems, which are vital to many small companies. Special cyber policies might be available.

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Besides insurance coverage, there are things you can do to proactively keep data and other records intact, even in worst case scenarios.

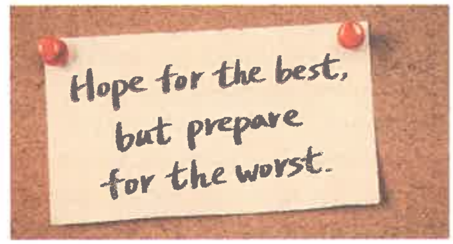
Backing up computer files is an obvious yet vital procedure. Store the backups offsite or use a cloud-based solution. If your company operates in different areas, one place might store backup records for the other place. Some small companies have gone from desktop computers and related accessories to laptops, which are easier to move quickly, if circumstances require swift action.

Power play

As we've seen, some storms bring high winds that can bring down power lines. Hurricane Irma impaired electricity for millions of users in Florida and surrounding states. If you have a generator that can supply emergency power for critical usage, that can reduce the time operations cease altogether.

Again, during and immediately after a disastrous event, it's vital for employees to have power at home so they can go on with their lives and perhaps get some work done. Your company might inform key people about sources of backup power and even provide a financial incentive to have a residential generator installed.

These steps can serve as part of a natural disaster plan. To create a complete course of action, take on the role yourself or assign an employee to



head this effort. The leader's first job might be to find a local consultant or other expert to create a formal policy for your company. Asking your own company's executives and staffers for suggestions can lead to valuable input from all areas of the firm. Once a plan has been adopted, it should be circulated to all employees so they know what to do and who to contact in case of a true emergency. ■

TAX CALENDAR

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 2017 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.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2017. Payments that are covered include the following: compensation for workers who are not considered employees; dividends and other corporate distributions; interest; rents; royalties; profit-sharing distributions; retirement plan distributions; original issue discounts; prizes and awards; medical and health care payments; payments of Indian gaming profits to tribal members; debt cancellations (treated as payment to debtor); and cash payments over $10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2017. If an employee agreed to receive Form W2 electronically, have it posted on a website and notify the employee of the posting.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2017 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs. Deposit or pay any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the year in full and on time, you have until February 12 to file the return.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2017. Deposit and pay any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the year in full and on time, you have until February 12 to file the return.

For federal unemployment tax, file Form 940 for 2017. If your undeposited tax is $500 or less, you can either pay it with your return or deposit it. If it is more than $500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 12 to file the return.

FEBRUARY 2018

February 15

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2017. Payments that are covered include (1) amounts paid in real estate transactions;(2) amounts paid in broker and barter exchange transactions; and (3) payments 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 any employee's pay who claimed exemption from withholding in 2017, but did not provide a new Form W-4 to continue the exemption for 2018.

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TAXES | TOM HERMAN

Everything You Really Should Know About the 'Nanny Tax'

After a long absence, nanny taxes are back in the headlines.

Nanny taxes don't just apply to nannies. The term is shorthand for federal and state employment taxes required of many people who hire nannies, housekeepers, cooks, drivers and other household employees and who pay them more than a certain amount. The subject rarely draws much attention until someone in the news admits a problem. The latest stories to emerge involve Rep. Mick Mulvaney (R., S.C.), President Donald Trump's choice to run the Office of Management and Budget, and Andy Puzder, nominated to be labor secretary.

Shortly after Mr. Mulvaney was nominated, he disclosed he hadn't paid more than $15,000 in taxes for a household employee hired from 2000 to 2004 to help care for the family's triplets. He said he hadn't realized the worker qualified as an employee. He also said he recently paid the federal taxes and promised to take care of everything else owed. Mr. Puzder, chief executive of CKE Restaurants, didn't pay taxes for an undocumented worker he employed as a housekeeper for a few years but did so after he was nominated, a spokesman for the executive said recently. Mr. Puzder said he had been unaware the housekeeper wasn't legally permitted to work in the U.S.

In the past, nanny-tax-related issues have cost prominent figures their chance to serve in high-profile jobs. What happens with the Mulvaney and Puzder nominations remains to be seen. But tax experts say many readers should pay attention whether or not they dream of landing a top job in Washington.

It can be dangerous for employers to assume they won't get caught. For example, trouble sometimes erupts when employers and employees part ways. Nevertheless, the number of people who file the Internal Revenue Service's "Schedule H" for household employment taxes has fallen sharply. The nanny tax "appears to have fallen off the compliance radar screen" for many taxpayers, says Martin Hall, a partner at the Ropes & Gray law firm in Boston and head of its private client group.

AARON P. BERNSTEIN/BLOOMBERG NEWS

Rep. Mick Mulvaney drew criticism after acknowledging a nanny-tax issue involving a former household employee.

Ignorance of the law may play a role in noncompliance. People who hire household workers for the first time may not be aware of all the rules, such as how to define a household "employee," says Guy Maddalone, founder and chief executive officer of GTM Payroll Services Inc. and author of "How to Hire a Nanny: A Household HR Handbook."

Here's a suggestion for busy people who want to comply but can't stand all the time-consuming paperwork hassles: Turn to a professional company, such as GTM or many others, to handle the job. For the do-it-yourself crowd, keep in mind that the rules "can be tricky" and include important exceptions, says Greg Rosica, a tax partner at Ernst & Young LLP in Tampa, Fla., and a contributor to the "EY Tax Guide."

Here are a few key points:

◆ Nanny tax rules apply to household "employees," but not "independent contractors." What's the difference? "The worker is your employee if you can control not only what work is done, but how it is done," the IRS says in Publication 926. "If only the worker can control how the work is done, the worker isn't your employee but is self-employed. A self-employed worker usually provides his or her own tools and offers services to the general public in an independent business."

Also, if an agency provides the worker and controls what work is done and how, "the worker isn't your employee."

◆ Generally, for 2016 and 2017, an employer needs to pay Social Security and Medicare taxes for "cash wages" of $2,000 or more paid to any one employee. Cash wages refer to checks, money orders and the like. They don't include "the value of food, lodging, clothing, transit passes and other noncash items you give your household employee." But cash given to an employee in place of those items counts as cash wages.

◆ Don't count wages paid to your spouse or your child under 21, the IRS says. Wages paid to your parent typically don't apply, either, although there are exceptions.

◆ Don't count wages paid to an employee under 18 at any time during the year, unless providing household services is "the employee's principal occupation," the IRS says. If the employee is a student, "providing household services isn't considered to be his or her principal occupation."

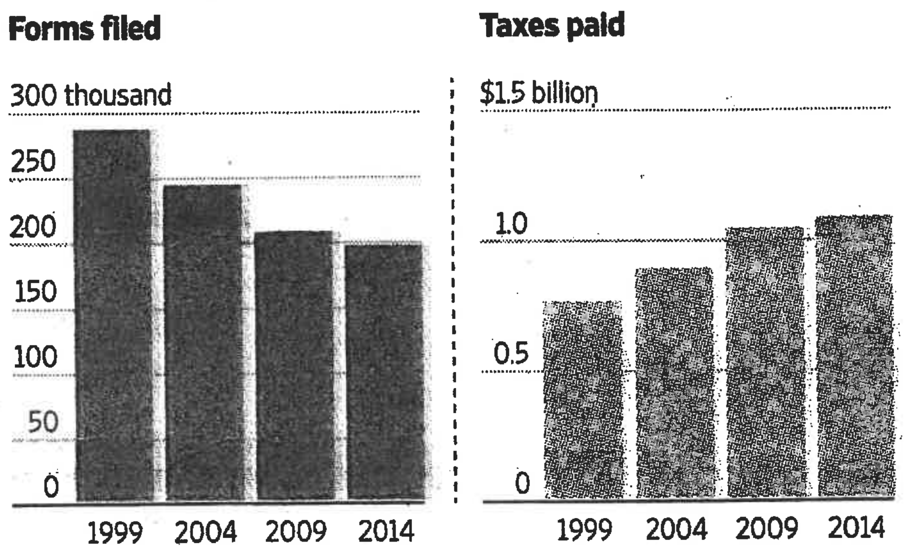
◆ For details on how much to pay and on the federal unemployment tax, known as FUTA, see Table 1 on page 4 of Publication 926. Table 2 has a handy household employer's checklist of what to do for those with a household employee.

◆ Ask your state unemployment-tax agency for the rules on state unemployment tax. Also check out the rules on other state employment taxes or requirements for workers' compensation insurance.

◆ Don't focus solely on tax issues. Make sure you have arranged for all the proper insurance coverage needed to protect you and people working in your home, says Mr. Hall of Ropes & Gray. "There's an awful lot more to this than just filling out tax forms. Shortcuts can prove expensive," he warns.

Fewer Filers...But Bigger Payments

The number of people filing Schedule H, the IRS form for household employment taxes, has decreased over the years, but the amount of household employment taxes has increased.



Source: Internal Revenue Service

THE WALL STREET JOURNAL.