

CPA Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business Advisor™

How to Pay an Investment Advisor



As we've seen in recent years, investment markets can be extremely volatile. You may decide to seek the help of an investment advisor to improve returns, reduce risk, or both. As is generally the case when you work with any advisor, you should get recommendations from people whose judgment you trust. Additionally, meet with several investment professionals before you make any commitments.

Of course, your advisor will be compensated for work done on your behalf. Therefore, you should find out in advance how a prospective advisor will be paid. Here are the most common arrangements:

Commissions

Many advisors are licensed to receive sales charges on securities transactions. You might pay commissions when you buy stocks, for example. Many mutual funds are "load" funds, with various types of sales charges.

Example 1: Mona Grant, a financial consultant, advises Jim Harris to invest \$10,000 in ABC Mutual Fund, which has a 5% upfront sales charge. Thus, Jim actually

owns \$9,500 worth of ABC shares, and \$500 goes to Mona.

If Jim is a buy-and-hold investor, this arrangement may serve him well. After paying \$500 upfront, he might pay little or no extra compensation to Mona, even if he holds onto the fund for 10 years, 20 years, or longer.

On the other hand, investment professionals who get paid when a customer makes a transaction may encourage their customers to make unnecessary trades. To prevent such abuses, you can work with an advisor who comes strongly recommended for his or her integrity.

What's more, not all investments have simple initial commissions. Mutual funds, for example, often have different share classes. You might pay a smaller upfront sales charge for some types of shares but pay ongoing fees in subsequent years. A trustworthy advisor will explain those options and let you decide which one you prefer.

Assets under management

As a client, you may pay fees rather than commissions to an investment advisor. Among several methods of assessing fees, the assets under management (AUM) technique is increasingly popular. In this arrangement, you pay a fee that's directly related to the amount of investment assets for which the advisor is handling trades. An annual fee of 1% may be typical. That percentage may be higher for small accounts and lower for large accounts.

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Sales commissions paid when trading securities can be added to your purchase price and subtracted from your selling price, reducing your taxable gain or increasing your loss.

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Example 2: Jenny Parker has \$1 million invested with her advisor, Mark Thomas. The AUM fee is 1%, so Jenny pays \$10,000 each year. The fee is collected quarterly; therefore, Jenny pays \$2,500 every three months, assuming no change in her AUM. Mark offers a reduced fee of 8% per year for AUM in excess of \$1 million. Therefore, if Jenny's assets increase by 10%, to \$1.1 million, her asset management fee would increase only 8%, from \$10,000 to \$10,800 per year.

The AUM method has gained supporters for several reasons. It is simple for advisors to calculate and easy for clients to understand. The fee includes all transaction costs, so investors won't worry that advisors will suggest unnecessary trades to boost commissions. With the AUM structure, an advisor's compensation will increase if a client's assets appreciate; thus, an advisor has a strong incentive to recommend investments that perform well.

However, the AUM approach comes with its own conflicts of interest. An advisor might suggest that a client invest in stocks, for example, rather than buy a vacation home because the advisor's fee will be greater with more money under management. Beyond potential conflicts, an investor who sets up an investment plan and stays with it might wind up paying a hefty advisory

fee each year, even though the advisor has made minimal changes. Moreover, advisors who charge by AUM may have a minimum account size, effectively shutting out many people who want help with their portfolios.

Flat fees

Some advisors charge clients a set annual fee, determined by an estimate of how much time and effort they'll need to serve a particular client. This fee might rise or fall in future years as a client becomes more or less challenging to advise.

Such a system provides predictability of income and cost for the advisor and the client. Nevertheless, relatively few investment advisors use this method because it's difficult to accurately predict how much effort each client will require in a given year.

Hourly rates

A number of investment advisors bill clients by the hour, just as CPAs and attorneys frequently do. Hourly billing requires extensive recordkeeping by advisors and may inhibit clients from calling with questions for fear of incurring expenses. Even with these drawbacks, hourly billing has its advantages. Advisors benefit by being compensated for all the hours they spend with clients, and clients who require few hours of an advisor's time

each year benefit by only paying for the time spent on their accounts.

Cost comparisons

No system of advisor compensation is ideal for all clients. Indeed, some investment advisors have multiple compensation methods. They'll discuss these methods with prospective clients and agree on an arrangement that's most appropriate.

Not only should you know an advisor's compensation method in advance, you also should know what services you'll receive. Will an advisor simply manage your investments, or will that advisor offer comprehensive wealth management, from budgeting to insurance to retirement planning? Once you know what you're paying for, you'll have a better idea of how to pay for it. ■

Did You Know?

In fiscal year 2009 (ended September 30), the IRS examined 1,425,888 individual tax returns. That was 1.03% of the returns filed in 2008. The number of examinations in fiscal year 2009 was nearly double the number of examinations in fiscal year 2001.

Source: IRS

Hiring Relatives Will Become More Attractive

As of this writing, Congress appears to be focusing on issues other than income tax. If Congress doesn't make any changes this year, tax rates will rise across the board. In another possible scenario, one favored by President Obama, tax rates will rise only for high income taxpayers. (See the article "Higher Taxes Are Likely, But Perhaps Not for Everyone" in the May 2010 issue of *CPA Client Bulletin*.) Either outcome would make income shifting more attractive than it

has been in recent years. As the spread between the highest and lowest tax rates widens, families will enjoy more tax savings by shifting income from high income parents to lower income children or grandparents.

If you are self-employed, a professional, or the owner of a small company, you may have the best opportunity to save on taxes by shifting income. This could be the case if you are in a position to hire lower income relatives, such as your



children. If you pay your kids a fair wage for work they actually do, you or your company can deduct those payments and save tax at rates up to

35% in 2010. You should avoid paying relatives more than you'd pay other employees for the same tasks, however, because the IRS may disallow deductions for excessive compensation.

Meanwhile, your children may be able to receive tax-free income. In 2010, the standard deduction can shelter up to \$5,700 of earned income from tax. Additional earned income will be taxed at 10%, up to the upper limit of the 10% bracket: \$8,375 of taxable income in 2010.

Example: Amanda Perkins is a self-employed consultant. She files a joint tax return with her husband; together they are in the 35% tax bracket this year. Amanda hires her teenage son, Brett, to handle her office computer systems, run work-related errands, and so on. Brett works 500 hours this year, and Amanda pays him \$7,500 at \$15 an hour.

Brett owes no income tax on the first \$5,700 of earnings, thanks to the standard deduction. On the remaining \$1,800, he only owes \$180 at a 10% rate. Thus, Amanda has reduced her tax obligation by \$2,625 (the \$7,500 she pays Brett times her 35% tax rate), and Brett only owes \$180 in income tax.

All in the family

If you are in a position to hire your children, you also may be able to hire your retired parents. Again, you might save tax in a high bracket while your parents owe little or no tax on the money they earn. If your parents need extra income after they are out of the work force, hiring them can be a tax efficient way to provide support. Your parents also may benefit from the ongoing mental activity and socialization of continuing to work part time.

As previously mentioned, your children can offset earned income with a standard deduction of \$5,700 in 2010. Your parents may get an even greater standard deduction. For married couples, the standard deduction is \$11,400 in 2010. Each spouse who is age 65 or older gets an additional \$1,100 standard deduction. Thus, if your parents file a joint return, and are both age 65 or older, their standard deduction for 2010 would be \$13,600. If you hire a parent age 65 or older who files as a single taxpayer, he or she would have a standard deduction of \$7,100: \$5,700 plus an additional \$1,400 for reaching age 65. ■

Trusted Advice

Preparing the Paperwork

- ❖ If you hire family members, keep records of their work and pay them what you'd pay a nonrelative for such tasks.
- ❖ You should issue a form W-2 at the end of the year, reporting a relative's earnings to the IRS.
- ❖ Generally, you'll have to follow the payroll tax rules for relatives you hire.
- ❖ If your business is not incorporated, you won't have to withhold for Social Security or Medicare if you hire your child who is under age 18.
- ❖ Also, if your business is not incorporated, you don't have to withhold federal unemployment tax for a child under age 21 or for your parents.

Relocation May Cut the Tax on IRA Distributions and Conversions

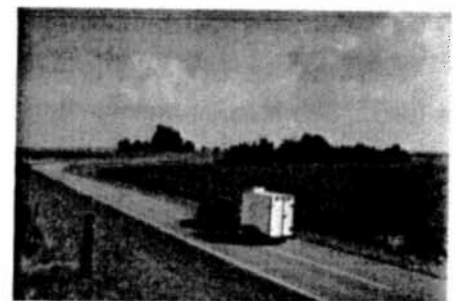
Residents of high tax states and cities know that taxes don't begin and end with the IRS. You might be in a 25% or 28% federal income tax bracket, yet each dollar you earn could be taxed at 30 to 35 cents or more after paying state and local income tax, as well as federal income tax.

Taxpayers in high tax jurisdictions have a mixed blessing, however. Their steep tax rates increase the value of tax deductions, including contributions to retirement plans. What's more, a move to a low tax area in retirement can increase the effective benefit from those plans.

Example: Frank Richards lived in a high tax area when he made most of his retirement plan contributions. His effective tax rate in many of those years was 45%, counting federal, state, and local taxes. Frank now has \$600,000 in his IRA, all from pretax contributions.

Frank is considering two options now:

1. He can convert all or part of this traditional IRA to a Roth IRA, from which he can take tax-free distributions after five years and after age 59½. Frank will owe income tax on the amount of money he converts.



2. He can leave all the money in his traditional IRA. All distributions will be fully taxable. Even if Frank does not need money, he must take required minimum distributions after age 70½ and pay tax on those distributions.

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If Frank stays in his high tax area, he will owe applicable federal, state, and local income tax on Roth IRA conversions and traditional IRA distributions.

Smart move

Alternatively, Frank can move to a low tax state or even a state with no income tax. (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no personal income tax, and New Hampshire and Tennessee only tax interest and dividends.) Subsequently, he would owe little or no state tax on IRA conversions and distributions. In addition to Frank's retirement plan contributions saving him 45 cents on the dollar, in this example, he also might only pay federal income tax of 25 or 28 cents on the dollar on withdrawals.

As you can see, high tax states are losers in this type of relocation. If you worked in California while you built up your retirement fund with

pretax contributions, you paid less tax to California. But California will receive no makeup income if you move to Nevada before taking IRA distributions.

Federal law prevents states from taxing IRA or pension distributions paid to a former resident who is now living in another state. However, that law does not prevent states from continuing to claim you as a resident and demanding tax on your retirement plan distributions if your accounts and holdings remain active in that state. Therefore, if you want to avoid paying tax to your former state, you should sever all ties. Sell your home in the old state, close bank accounts there, file federal tax returns with your address in the new state, and so on. Often, states with high income taxes have high estate taxes, as well, so thoroughly changing your state of residence may pay off for you during your lifetime and also may benefit your beneficiaries after your death. ■

Trusted Advice

State and Local Snares

- ◆ State and local income taxes usually are deductible on your federal tax return. This deduction lowers your effective state and local income tax rate.
- ◆ To get the state and local tax break on your federal income tax return, you must itemize deductions. Many retirees no longer itemize because they no longer pay mortgage interest.
- ◆ If you do not itemize deductions, you will pay state and local income tax and get no corresponding tax break in return.
- ◆ The same is true if you are subject to the alternative minimum tax: you'll pay state and local income tax yet receive no federal tax deduction.

TAX CALENDAR

AUGUST 2010

August 2

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2010. Deposit 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 quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than \$500.

If you maintain an employee benefit plan with a calendar year-end, file Form 5500 or 5500-EZ for calendar year 2009.

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2010. This due date applies only if you deposited the tax for the quarter in full and on time.

August 16

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

SEPTEMBER 2010

September 15

Individuals. If you are not paying your 2010 income tax through withholding (or will not pay enough tax during the year that way), pay the third installment of your 2010 estimated tax. Use Form 1040-ES.

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

Corporations. File a 2009 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2010. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2009 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

Partnerships. If you were given an additional 5 month extension, file a 2009 calendar year tax return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.