JOEL ISAACSON & CO.
REAL FINANCIAL EXPERTISE. PERSONALLY DELIVERED.
Winter 2012 www.joelisaacson.com (212) 302-6300

Big Tax Breaks For Small Biz Owners In New Laws

Recent federal tax legislation, designed to stimulate the economy, has created several significant tax breaks for business owners during the past few years. Consider these key provisions.

Section 179 deductions. Under Section 179 of the tax code, you can claim a current deduction for qualified business property placed in service during the year, within certain limits. Prior to 2010, the maximum Section 179 deduction had been increased from $125,000 to $250,000, with deductions phased out for purchases exceeding an $800,000 threshold. For businesses' tax years beginning in 2010 and 2011, the Small Business Jobs Creation Act of 2010 doubles the maximum annual write-off to $500,000, with a $2 million phase-out threshold. It also authorizes a maximum Section 179 deduction of $250,000 for qualified real estate.

These figures had been scheduled to revert to a maximum $25,000 deduction, with a $200,000 phase-out threshold, but the mammoth Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, passed in December during a lame-duck session of Congress, preserves a $125,000 maximum Section 179 deduction, with a $500,000 phase-out threshold, for tax years beginning in 2012.

Bonus depreciation. The 2010 small business law retroactively extended the 50% "bonus depreciation" tax break, which had expired after 2009, through 2010, and the 2010 Tax Relief Act authorizes 100% bonus depreciation for qualified business property placed in service after September 8, 2010 and before January 1, 2012. (Certain property with a long "useful life" qualifies if placed in service before January 1, 2013.) The 50% bonus depreciation break is generally reinstated for qualified business property placed in service during 2012.

Building improvements. Normally, write-offs for improvements to business real estate must be spaced out over 39 years. However, under a special tax law exception, a business building owner could depreciate qualified leasehold improvements, restaurant improvements, and retail building improvements during a 15-year period. This tax break, which had expired after 2009, is retroactively reinstated for 2010 and extended through 2011 by the 2010 Tax Relief Act.

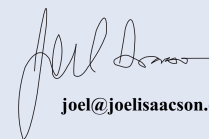
Qualified small business stock. Previously, an investor in "qualified small business stock" (QSBS) could exclude up to 50% of the gain from a sale of the stock if the QSBS was held at least five years. The maximum exclusion was temporarily raised to 75% for sales of QSBS acquired after February 17, 2009 and before January 1, 2011. For sales of QSBS bought after September 27, 2010 and before January 1, 2011, the small business law hiked

(Continued on page 4)

Risk On, Risk Off

Following on the heels of a dismal third quarter, equity markets rallied to finish the year on a positive note. For the quarter, the S&P 500 returned 11.8% (+2.2% for the year), the Russell 2000 small company index returned 15.5% (-4.4% for the year) and the MSCI EAFE international index returned 3.3% (-12.1% for the year). Bond markets had a very strong year, with municipals returning over 6% and taxable bonds in the 5%–8% range depending on credit quality.

Most clients' balanced portfolios finished the year essentially where they started, although significant volatility along the way made the year feel anything but flat. The S&P 500 was as high as +10% during the Spring and as low as -10% in early Fall. While "risk off" asset classes such as Treasuries, municipal bonds and gold all materially outperformed their historic averages, "risk on" asset classes such as small cap, international and emerging markets stocks were hit particularly hard. What is important to keep in mind is that while these "risk on" asset classes have consistently been the most volatile segments of a diversified portfolio, they have also historically been the best performing segments of the market over longer stretches of time. Investors can be rewarded with the inclusion of these asset classes in their portfolios if they can stomach the short term volatility and resist the urge to sell during periods of sharp underperformance. If you have any questions about specific fund managers or your portfolio in general, please do not hesitate to contact us.



joel@joelisaacson.com

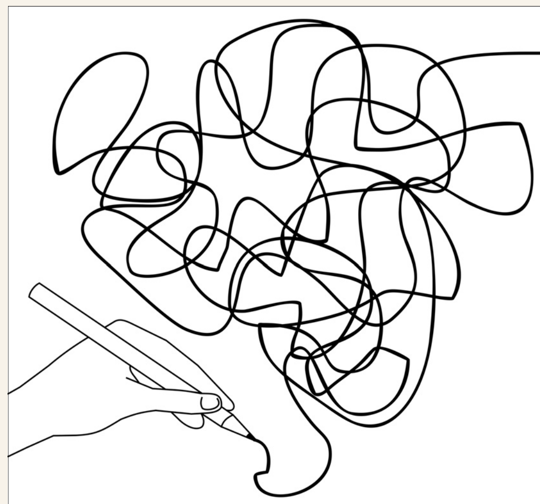
Inflation Out Of Control? Not Really

Sick of sticker shock at the gas pump and the grocery store, many people have been questioning government statistics that suggest inflation remains under control. "A lot of Americans don't believe the consumer price index [CPI] is an accurate gauge," says economist Fritz Meyer. Yet when he explored the data, Meyer discovered that recent increases in the cost of what most families need in fact hew fairly closely to the CPI rate of inflation.

Some have argued the CPI downplays the rising price of necessities—food, fuel, housing—while focusing too much on discretionary spending. Rent and mortgage payments, for example, are among the biggest drains on most U.S. budgets, easily devouring 20% to 25% of many middle-class paychecks. But Meyer found shelter costs have edged up a mere 1.8% during the past year, well below the overall inflation rate of 3.4%.

And though rising food costs have sparked concerns off and on since around 2005, this crucial category, too, has more or less tracked official inflation statistics, Meyer says. During the past year, the price of food climbed at a rate of 4.6%—1.2 percentage points above overall inflation but still relatively sedate. Groceries that cost $100 in November 2010 went for $104.60 a year later. Meanwhile, the price of food consumed away from home edged up just 2.9%.

So if costs for housing and food—which together account for almost half of a typical household's total spending, according to the latest government tally—haven't suffered out-of-control inflation, why does it feel like prices are zooming upward?



Meyer's analysis reveals that costs of clothing, computers, and cars, too, have increased at a rate well below overall inflation, both during the past year and over the long term. But outlays for college tuition, medical care, and legal services have indeed gone up at a rapid clip. "Heavy consumers of those things have obvious reasons to believe the CPI isn't accurate," Meyer says. "But it all depends on what you consume most."

Another pain point is energy. Gasoline costs alone soared 19.7% during the 12 months that ended in November, so people who drive a lot have reason to complain. But how much do gas prices hurt a typical American household? Less than 5% of expenditures go for "gasoline and motor oil," according to the latest government statistics, with another 4.1% spent on home heating and lighting.

The CPI works on a statistical level because it measures the broadest possible basket of what Americans buy. Because the economy is constantly evolving, prices in some categories will inevitably rise faster than others, so economists watch the index for the big picture. And measured against the historical long-term rate of 3.1% annual inflation, today's 3.4% doesn't seem unusually elevated or out of control, Meyer says.

Study Supports Long-Term Stock Investing

Index mutual funds and exchange-traded funds capture more investment dollars every year as the theory of passive investing gains adherents. The advocates of this approach contend that actively searching for the best companies adds costs but little value—so why not buy funds that passively and cheaply track market benchmarks? Now, though, a new study by a Norwegian professor pokes holes in the research supporting passive investing and suggests that active portfolio management can indeed be valuable.

Passive investment strategies are based on the idea that money managers can't consistently outperform the overall market because stock prices evolve randomly. And even if a manager does beat the market, in many cases an investor's gains will be wiped out by the costs of actively trading equities or other assets—or so this theory asserts.

As a result, passive strategists say, investors are better off simply following market indexes. If the market goes up, their portfolios will rise, and with only nominal trading costs. The most common form of passive investing simply mimics the movements of a specific index by buying index funds, which offer low management fees, good diversification, and low turnover.

The downside to this strategy is that it is indeed passive, and a broad index may not react as strongly to good economic news, for example, as particular stocks in an actively managed portfolio might. Passive investors can miss out when the market trends sharply upward. Also, of course, when an index declines, so will a fund tracking that index.

Active management is just the opposite—a money manager selects stocks or other assets based on their potential to outperform an index. Such a strategy may result in a more

New IRS Data Indicates Audit Triggers

The IRS issues vital tax statistics about individuals and businesses in its annual "Data Book" (also referred to as Publication 55B). The latest edition, covering the federal government's 2010 fiscal year—from October 1, 2009 through September 30, 2010—was released in March 2011 and reveals the latest patterns in the tax agency's enforcement efforts. Studying those trends can show what activities and circumstances may be most likely to put you at risk of a tax audit.

Not surprisingly, businesses and individuals generating the highest incomes are most likely to be targeted. But the IRS also continues to examine some taxpayers at all income levels to keep anyone from feeling audit-proof. Consider these key findings from the 2010 Data Book.

Types of audits. There are two main types of audits: correspondence audits, in which a letter from the IRS requests additional information about a return; and field audits, which tend to be more thorough and may be conducted by an IRS agent in your place of business, your tax advisor's office, or in IRS offices. Almost 80% of the audits in 2010 were correspondence audits, a slightly higher percentage than in 2009.

In most cases, an audit will begin with a letter that raises questions about particular items on a return. If issues under dispute are complex, the IRS may launch a closer examination of your personal or business records. But even most field audits are targeted to a specific area, and it's rare for an entire return to be called into question. A return may have been flagged for investigation because of an entry on a specific line or a combination of two or three lines. If you do end up being audited, be forthright with the IRS agent but don't volunteer information. As a practical matter, the agent will want to close the case as quickly as possible.

Audit rates. The overall audit rate for individual tax returns in 2010 was 1.1%. That means that about 1.6 million of a total 143 million individual tax returns were audited. But the likelihood of being asked for more information varied widely according to income level, type of return, and tax benefits claimed. For returns showing total positive income (TPI) of $200,000 to $1 million, 2.5% of returns not showing business activity were audited (up from 2.3% in 2009), while 2.9% of returns showing business activity were audited (down from 3.1%). For returns with TPI of $1 million or more, 8.4% were audited, compared with 6.4% the previous year.

Frequently, an individual return is audited because a particular line item "jumped out" as being sharply different from normal levels. Frequent triggers include unusually high deductions for mortgage interest, charitable donations, or medical expenses.

Business returns. For businesses (not including farms) that brought in total gross receipts of $100,000 to $200,000, 4.7% of returns were audited in 2010 (up from 4.2%). For businesses (not including farms) with total gross receipts of $200,000 or more, 3.3% of returns were audited in 2010 (up from 3.2%). The audit rate for all corporate returns, excluding those of S corporations, was 1.4% (up from 1.3%). For partnership and S corporation returns, the audit rate was 0.4% (virtually the same as in 2009).

Mathematical errors. The IRS caught about 10.5 million math errors on 2009 returns. Of these, 60.8% were attributable to the Making Work Pay Credit, 9% were for calculating other taxes, 4.9% were related to personal exemptions, and 1.3% were related to the first-time homebuyer tax credit.

Penalties. The IRS assessed 27.1 million civil penalties against individual taxpayers in the 2010 fiscal year (up from 26.4 million a year earlier). Of these, 57.3% were assessed for failure to pay taxes, 27.3% were for underpaying estimated taxes, and 13% had to do with delinquent payments. For businesses, 145,931 civil penalty assessments were made (up from 970,098 in 2009). Of those, more than four in 10 were for failing to pay taxes or underpaying estimated taxes.

Criminal cases. The IRS launched 4,706 criminal investigations in 2010 (up from 4,121 the previous year). This resulted in 3,034 referrals for prosecution (up from 2,570). Of those who lost criminal cases, 81.5% ended up being incarcerated (up from 81.2%).

These statistics and trends can't protect you from an IRS audit, but they do point toward potential trouble spots, and underscore the importance of minimizing mistakes on your return. ●

concentrated portfolio that's more sensitive to economic and market trends.

The new study, "Very Long-Term Mean Reversion and Predictability of the U.S. Stock Market Returns," was written by Valeri Zakamouline, an economics professor of the University of Agder. Zakamouline shows that while stock prices may fluctuate, they do tend to revert to their long-term averages. Zakamouline also demonstrates that long-term investment risk decreases over time and that a period of above-average returns tends to be followed by an equal span of below-average returns.

While the study doesn't prove that advisors can actually use market predictability to consistently generate returns that exceed market averages on a risk-adjusted basis, it does indicate that the stock market is predictable over the long term. And that is powerful evidence that long-term investing in the stock market will generate positive returns on a risk-adjusted basis. ●

Don’t Be Trapped By Another State’s Tax

Do you own a second home in a resort area that you use personally or occasionally rent out? You could be in for a rude surprise at tax time, if the state where the home is located insists you’re a legal resident and must pay income taxes. In some cases, that may trigger hundreds of thousands of dollars of extra tax liability.

Several states, including Arizona, California, Hawaii, and New York, have been challenging the assertions of homeowners who claim to live out of state. A state may maintain that the owners actually reside within its borders, even if they consider the dwelling to be a vacation home. With other cash-strapped states taking notice of these tactics, the trend may well continue and expand.

In one high-profile case, John J. Barker, a Wall Street investment manager, and his wife argued that they were Connecticut residents who made only sporadic visits to a second home near the exclusive Hamptons area of New York. During the tax years that a New York state audit brought into question—2002 through 2004—the Barkers said the home was used by other family members. But the couple spent more than half of each of those years in New York, and the state has assessed a tax bill of more $1 million for the three years and tacked on penalties of around $220,000. The Barkers have appealed the ruling but may eventually have to pay at least part of the bill.

In another recent case, media personality Martha Stewart, too, argued that her legal residence was in Connecticut and her place in the Hamptons was just a second home. But New York prevailed and Stewart had to pay almost $222,000 in back taxes.

The Empire State has a reputation for being one of the toughest states for audits, and it often targets residents of states such as Florida, Nevada, and Texas that have no income taxes. But farmers in the heartland and jet setters up and down both coasts face similar problems. In the worst-case scenario, you could even be hit by taxes from two states on a single property.

You may be able to avoid trouble if you clearly establish your residency in a single state of your choosing. Because residency laws vary from state to state, you’ll have to research the method for documenting your legal domicile. At the very least, obtain a driver’s license, register to vote, and file your income tax returns in your home state. Other things that generally help evidence where you live include memberships, where you receive you mail and maintain your bank accounts, and where you register your vehicles. And be sure to keep detailed records of your whereabouts, including a summary of frequent-flier accounts, credit card receipts documenting trips between homes, and phone records that you could use to bolster a claim of residency (or of non-residency). ●

Big Tax Breaks

(Continued from page 1)

the maximum exclusion to 100%, and the Tax Relief Act extended that tax break through 2011.

Research credits. A business that engages in qualified research and development may qualify for a special tax credit. This credit, which had been extended several times, expired after 2009, but the 2010 Tax Relief Act retroactively reinstated it for 2010 and extended it through 2011. The research credit is generally equal to 20% of the qualified expenses that exceed a base amount.

Roth rollovers. Effective September 27, 2010, participants (including business owners) in 401(k) and 403(b) retirement plans could roll over those accounts to a designated Roth account that will provide tax-free distributions during retirement. The rollover amount, minus any after-tax contributions, is taxable as ordinary income.

BIG tax on S corporations. The built-in gains (BIG) tax may apply if a corporation sells assets after converting to S corporation status. Normally, the holding period for BIG tax purposes is 10 years, but it was temporarily reduced to seven years for asset dispositions in fiscal years beginning in 2009 and 2010. The small business law reduces the holding period to just five years for dispositions in tax years beginning in 2011.

Electronic devices. Previously, employees had to meet tough substantiation requirements regarding the business use of employer-provided cell phones and similar electronic devices. For tax years beginning after 2009, these difficult-to-enforce requirements have been dropped and as an employer, you can now treat personal use of company-owned electronic devices by your employees (and by you) as a tax-free fringe benefit. ●

©2012 API