CPA

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Client Bulletin

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

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Freeze Your Credit to Foil Identity Theft

Each year, millions of Americans fall victim to fraudulent schemes stemming from identity theft. Someone might use your personal information to charge goods and services on a bogus credit card; in another scenario, a thief might obtain a loan using your name and make no effort to repay the money. In some cases, the identity theft can be cleared up fairly easily, with little or no financial loss. Other victims, however, spend months or even years attempting to recover financial losses and repair their credit ratings.

To minimize your risk in this area, it makes sense to take some basic precautions. Don't reveal personal information unnecessarily, use passwords to protect online accounts, and shred financial documents you don't need to retain. In addition, you can monitor your credit reports regularly to spot suspicious activity.

There are three major credit bureaus that gather information on how consumers use credit, then sell the data to parties that have a legitimate reason for asking, such as mortgage lenders. Those credit bureaus are Equifax, Experian, and TransUnion.

At *www.annualcreditreport.com*, you can get one free credit report from each bureau every 12 months. With careful planning you can access your credit report every four months, at no cost. For example, you might request your credit report from Equifax in September 2011, from Experian in January 2012, and from TransUnion in May 2012. Then you can start the cycle all over in September 2012.

Once you have your free credit report, you can verify the information and file a complaint with that credit bureau if you find errors. The credit bureau must investigate and correct any misinformation it confirms. Although each credit bureau is responsible for notifying the other two credit bureaus if an error is corrected, you may want to follow up to make sure all of your credit reports are updated.

In addition to getting your free credit reports regularly, you also may want to sign up for a credit monitoring service.

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What's Inside

Fraud Alert

According to Javelin Strategy & Research, the mean consumer out-of-pocket cost because of identity fraud increased 63%, from $387 per incident in 2009 to $631 in 2010.

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These services, offered by a wide variety of companies, will notify you of any new or unusual activity on your credit accounts. Fees might be $10–$15 a month.

Cold comfort

Relying on free credit reports and credit monitoring services may help you discover identity thefts but won't prevent them from happening. There may be a considerable time lag between the fraud's occurrence and your learning that you have been victimized.

For prevention, you can initiate a security freeze, also known as a credit freeze. For a complete freeze, you must notify all three credit bureaus. At *www.equifax.com*, *www.experian.com*, and *www.transunion.com*, you can learn the required procedures. Generally, you must provide certain personal information and pay a modest fee. Depending on your state of residence and whether or not you've been a victim of identity theft, those fees range from zero to $20. Thus, you can freeze access to your credit report at all three credit bureaus for $60 or less.

Once you freeze your credit in this way, new creditors won't have access to your credit report. Thus, thieves are unlikely to get new credit cards, auto loans, cell phone contracts, etc., in your name. As long as you are not applying for credit, you won't miss this access. You can still use your existing credit cards, for instance. Also, at any time you can temporarily lift this freeze for up to 30 days if you need credit. The fee for a temporary lift is comparable to what you'd pay to establish the freeze in the first place.

Security freezes won't provide absolute prevention of identity theft, but they can deliver a valuable extra layer of protection. They are especially worthwhile if you don't anticipate the need for a credit check in the foreseeable future. ■

Convertibles Offer Bond-Like Yields, Stock-Like Potential

Historically, the stock market has offered excellent long-term returns to investors. The historic record, though, may offer scant consolation when stocks skid by 5%, 10%, or even more. Wary investors can turn to bonds or cash equivalents, but yields are depressingly low now.

One possible solution is to invest in convertible securities. Converts, as they're known, may be issued as corporate bonds or shares of preferred stock. Either way, they generally pay a fixed yield that is comparable to bond market payouts. Moreover, as the name indicates, these securities can be converted to common shares, which have the potential to deliver outstanding returns. Advocates claim that convertibles have 75% of the stock market's upside potential but only 50% of the market's exposure to bear market losses. When stocks head south, the relatively high yields offered by convertibles may keep some investors from selling and thus support trading prices.

History lesson

Does the record support this favorable upside-downside outlook? Judging by the last two bear markets in stocks, the results have been mixed. Convertibles held up well in the stock market crash of 2000–2002, after the technology bubble collapsed. However, they provided little help in the financial crisis of late 2008 and early 2009.

From 2000–2002, the broad U.S. stock market, as measured by the S&P 500 Index, lost 9%, 12%, and 22% in successive calendar years. Mutual funds holding convertibles actually gained 2.5% on average in 2000, according to Morningstar. These funds lost less than 7% in 2001 and less than 8% in 2002, far outperforming stocks in those years as well. (You can invest in individual convertible issues, but they can be difficult to evaluate. Accordingly, many investors prefer the diversification and professional management of mutual funds.)

Did You Know?

In fiscal 2010, the federal Pension Benefit Guaranty Corporation paid nearly $5.5 billion to participants in failed single-employer pension plans. That was an increase of 34% from 2006, when PBGC paid just over $4 billion in such benefits.

Source: www.pbgc.gov

Convertibles funds delivered solid gains throughout the bull market of 2003–2007. In 2008, however, the average convertibles fund lost more than 33%, nearly matching the 37% loss of the broad U.S. stock market. During the worst of the financial crisis, converts provided little shelter.

Affected by arbitrage

Many observers believe that convertibles' poor record in the last bear market was an aberration. In the years immediately preceding the meltdown, hedge funds invested billions of dollars in convertible arbitrage. That is, these funds would buy the convertible and sell short the underlying common stock, hoping to make money if the convert outperformed the stock. Hedge funds often borrowed money to buy more converts and increase their profit potential.

When the financial crisis emerged in late 2008, banks called in their loans, some investors bailed out of hedge funds, and hedge funds had to sell their converts to raise the cash they needed. This increased selling contributed to the poor performance of convertibles in 2008.

After the deluge

Since the debacle of 2008, convertibles funds have posted strong years in 2009 and 2010. As of this writing, these funds are showing substantial returns for 2011 as well. Apparently, hedge funds have pulled back from convertible arbitrage and the converts market has generally returned to normalcy. Convertibles funds now yield 2.8% on average, far higher than the 0.5% average yield of domestic stock funds and nearly as high as the 3.3% average yield of general bond funds. Consequently, investors can get current cash flow that's comparable to the interest from bonds while waiting for the long-term results that stocks might provide.

Therefore, you might want to include convertibles in a diversified portfolio. Converts have risks and are not for everyone, but some investors may appreciate the combination of significant yield and potential stock market gains. ■

Trusted Advice

Taxing Convertibles

- Convertible securities may be either bonds or preferred stocks.
- Convertible bonds pay interest, which is taxed at ordinary income rates, up to 35%.
- Convertible preferred stocks pay dividends. Some pay qualified dividends, which are taxed no higher than 15%, while others pay dividends that are taxed as ordinary income.
- If you are buying an individual issue of convertible preferred stock, ask your broker if the dividends will qualify for the low tax rate.
- If you are considering a convertibles mutual fund, check the fund's website to see the percentage of dividend income that qualified for lower tax rates in the previous year.

A SIMPLE Solution for Company Retirement Plans

Business owners who wish to sponsor a retirement plan have many options from which to choose. The choices include 401(k), profit sharing, defined benefit, and simplified employee pension (SEP) plans. In some situations, yet another arrangement might work best: a SIMPLE (savings incentive match plan for employees) individual retirement account (IRA).

Keeping it simple

SIMPLE IRAs offer several benefits:

- As the name indicates, these plans require little paperwork, so they may be relatively easy to administer.
- SIMPLE IRAs have modest requirements for employer contributions.

The catch? The maximum SIMPLE IRA contributions are modest as well. In 2011, total contributions to any individual's account cannot exceed $28,000, as explained later in this article. Other types of employer-sponsored retirement permit total contributions to reach six figures in some situations.

Strictly for small companies

To establish a SIMPLE IRA, your company must have 100 or fewer employees. An employee, for this purpose, is someone who earned at least $5,000 in compensation during any two preceding years and is reasonably expected to earn at least $5,000 in compensation during the current calendar year. Also, your company can't have a SIMPLE plan if it already has a qualified retirement plan.

If your company qualifies, it can use IRS Form 5304-SIMPLE or Form 5305-SIMPLE to create the plan. The company also must set up an IRA account for each employee. The only other requirement is annual notification. You can fulfill this obligation by sending each employee a copy of the Form 5304-SIMPLE or Form 5305-SIMPLE your company used to set up the plan.

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Once the plan is in place, each employee can defer as much as 100% of his or her annual pay, up to specified annual limits. In 2011, the cap is $11,500, plus a "catch up" contribution up to $2,500 for SIMPLE IRA participants who are over age 50 by year end. Thus, the maximum salary deferral is $14,000 in 2011.

In addition, the company can choose to match employee contributions, up to 3% of the employee's compensation for the calendar year. Compared to the complex rules that apply to 401(k) plans, the rules for SIMPLE plans are, well, simple. If an employer chooses to match contributions, the matches are required for all employees, so business owners and key employees can maximize their contributions even if other employees contribute little or nothing. For example, a 50+ business owner whose pay is at least $466,667 can get the maximum $14,000 match (3% of $466,667) and put a total of $28,000 into his or her SIMPLE IRA this year.

As an alternative to making matching contributions, the employer can choose to make nonelective contributions of 2% of the income of each eligible employee that earns $5,000 (or a lesser amount if the employer selects) of compensation for the calendar year.

With most retirement plans, participants generally owe a 10% penalty for withdrawals before age 59½. With SIMPLE IRAs, participants owe a 25% penalty for such early withdrawals in the first two years they are in the plan. Subsequently, they'll owe the regular 10% penalty. During those first two years, no one can roll over a SIMPLE IRA account to a traditional IRA. Such rollovers are permitted once this period expires.

Living with the limits

If those are the basic rules, which companies should consider SIMPLE IRAs? These plans may work best for companies where the owners and other key employees are satisfied with maximum contributions of $23,000 or—for those 50 and older—$28,000 per year. In addition, SIMPLE IRAs may be ideal for companies that have few employees, especially if those employees are likely to make minimal SIMPLE IRA contributions. The smaller the total amount of employee salary deferrals, the less money your company will have to provide as an employer's match. Our office can help you go over the numbers if you are interested in setting up a SIMPLE IRA. Your company generally must establish a SIMPLE IRA by October 1 in order to have the plan in effect for the current year. ■

TAX CALENDAR

SEPTEMBER 2011

September 15

Individuals. If you are not paying your 2011 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2011 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 2010 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 6-month extension.

Deposit the third installment of estimated income tax for 2011. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2010 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic 6-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

OCTOBER 2011

October 17

Individuals. If you have an automatic six-month extension to file your income tax return for 2010, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

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

Electing large partnerships. If you were given an additional six-month extension, file a 2010 calendar year tax (Form 1065-B).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2011. 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 November 10 to file the return.

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

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