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THE COST OF BALANCE

The article, *Appreciating the Helpful Balance of Bonds*, appearing in the accompanying Tax & Business Alert indicates that those looking to preserve capital should consider investing in bonds. While this is accurate as bonds (and other fixed income investments) provide short-term protection for capital, it is misleading in that over long periods of time (the investment horizons of most successful investors) bonds have failed to preserve capital. For long-term buy and hold diversified equity investors, equity index funds have provided inflation protection and have significantly outperformed bonds.

For the five years ended May 31, 2023, the

Vanguard S&P 500 Index returned (in spite of a loss of over 18 percent in 2022) 10.98 percent compounded annually. The annual compounded return for the same five-year period on the Vanguard Total Bond Market Index was .80 percent. The pretax net-of-inflation adjusted return for the Stock Index was a 6.90 percent gain and the pretax net-of-inflation adjusted return was a loss of 2.90 percent for the Bond Index. For the 20-year period ended May 31, 2023, the pretax net-of-inflation return for the Stock Index was 6.97 percent and for the Bond Index Fund was .32 percent. Even for taxpayers in the lower brackets, the net-of-inflation and income tax returns for bonds were negative.

ROTH CONVERSION

The accompanying Tax & Business Alert contains on page 1 an article styled *Is it a Good Time for Roth Conversion?* The answer to that question requires knowledge of specific facts and circumstances of the taxpayer. That said, however, a taxpayer who can pay the "conversion tax" from sources outside the IRA and does not anticipate significantly reduced tax rates on traditional IRA withdrawals is a good candidate for a Roth conversion. Conversion allows a significant expansion (as much as two-thirds) of the tax benefits from those of a traditional IRA.

Tax law allows all taxpayers (without income limitations) to convert all or part of their traditional IRAs to Roth IRAs. We believe that conventional wisdom is correct in holding that the

early payment of taxes is generally a bad idea. However, for some IRA owners, consideration of converting a traditional IRA into a Roth IRA and paying the related income tax now can create a very significant benefit.

Thinking about conversion to Roth raises a question – are the income taxes paid for a conversion of a traditional IRA to a Roth IRA "income taxes" or might they be considered the "purchase of an investment?"

For some taxpayers, the conversion might appropriately be viewed as the "purchase" at a bargain price of an asset which can grow tax-free. For example, assume (to remove the effect of bracket changes) that the taxpayer has a constant total state

(Continued on reverse)

and federal tax rate of 40 percent. For this constant bracket taxpayer, \$1,000 inside a traditional IRA is in effect "owned" by the taxpayer in the amount of \$600 and by the taxing authorities \$400. While no taxes are being paid currently (it is a tax-deferred account), all distributions will, in the future, benefit the IRA owner 60 percent and 40 percent will be consumed by income taxes. A Roth IRA conversion will cause the taxpayer to pay \$400 (40 percent of \$1,000) in current tax and will result in the entire amount of the IRA working for the owner tax-free for the balance of the life of the Roth IRA, which can exceed the life of its original owner. By converting to Roth, this owner has "purchased" the taxing authorities' "ownership interest" in the traditional IRA for \$400. Assuming the owner's tax bracket is constant (to remove the benefit or detriment of any future change in the applicable tax rate), the

taxpayer has not, from one perspective, "paid tax" of \$400 but rather has purchased a \$400 investment, which is likely worth more than \$400 as it compounds tax-free over the balance of the taxpayer's life and, if the taxpayer predeceases a spouse, over the longer life of the spouse. Additionally, following the death of the second to die of the couple, the Roth IRA can continue to compound tax-free for almost all of the following 10 years.

To repeat, taxpayers who can pay the conversion tax from sources outside the IRA and who do not anticipate significantly reduced tax rates on IRA withdrawals, conversion allows an expansion of the tax benefits of an IRA by as much as 66⅔ percent by "purchasing" the governments' interest in the traditional IRA.

RETIREMENT PLANS AND COMMERCIAL ANNUITIES

A recent article in The Wall Street Journal about 401(k) retirement accounts discusses the increased interest among employers to offer employees the purchase of a commercial annuity inside their retirement plan account. The purpose is to make an employee's 401(k) account more like a traditional pension plan that will provide a steady retirement income for life without the volatility and uncertainties of direct investments in marketable equity and debt securities. That relative certainty of retirement income could have appeal to many employees. However, reducing the uncertain consequences of market ups and downs, while a good thing, comes at a cost.

The article further mentions a trend in retirement plans to offer "target-date" mutual funds to participants. A "target-date" fund is a managed mutual fund that attempts to achieve the retirement financial goals of the investor who has a particular retirement date in mind. The fund is actively managed to adjust its investment mix of equities and debt securities over time as the individual gets closer to retirement (e.g., more risk and volatility in earlier years; less so as the retirement date approaches). As with most managed mutual funds, however, the fees within these target-date mutual funds can be relatively large. In fact, some target-date funds offered by financial institutions invest in other mutual funds of the same institution. So, not only

might the target-date fund itself charge a fee, additional fees can be imbedded in the individual mutual funds in which the target-fund invests.

The two trends are now coming together with some financial institutions holding annuities inside their target-date funds that are available to 401(k) retirement plans. Security investments inside the retirement account are sold to purchase commercial annuities either on the target retirement date or gradually over several years during the latter part of the retirement account's accumulation period. The pitch is the promise of a safe and fixed retirement income for the employee. The price for that promise, however, is the cost in additional fees (which will be mostly veiled to the participant) extracted from the account's investment earnings.

We believe that the goal of achieving financial security for most can be achieved by getting an early start in buying and holding a diversified portfolio of marketable securities or low-cost index mutual funds (both inside and outside a tax-deferred retirement account) over a long period of time and resisting the temptation to sell in a down market. It occurs to us that a significant benefit of these newer retirement plan offerings accrues to the institutions selling the fund and annuity products.

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Tax & Business Alert

JUNE 2023

IS IT A GOOD TIME FOR A ROTH CONVERSION? _____

The volatility in the stock market may have caused the value of your retirement account to decrease. But if you have a traditional IRA invested in stocks, a decline may provide a valuable opportunity by allowing you to convert your traditional IRA to a Roth IRA at a lower tax cost.

TRADITIONAL VS. ROTH

Here are some key differences between these two types of accounts:

Traditional IRA. Contributions to a traditional IRA may be deductible, depending on your modified adjusted gross income (MAGI) and whether you (or your spouse) participate in a qualified retirement plan, such as a 401(k). Funds in the account grow tax-deferred.

However, you generally must pay income tax on withdrawals. You'll also face a penalty if you withdraw funds before age 59½ — unless you qualify for an exception. And you'll face an even larger penalty if you don't take your required minimum distributions (RMDs) when you reach age 72 (73 if you reach age 72 after Dec. 31, 2022).

Roth IRA. Roth IRA contributions aren't deductible. But withdrawals — including earnings — are tax-free as long as you are age 59½ or older and the account has been open at least five years. Plus, you're allowed to withdraw *contributions* at any time tax- and penalty-free and you aren't subject to RMDs.

However, the ability to *contribute* to a Roth IRA is subject to limits based on your MAGI. Fortunately,

no matter how high your income, you're eligible to *convert* a traditional IRA to a Roth, but you'll have to pay income tax on the amount converted.



YOUR TAX HIT MAY BE REDUCED

If your traditional IRA has lost value, converting to a Roth now instead of waiting could minimize your tax hit. You'll also avoid tax on future appreciation if the value of your account goes back up.

Before converting, take time to think through the details. Here are some key issues to consider:

Money to pay the tax bill. If you don't have the cash on hand to cover the taxes owed on the

STRETCH OUT THE TAX BILL

If the idea of paying the tax bite related to converting from a traditional IRA to a Roth IRA is daunting, consider a gradual conversion. It's not an all-or-nothing process, so you can stretch out the tax bill over time, depending on how long you expect to wait to retire.

Suppose you have \$100,000 in a traditional IRA. You could, for example, convert that in five steps: \$20,000 per year for five years. We can estimate what the tax bite will be at varying steps.

conversion, you may have to dip into your retirement funds, eroding your nest egg. The more money you convert and the higher your tax bracket, the bigger the tax hit.

Your retirement plans. Typically, you wouldn't convert a traditional IRA to a Roth IRA if you expect to retire soon and will start drawing down on the account right away. Usually, the goal is to allow the

funds to grow and compound over time without any tax erosion.

There are also other issues that need to be considered before executing a Roth IRA conversion. If this sounds like something you're interested in, contact us to discuss whether a conversion is right for you. ■

THE TAX OBLIGATIONS IF YOUR BUSINESS CLOSES ITS DOORS

Sadly, many businesses have been forced to shut down recently due to the challenges of the economy, including the supply chain. If this is your situation, we can help you meet the various tax responsibilities that go with closing a business.

Of course, a business must file a final income tax return and some other related forms for the year it closes its doors. The type of return to be filed depends on the type of business you have. Here's a rundown of the basic requirements.

Sole Proprietorships. Your tax preparer will need to file the usual Schedule C (Form 1040), "Profit or Loss from Business," with your individual return for the year you close the business. You may also need to report self-employment tax.

Partnerships. A partnership must file Form 1065, "U.S. Return of Partnership Income," for the year it closes. Your tax preparer will report any capital gains and losses on Schedule D. It will indicate that this is the final return and the same will be reflected on Schedule K-1, "Partner's Share of Income, Deductions, Credits, etc."

All Corporations. Form 966, "Corporate Dissolution or Liquidation," must be filed if you adopt a resolution or plan to dissolve a corporation or liquidate any of its stock.

C Corporations. Form 1120, "U.S. Corporate Income Tax Return," must be filed for the year you

close. Report any capital gains and losses on Schedule D. Indicate this is the final return.

S Corporations. File Form 1120-S, "U.S. Income Tax Return for an S Corporation," for the year of closing. Report capital gains and losses on Schedule D. The "final return" box must be checked on Schedule K-1.



All Businesses. Other forms may need to be filed to report sales of business property and asset acquisitions if you sell your business.

EMPLOYEES AND CONTRACT WORKERS

If you have employees, you must pay them final wages and compensation owed, make final federal tax deposits

and report employment taxes. Failure to withhold or deposit employee income, Social Security and Medicare taxes can result in full personal liability for what's known as the "Trust Fund Recovery Penalty."

If you've paid any contractors at least \$600 during the calendar year in which you close your business, you must report those payments on Form 1099-NEC, "Nonemployee Compensation."

OTHER TAX ISSUES

If your business has a retirement plan for employees, you'll want to terminate the plan and distribute benefits to participants. There are detailed notices, funding, timing and filing requirements that must be met by a terminating plan. There are also complex requirements

related to flexible spending accounts, Health Savings Accounts and other programs for your employees.

We can assist you with many other complicated tax issues related to closing your business, including debt cancellation, use of net operating losses, freeing up any remaining passive activity losses, depreciation recapture and possible bankruptcy issues.

We can also advise you on the length of time you need to keep business records. In addition, you'll need to cancel your Employer Identification Number and close your IRS business account.

If your business is unable to pay all the taxes it owes, we can explain the available payment options. Contact us to discuss these issues and get answers to any questions. ■

ADOPTING A CHILD? BRING HOME A TAX BREAK TOO

Two tax benefits are available to offset the expenses of adopting a child. In 2023, adoptive parents may be able to claim a credit against their federal tax for up to \$15,950 of "qualified adoption expenses" for each child. That's a dollar-for-dollar reduction of tax.

Also in 2023, adoptive parents may be able to exclude from gross income up to \$15,950 of qualified expenses paid by an employer under an adoption assistance program. Both the credit and the exclusion are phased out if the parents' income exceeds certain limits.

Parents can claim both a credit and an exclusion for expenses of adopting a child. But they can't claim both a credit and an exclusion for the same expenses.

QUALIFIED EXPENSES

Only "qualified adoption expenses" are eligible for the adoption credit or exclusion. These are the reasonable and necessary adoption fees, court costs, attorney fees, travel expenses (including meals and lodging), and other expenses directly related to the legal adoption of an "eligible child."

Not included in qualified expenses are those connected with the adoption of a child of a spouse, a surrogate parenting arrangement, a violation of state or federal law, or the use of funds received from a government program. Expenses reimbursed by an employer don't qualify for the credit, but as explained above, benefits provided by an employer under an adoption assistance program may qualify for the exclusion. If an adoption attempt is unsuccessful, the related expenses may still qualify, if the child is a U.S. citizen or resident.



Taxpayers who adopt a special needs child can also take a credit or exclusion for \$15,950. This is true whether or not they had that amount in actual expenses.

ELIGIBLE CHILD

To be eligible, a child must be under age 18 when the expense is paid, though partial deductions may be available if a child turns 18 during the year. Adoptees who are incapable of self-care may qualify regardless of age.

A special needs child is one that a state determines can't, or shouldn't, be returned to his or her parent's home, and due to certain factors, won't be adoptable without assistance provided to the adoptive family. Only a child who is a citizen or U.S. resident can be included in this category.

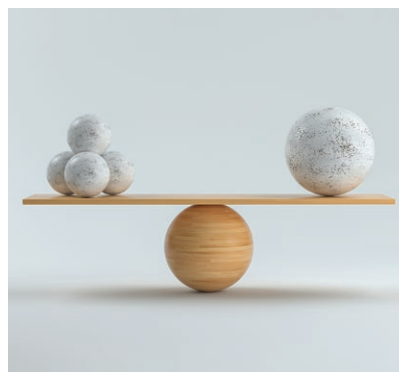
GET THE FULL BENEFIT

Contact us with questions. We can help ensure you get the full benefit of the tax savings available to adoptive parents. ■

APPRECIATING THE HELPFUL BALANCE OF BONDS

Stock market and interest rate uncertainty may cause some investors to turn to bonds. Perhaps the most “user friendly” bond is a U.S. government savings bond. Buying one means you’re essentially lending the federal government money under certain terms, in exchange for a future return. U.S. savings bonds don’t offer as high a yield as other investment instruments, but they’re highly stable. The amount earned on U.S. government bonds is taxable on federal income tax returns when they’re redeemed, but it’s often exempt on state and local returns. However, you can make a one-time election to report the interest on these bonds each year as it accrues if this is more beneficial.

Another government investment option is a Treasury bill. These are short-term government securities with maturities ranging from a few days to 52 weeks. For a more long-term option, investigate Treasury notes. These government securities are generally issued with maturities of two, three, five, seven and 10 years and pay interest every six months.



If you’re looking to preserve capital while generating some tax-free income, consider a tax-exempt state or municipal bond. Here, you lend money to a more localized government entity

in exchange for regular payments. Keep in mind that interest may be taxable on state and local returns.

Corporate bonds are another option. These generally offer a higher yield than their federal or municipal counterparts but come with a greater risk in terms of price fluctuation as markets change and sometimes, issuers default. There are also tax implications, in that interest from corporate bonds is subject to federal, state and local income tax. Plus, as with other types of bonds, you could incur capital gains if you sell the bond at a profit before it matures. ■