Q4 2015 NEWSLETTER

Welcome Matt!

New Hire

I'd like to introduce Matt Goren, a PhD in psychology and CFP® candidate. He'll help manage the growing business and craft client financial plans.

Arete Wealth Australia

Welcome my new brand - Arete Wealth Australia - for Aussie ex-pats and American ex-pat's in Australia who simultaneously navigate the US and Australian financial worlds.

The Year that was 2015

"My dear, here we must run as fast as we can, just to stay in place. And if you wish to go anywhere you must run twice as fast as that." — Lewis Carroll, "Alice in Wonderland"

As we close the final chapter of a tumultuous 2015, the above quote adequately characterizes the challenges the year presented for investors. For the first time in several years, all iterations of globally diversified portfolios produced negative returns. The struggle to generate any modicum of return was palpable across both traditional and alternative managers. Simply "staying in place" was a formidable task, a task achieved by very few.

The chart below highlights the challenging year across global markets; we've extracted key asset classes that are most relevant to our client portfolios. These broader asset class returns illustrate that dismal performance was not discriminate to geography, asset class, or capitalization.

With returns markedly to the downside, diversified portfolios had no chance to generate performance consistent with historical levels, let alone generate net positive returns.

Growing Business!

Business grew by 62% in 2015, a reflection of my dedication to my clients and their dedication to me. Thank you for your support and referrals!

Investment in New Tech

To streamline and improve the client experience I've made a big investment in new technologies. MyPlanMap will help with the implementation of recommendations, PreciseFP is used to streamline the process of data gathering, Redtail helps us better manage client information, and LaserApp improves the efficiency of form completion.

Stocks

The final quarter of the year provided investors with gains that were tantalizingly close to wiping out the losses of the previous three. The Wilshire 5000--the broadest measure of U.S. stocks—gained 5.89% in the fourth quarter of 2015, ending the year down a mere 0.25%. The comparable Russell 3000 index was also essentially flat, gaining 0.48% for the year.

Large cap stocks were comparably flat. The Wilshire U.S. Large Cap index gained 6.77% in the fourth quarter, and managed to finish the year up 1.27%. The Russell 1000 large-cap index finished the year up 0.92%, while the widely-quoted S&P 500 index of large company stocks was up 6.45% in the fourth quarter, but finished down 0.73% for all of 2015—its first yearly loss since 2008.

The Wilshire U.S. Mid-Cap index gained 2.34% in Q4, but finished the year down 2.63%. The Russell Midcap Index lost 2.44% in calendar 2015.

This was a year to forget for investors in small company stocks. As measured by the Wilshire U.S. Small-Cap index, investors posted a small 2.62% gain over the last three months of the year, but in the end the index had lost 4.86% over the entire 12 months, dragging many diversified portfolios into negative territory. The comparable Russell 2000 Small-Cap Index finished the forgettable year down 4.41%, while the technology-heavy Nasdaq Composite Index rose 8.38% in the fourth quarter, to finish the year up 5.73%.

International investments contributed a slight decline to overall portfolio returns. The broad-based EAFE index of companies in developed foreign economies gained 4.37% in the fourth quarter of the year, but finished the year down 3.30% in dollar terms. In aggregate, European stocks lost 6.06% for the year, while EAFE's Far East Index was up 4.72%. Emerging markets stocks of less developed countries, as represented by the EAFE EM index, lost 16.96% for the year.

Real Estate

Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT index, gained 7.47% during the year's final quarter, wiping out previous losses to finish up 4.23% for calendar 2015.

Commodities

Many investors will look at their statements and see lower returns than the stock indices indicate, in part because a portion of their portfolio was invested in commodities—by far the biggest loser of 2015. Commodity investments are considered an excellent diversifier. In some years, they're going to add significantly to a portfolio's value; but in the last 12 months, they continued a losing streak, with the Standard & Poor's GSCI falling 16.63% in Q4 alone on its way to a whopping 32.86% annual loss. Some have speculated that the largest contributor, a surprising continuation of the decline in oil prices, may have been accelerated by the decline in Chinese growth and a Saudi Arabian attempt to flood the oil markets as a strategy to put American frackers out of business.

Meanwhile, gold prices were off 10% in 2015, and gold investments actually outperformed silver, copper, platinum and palladium—the latter losing more than 30% in the past 12 months.

Bonds

Meanwhile, bond investors started the year, as in years past, expecting that 2015 would finally see interest rates rise across the board. Many professionals have been holding very low-yielding short-term instruments or cash in their bond portfolio allocations as a defensive measure, and had to endure almost zero returns without the satisfaction of having ducked the long-anticipated nasty downturn in bond values.

According to Barclay's Bank indices, U.S. liquid corporate bonds with a 1-5 year maturity are yielding 2.4% on average while 5-10 years brings the yield up to 3.69%. 30-year Treasuries are yielding 3.00%, and 10-year Treasuries currently yield 2.25%.

Looking Forward

As always, 2015 revealed many anomalies in the investment world. In the currency markets, anyone lucky enough to have speculated on the Somali shilling would have experienced a nice 20% annual return. A bet on the Azerbaijani manta, however, would have lost you 50%. In international stock markets, the Johannesburg (South Africa) market index gained over 80%, while the Ukranian Equities Index dropped the farthest, falling 60%.

What's going to happen in 2016? Of course, nobody knows with any degree of certainty.

On one hand, many professional investors are approaching the new year with an unusual degree of caution. By most metrics, U.S. stocks are pricier than their historical averages. Meanwhile, economic growth is moderate at best, which suggests that, in aggregate, U.S.-based companies will only be able to increase their value at moderate rates as well.

There are also some warning signs in the high-yield bond market. Is

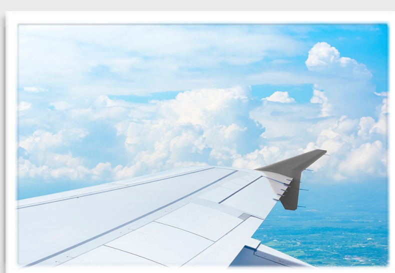
MaxMyInterest

I've partnered with FinTech startup MaxMyInterest to help clients increase their return on cash savings.

Visit Down Under

In late November I was at the Financial Planning Association of Australia conference in Brisbane. I met with local financial planners, various vendors and FPA staff.

Travel Plans



Next Bay Area trip:

Feb 1st - 3rd, 2016

Next Australia Trip:

November 19th - 27th, 2016

the recent downturn a sign of long-term problems or a blip on the screen? One could argue that emerging-market governments and companies with low credit ratings have gotten away with giving their lenders extremely low (by historical standards) interest rates. If rates rise, investors may want to sell those bonds, causing a sudden rush for the exits, and potentially creating liquidity problems for the funds that are holding them. But one would expect those funds to be preparing for this possibility, and similar dour forecasts have, in the past, had a habit of not showing up in the real world.

And while it may seem like a good time to buy oil futures, we may have to wait for a return to high oil prices. Oil production from post-sanctions Iran will soon hit the market, adding to what economists are already describing as an oil and gas glut.

The Federal Reserve Board's finally made a tentative effort to let the short-term fixed income markets find their natural level, which has already led to higher mortgage rates. Nobody knows if or when the Fed will raise rates again, or what the impact would be, but that it's an election year, and the economy is still not exactly robust, suggests that the central bank's policymakers will proceed cautiously.

Meanwhile, China is becoming the 800 pound gorilla of the global markets. The Shanghai Composite Index lost 43% of its value during a frightening summer selloff, and China's economic growth has clearly slowed from the pell-mell double-digit growth rates of the past 20 years. More troubling than the losses is the government's willingness to try to manipulate its equity markets, which means it's hard to discern the fair value of individual Chinese stocks.

But lost in the hand-wringing is the fact that China's primary index finished the year with a 9% gain. The selloff simply wiped out most of an enormous bull run in the first three months of the year. And, closer to home, the U.S. economy is humming along at near-full employment with an improving manufacturing sector and healthy real estate prices.

The truth is, we have no idea what returns will be in the coming year. We do, however, have confidence that any future bear market will be followed by a subsequent recovery, and eventually (who knows when?) the U.S. and European markets will again be testing and surpassing their previous record highs.

We also know that markets often punish those who try to outsmart them. If the market drops this year, it means we all will be able to secure investments at cheaper prices in anticipation of the next rise—whenever and however it arrives. So, stay the course and trust the power of a diversified portfolio to meet your long-term financial goals.

Sources

Wilshire index data: http://www.wilshire.com/Indexes/calculator/

Russell index data: http://www.russell.com/indexes/data/daily_total_returns_us.asp

S&P index data: http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--

Nasdaq index data: http://quicktake.morningstar.com/Index/IndexCharts.aspx?Symbol=COMP ; http://www.nasdaq.com/markets/indices/nasdaq-total-returns.aspx

Commodities index data: http://us.spindices.com/index-family/commodities/sp-gsci

Treasury market rates: http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/

Aggregate corporate bond rates: https://indices.barcap.com/show?url=Benchmark_Indices/Aggregate/Bond_Indices

Aggregate corporate bond rates: http://www.bloomberg.com/markets/rates-bonds/corporate-bonds/

Unemployment rate: http://www.tradingeconomics.com/united-states/unemployment-rate

International indices: https://www.msci.com/end-of-day-data-search

http://www.bloomberg.com/news/articles/2015-12-31/here-are-the-best-and-worst-performing-assets-of-2015

Muni rates: https://indices.barcap.com/show?url=Benchmark_Indices/Aggregate/Bond_Indices

Chinese markets: http://www.wsj.com/articles/chinas-stock-market-still-a-draw-after-tumultuous-year-1451303164

http://www.theworldin.com/article/10632/unsettling-year-markets

December 2015 Highlights

- A report from Pew Research Center reveals that the U.S. middle class no longer represents the majority of the country, comprising just under 50 percent of the adult population. The report shows that the middle class has been steadily shrinking since it included 61 percent of people in the 1970s.
- The U.S. Department of Labor revises up a number of third quarter economic statistics from the previous month, including raising annual productivity growth from 1.6 percent to 2.2 percent and annualized GDP growth from 1.5 percent to 2.1 percent.
- Following the birth of their first child, Facebook founder Mark Zuckerberg and his wife announce a plan to donate 99 percent of their Facebook shares to charity during their lives. At the time of the announcement, the shares were worth over $40B, making it one of the largest charitable pledges in history.
- An early MasterCard SpendingPulse™ report shows that holiday retail sales (sales between Thanksgiving and Christmas) rose 7.9 percent from the same time last year. Online sales continued to become increasingly important to retailers, growing 20 percent since last year.
- Finland's government starts a proposal to replace its current welfare system with a government-provided monthly income of €800 (around $10,000 annually) for every adult citizen. Despite being untaxed, the guaranteed income system is projected to improve the Finnish government's budget.

Top Small Business Tax Deductions

The tax burdens that come with owning a business can be discouraging, especially for first-time business owners. However, these additional taxes come hand-in-hand with additional tax deductions. Understanding and correctly using these deductions can be crucial to the success of your business, while using them incorrectly can lead to unwanted attention from the IRS. Small businesses are three times more likely to be audited than individuals are, but this is more often due to genuine mistakes than deliberate fraud. Before filing taxes for your business, it's important to understand what qualifies as a business expense and what qualifies as a personal expense so that you only file for legal business deductions.

You may be able to deduct many of the costs involved with running a business, including the following:

- **Auto expenses**
- **Home office deduction**
- **Travel**

- **Entertainment**
- **Equipment and operating costs**
- **Taxes and insurance**
- **Other deductions**

Before considering the different types of business expenses, you should first familiarize yourself with the broad definition of a business expense as it applies to taxes. When determining whether an expense is business or personal, consider the IRS definition that a business expense must be both ordinary and necessary in order to be deductible: An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. By considering these two qualifications, you can decide whether your deduction can truly be classified as a business expense.

Auto expenses

Certain professions require a fair amount of driving. While commuting to and from the office doesn't count as a deductible business expense, other job-related driving does. There are two ways to deduct your mileage:

- **Actual expense method:** Using this method, you would be responsible for tracking all of your business-related driving expenses for the year, including gas, maintenance and repair costs, car insurance and your vehicle's depreciation. Record keeping for this method is easier if you have a designated business vehicle. Using one vehicle for both business and personal matters complicates your calculations, but it may be worth it if it saves you money.

- **Standard mileage rate:** Instead of keeping track of all of your auto expenses, you'll only need to record your mileage (again, only that related to business activities). At the end of the year, multiply your mileage by the standard mileage rate, which is 57.5 cents per mile in 2015, and the product is your deduction. This rate takes gas, insurance, auto repairs, depreciation and other auto expenses into account, so there is no need to track anything other than business mileage.

Deciding which method to use is not as simple as choosing the bigger deduction. In your first year of business, choosing the actual expense method will preclude you from using the standard mileage rate in future years. On the other hand, if you use the standard mileage rate in the first year, you can switch back and forth between the two methods in future years. It's probably a good idea to use the standard mileage rate in the first year and then calculate both to find the largest deduction for your business in the future.

Home Office Deduction

Many small business owners are hesitant to claim the home office deduction because they fear it is an audit red flag. However, as long as you define home office correctly, you're not increasing your risk for an audit. Keep in mind that a home office must only be used for business purposes in order to be completely deductible. For instance, if your office doubles as a guest room, you cannot deduct it. That said, you can deduct a partial room if only part of your office is used for business. To claim the deduction, you must also show that you use your home as your principal place of business.

The home office deduction takes all home costs into account for your office or partial office, including utilities, homeowners or rental insurance, mortgage interest or rent payments and more. There are two ways to calculate your home office deduction:

• Actual expense method: This method involves taking the square footage of your office (either the whole room or the part devoted solely to business activities) and dividing it by the total square footage of your house. The percentage you get is the percentage of home expenses that you can deduct for your home office. This method will require you to calculate all home expenses, which can be a cumbersome process.

• Safe harbor method: The second option, available for the first time for the 2013 tax year, provides a standard deduction of $5 per square foot of the home used for business, up to 300 square feet. While this eliminates the need for tricky calculations on the taxpayer's part, it also eliminates certain deductions as well. Specifically, the depreciation of any home office space cannot be deducted under this method.

Choosing between these two methods may depend on the size of deduction you expect; as the safe harbor method has a maximum of 300 square feet, the total maximum deduction will be $1,500. If you expect to yield a much higher deduction with the actual expenses method, it may be worth the extra work it takes to calculate your home expenses.

Travel

For legitimate business travel, airfare, hotels and other travel expenses can be deducted. Almost any cost related to business travel is 100 percent deductible, but it's important to make sure you can prove that your trip was for business purposes. You can mix business with pleasure to some degree—for instance, if you take your family with you and stay in a hotel together, the cost of the hotel is deductible. Calculating deductions for business trips that are over a week long or part of vacation travel can be difficult and may require some tax research to do correctly.

Entertainment

Entertaining clients, customers, prospective business partners, etc. is deductible at 50 percent. This means you can deduct restaurant bills, theater tickets, sports events and more, as long as you can prove that the entertaining happened immediately before, after or during business activities. Proper documentation is important for this deduction. You should note on each receipt who was present and what business discussions or activities took place.

Equipment and Operating Costs

Running a business and spending money go hand in hand. You'll have to buy equipment and supplies and pay regular bills to run your business—anything from furniture and computers to Internet service and advertising costs are deductible. Not all business purchases can be deducted the same way, however, and there are limits to how much you can claim.

- **Business Assets:** When you purchase something for your business that you intend to use for longer than a year (such as a computer, office furniture or specialized tools and equipment), you must either depreciate it over a number of years or deduct the entire expense under Section 179 of the Internal

Revenue Code. Under Section 179, you can deduct up to $500,000 in 2014, with phase- outs beginning after $2 million of assets are purchased. Real estate, assets above the $500,000 limit and other exceptions must be depreciated yearly instead. Inventory purchased for resale is not deductible**.**

- **Bonus Depreciation:** In 2015, business owners can take an additional 50 percent deduction on qualified assets that exceed the Section 179 limits, if placed into service for the first time that year. This means that if you write off $500,000 in business assets in 2014, you can also write off 50 percent of the remaining expenses you had in 2014.

- **Capital Expenses:** The costs associated with going into business also have their own tax deduction. You can deduct up to $5,000 in capital expenses before going into business.

- **Current Expenses:** Any expenses you incur for the daily operations of your business—office utilities, phone and Internet service, advertising costs, etc.—are considered current expenses. Subtract these expenses from your gross income at the end of the year.

Taxes and Insurance

As a business owner, even your taxes are tax deductible to a certain extent. The following taxes qualify:

- State income tax
- Employment taxes
- Sales tax on equipment and supplies (deducted with the cost of the items)
- Property tax for business real estate
- Various insurance expenses are also deductible for business owners:
- Auto insurance for a vehicle used in business activities is deductible if you use the actual expense method. Insurance premiums are not deductible if you use the standard mileage rate to calculate your car expenses.
- Homeowners or rental insurance can be deducted as part of the home office deduction. You can also deduct insurance for business real estate not attached to your home.
- If you are self-employed, your health insurance costs are 100 percent deductible, provided you don't have access to insurance through a spouse's plan.
- Business liability insurance and other ordinary and necessary insurance are also 100 percent deductible.

Other Deductions

There are many other tax deductions you can take if you qualify. A tax professional can help you maximize your deductions. Here are some common business deductions:

- **Employees' pay:** You can deduct your employees' paychecks as a business expense.
- **Retirement plans:** Contributions you make to your own and your employees' retirement plans are deductible.
- **Interest:** Interest you pay on loans used for financing your business is deductible.
- **Charity:** Donations of equipment and supplies are fully deductible unless they've already been depreciated.

- **Moving:** Under certain circumstances, you can deduct the costs of moving. To qualify, you must move at least 50 miles and be able to prove that the move was necessary for your business.
- **Bad debt:** You can deduct the cost of goods that you sell but aren't paid for, but you cannot deduct unpaid services.
- **Social events:** Parties, picnics, etc. for employees are 100 percent deductible.

Owning and operating a business comes with a variety of expenses and often a hefty tax bill. However, by taking advantage of the numerous tax deductions available to small business owners, you can greatly reduce your tax burden and improve your business's odds of success. The IRS won't remind you to take your applicable deductions, so it's important to learn which ones apply to you.

Source: The Better Business Owner, "Top Small Business Tax Deductions"

2016: The Year of the Raise

In the years since the Great Recession, America has seen numerous financial benchmarks return to positive levels: housing prices have largely recovered, unemployment has dropped to half its peak, new automobile sales have been pushed to record highs and most of world stock markets have significantly surpassed their pre-crisis values.

But despite all the major improvements, the recovery has been largely absent from wage growth. According to the Economic Policy Institute, U.S. workers have averaged annual wage increases of about 2.0 percent since the recovery started in 2010. That growth is around half the 3.5–4.0 percent seen in a healthy U.S. economy.

Why have wages stayed so low?

High unemployment has been the main reason for the low wage growth, but the sluggish consumer spending, low inflation and even corporate expansion strategies are also to blame. The recession slammed the economy, putting many companies out of business and taking huge tolls on the revenue of almost everyone else. Low on earnings, many companies cut or froze salaries during the decline and have only felt comfortable with smaller raises ever since.

Under normal economic conditions, absent or slow wage growth would quickly cost a company many of its employees; however, persistently high unemployment and a poor job market have kept workers from quitting and robbed them of power when negotiating salaries. Additionally, low inflation has hurt the argument for higher wages. The recovery's 2.0 percent wage growth is historically low, but it has outpaced its 1.4 percent average inflation rate. Wages are growing slowly, but employers can argue they still are growing in real value.

Why many think 2016 will be different:

There are several reasons to think that 2016 will be the year wage growth gains traction. In the last months of 2015, the unemployment rate dropped to 5 percent, a level the government associates with "full employment." There were also over 5 million job openings at year's end, with many employers complaining they couldn't find enough skilled workers to fill critical positions. This tightening labor pool suggests that employers will need to fight to keep employees in the coming years—and one of the best ways to do that is raising their wages. This isn't necessarily bad news for businesses. The economy has been steadily improving and consumer spending has been climbing. Many businesses have also consolidated in the past year, improving their efficiency. While companies may need to pay employees more, most should be making more money and many will be paying fewer employees for the total amount of work being done. Some of the compensation increases have already started happening, though not in the traditional form of pay raises. Data from the Bureau of Labor Statistics shows that companies have recently increased spending on benefits and bonuses in an effort to improve employee satisfaction, motivation and work-life balance.

Why 2016 might be the same:

There is no guarantee that 2016 will be year that wages move back to their pre-recession growth rates. The economy still faces many uncertainties. While the current unemployment rate reflects "full employment," the number of discouraged and underemployed workers is still abnormally high. Some economists believe that these potential employees may keep wages depressed until they find good jobs. Business mergers, while good for company efficiency, could actually contribute to this problem. Large mergers can lead to major layoffs, increasing the number of people looking for work. In the end, the ability to get a raise always comes down to the value employees provide to a company. If their skills are valuable and unique, their employer will happily pay more to keep their talents. A smart business cannot ignore the workers that make it successful.

Compensation Strategies: LLCs

Deciding how much to pay yourself when you're the one handing out the paychecks can be difficult. You want to make sure that you pay yourself a salary that you can live on, but you also want to make sure that your business doesn't suffer due to your salary. Based on the type of business entity you own, you will have to abide by certain governmental regulations that will affect how you pay yourself and how you pay income tax. With an LLC, you will also have different considerations for paying yourself based on whether you are the sole member or you have business partners. LLCs offer the most flexibility in choosing how to pay taxes, as they allow members to choose whether they want to be taxed as a sole proprietorship/partnership or corporation.   When determining how to pay yourself as an LLC member, consider the following:

- Electing tax classification
- Choosing a management structure
- Paying yourself if you are taxed as a corporation
- Paying yourself if you are taxed as a sole proprietorship
- Paying yourself if you are taxed as a partnership
- Paying yourself as a passive member of an LLC
- Avoiding IRS penalties

Electing tax classification

As a member of an LLC, you must first elect how you wish to be classified for tax purposes. Your tax classification is one of the largest determining factors in how you can pay yourself as an LLC member. LLCs can be taxed in four different ways: as a sole proprietorship, as a partnership, as a C corporation or as an S corporation. An LLC with one owner will automatically be taxed as a sole proprietorship unless you file to be taxed as a corporation, and the same goes for an LLC with multiple owners—the IRS will automatically treat it as a partnership unless it files to be treated as otherwise.

To keep the record-keeping and tax paperwork for your LLC as simple as possible, you will likely want to remain a pass-through entity for tax purposes. This allows you to file one simple, personal tax return and saves you time and money on administration requirements. If you choose to be taxed as a corporation, you'll want to determine how you'll hold the company's profits before deciding which classification will be most advantageous to your business. For members that are likely to keep profits in the company (instead of distributing all end-of-year profits to owners), a C corporation may be best as only the company is taxed on the profits and the owners are not paying unnecessary taxes on money that they aren't using (money that stays within the business). By electing to be taxed as a corporation, you will also likely receive a lower tax rate, depending on your profits. For LLCs that will likely have a lot of excess profits, an S corporation may make the most sense, as the distributions in an S corporation are taxed only once, and at a lower rate than income.

Choosing your tax classification will have considerable influence on your company's finances, and can have unforeseen consequences unless you are extremely familiar with the tax system. It is likely that you will have to seek legal advice from a tax attorney before making any final decisions.

Choosing a management structure

Just as electing a tax classification will alter how you are paid, so will choosing a management structure. You will have to decide how actively you (and your partners, if you have them) want to run your company and whether it will be member-managed or manager-managed. When members are in charge of actively running the company, they work for the company as employees and are referred to as "managing members." They are entitled to their share of profits from the company, but also to be compensated for the work they perform as employees. The other option is to choose a "manager," either a member or an outsider, to run the business. This usually occurs when there are members in an LLC that prefer to be passive investors but don't want to play an active role in the business. If the manager is an outsider, they will receive a regular salary from the LLC, but not a share of the profits in the way that members will, through distributions or draws. If the manager is also a member, the non-managing members will receive their share of the LLC profits, but only the managing member will make the final business decisions and receive both distributions and compensation for the work he or she performs for the company. If you are a managing member, the way you are paid from an LLC will be different than if you are a non-managing member.

Paying yourself if you are taxed as a corporation

The only way you will receive an actual "salary" as a member of an LLC is if you elect to be taxed as a corporation and you are a managing member. This is one of the most secure ways to pay yourself from an LLC, as a salary is more of a guaranteed source of income than a draw from profits. You can determine a salary based on factors such as your responsibilities within the company, the time you devote to the business and how much others in the industry in similar jobs are paid. You will pay income tax on this salary at your personal rate. However, if you choose to be taxed as a C corporation, you will be subjected to double taxation on any additional money you receive as distributions. Your company will be taxed on any company profits, and your distributions will be taxed again when you receive them. To avoid this, C corporation owners generally try to maximize their salary and minimize their distributions. This strategy works as long as the IRS deems your salary as “reasonable compensation”— that’s to say, it’s not vastly higher than others in the industry or vastly disproportionate to the amount of work you do for the company.

If you elect to be taxed as an S corporation, your compensation requirements change. You will still need to be paid “reasonable compensation” for your contribution to the business, so you will still receive a salary. You will pay income tax on this salary at your personal rate. However, for S corporations, you avoid double taxation as the company does not pay employment taxes on distributions. Since distributions are taxed at a lower rate than income, most S corporation owners try to maximize distributions and minimize salaries. Again, you will need to be careful to avoid IRS suspicion by using determining factors to make sure you are receiving at least “reasonable compensation.” This can be advantageous for members who will receive large shares of profits, as managing members in an S corporation structure will be subject to a lesser payroll tax than the same managing member in an LLC would have to pay in self-employment tax, should their share of profit exceed “reasonable compensation” standards. LLC members generally choose to be classified as a corporation for tax purposes if their profits will be fairly large. Otherwise, you will not benefit as much from receiving corporation tax treatment. However, you should be sure that this type of high profit is sustainable before electing to be taxed as a corporation, as the IRS does not allow an LLC to change its tax classification for five years after the initial election.

Paying yourself if you are taxed as a sole proprietorship

If you are a sole member LLC and you do not elect to be treated as a corporation by the IRS, you will automatically be treated as a sole proprietorship. This qualifies your business as a pass-through entity. The LLC itself will not pay taxes, but you must report all profits or losses of the LLC on your own personal tax return. If you have a relatively small amount of profits or if you leave a relatively small amount of money within the business, this can be the simplest way to pay taxes for your business. It requires very little paperwork and has small administrative costs. However, if you have a large amount of money in the company’s bank account at the end of the year, you are required to pay income tax on that money, even though you personally aren’t using it. In this arrangement, you are not considered an employee of a company—you are considered self-employed. Instead of receiving a salary, you will receive payments as draws of company profits. A draw is only available to the extent that profits are available, however, so you will have to determine how much of a draw you are able to take as a paycheck in order to keep both the company and yourself financially viable. You will also be required to pay self-employment taxes and estimated quarterly income taxes, since you will not be receiving a paycheck that automatically deducts these taxes for you.

Paying yourself if you are taxed as a partnership

Similar to a sole proprietorship, if you are a multimember LLC and you do not elect to be taxed as a corporation, the IRS will automatically classify you as a partnership. Your business will be a pass-through entity and will not pay any income taxes itself, although partnerships are required to submit an annual information return. Instead, each partner will pay individual income tax on his or her share of the business profits. Each member’s individual share of profits and losses is called a “distributive share.” You will also be required to pay self-employment taxes and estimated quarterly income taxes on this amount.

Unlike corporations, LLCs that elect to be taxed as partnerships do not have to distribute profits and losses in proportion to the money that each member puts in. Multi-member LLCs acting as partnerships can determine each member's distributive share amongst themselves. This is commonly recorded in an operating agreement, a binding legal document that sets out each member's distributive share, company responsibilities and other matters that are vital to a company's operation. Your operating agreement should also determine if you will receive regular distributions of profits or if each partner will be able to draw at will from business profits. This structure will likely vary according to each partner's financial needs. If you don't create an operating agreement, then state law will dictate your distributive share, and it will usually be directly proportionate to your ownership interest in the business.

If partnerships split up profits and losses in a way that is disproportional to their interest in the business, it is known as a "special allocation." The IRS pays close attention to special allocations to ensure that members aren't trying to avoid taxes, for example by allocating all business losses to members in the highest tax bracket. The regulations covering rules for special allocations are complicated, so you will want to consult a tax expert to be sure your allocations will not arouse IRS suspicion.

No matter how much money you actually take out of the business for your own personal use, if you are taxed as a partnership then the IRS will treat each member as though he or she has received his or her entire distributive share for the year. This means that even if you choose to leave the majority of your money in the business, you will be taxed on the entire percentage of business profits that you are technically entitled to, even if you don't actually receive those profits. In this case, it's important to take a draw large enough to be able to cover the income taxes that you'll owe on these profits. Paying yourself as a passive member of an LLC Most of the preceding pay information centers on LLC members who are managing members. Non-managing members, those who do not actively participate in the business, are also known as passive members. They usually receive their share of business profits solely through holding interest in the business, as they do not receive compensation for providing a service to the business. Just as managing members, you will receive a distributive share from the company, which is how you will profit from owning interest in the company. You will also be subject to income tax on this share. It is up to you and the rest of the members of the LLC to decide how much of a distributive share you will receive. Some members feel managing members should receive a higher share, while others feel that capital invested in the company is just as important as management roles, and will split distributive shares equally no matter the role of the member.

Avoiding IRS penalties However you choose to pay yourself, you should keep certain things in mind to avoid IRS penalties and maximize your own income: Look closely into what you are able to "write off" as business expenses. It's likely that you will have a large amount of deductible business expenses such as start-up costs, travel expenses, advertising costs, equipment costs, etc. All of these can lower the profits you are required to report to the IRS. If you make special allocations to members within an LLC, make sure that the allocations have "substantial economic effect." This means that the allocation relates directly to the member's actual economic circumstances, and is not merely a way to shift income in order to reduce taxes. Each LLC member should have a capital account within the LLC that tracks their contributions, profit and loss allocations and distributions made to them. Your capital account will equal the money/capital contributed plus your share of the profits minus your share of the losses minus money or property distributed to you. Be careful not to "pierce the corporate veil." Members can lose limited liability protection if they aren't careful to keep business and personal assets separate or fail to keep documentation of company formalities such as company meetings. This is called "piercing the corporate veil" and can cause you to be personally liable for any of the LLC's wrongdoings. Keep careful documentation. You should have lists of all current and past managers and members and their information as well as any meeting minutes and expense or credit records, including bank account statements and tax records.

The Other Type of College Savings Plan: A Prepaid Tuition Plan

For parents planning for their children's college education, there are several investment options to consider. One option that seems appealing is state-sponsored prepaid tuition plans available in several states. These plans allow parents to pay today's tuition rates with the assurance that the child will have the money to go to college when the time comes. They also allow participants to defer paying federal income tax on earnings until money is withdrawn for college.

These plans sound very attractive because of their guarantee as well as relative simplicity. Prepaid tuition plans differ from college savings plans that seek higher returns not tied to the increase in tuition. College savings plans do offer the potential for higher returns than the rate of tuition inflation, but there is a risk that your investment could lose value.

How Do the Plans Work?

Each state's plan works a bit differently, and the newer plans offer more flexibility. Essentially these plans allow parents (and relatives) to "buy" tuition for the child at a fixed price. You either pay in full or pay in installments and you are guaranteed that your investment will keep pace with rising college costs. Depending upon the number of years you have until your child first enters college, your cost may vary.

Since these plans work in part as insurance against rising college costs, there is some degree of speculation involved. Parents come out ahead if the tuition costs rise faster than the average and would do worse if college costs did not rise as fast. Historically, tuition costs have risen, keeping pace with inflation and sometimes outpacing the inflation rate. The other hidden benefit is that grandparents and other relatives who may be unsure as to what they should buy as gifts can also contribute to the plan.

Questions to Ask

- Is it transferable? To whom? When?
- What is the enrollment period?
- What costs are covered?
- Can out-of-state residents participate?
- What happens if you stop paying?
- What happens if your child goes to private college?
- What happens if your child goes to out-of-state college?
- What is the tax effect?

Factors to Consider

Despite their benefits, these plans are not for everyone. That's because the returns on these plans may not stack up to returns you might receive in other investments such as stocks, especially if your child has five or more years before starting college. However, if you are like many parents and did not start thinking seriously about investing for college until your child entered high school, stock investing may not be the best option due to your relatively short time frame before you will need the money.

One of the most cited drawbacks to these plans is their lack of flexibility. If your child chooses to go to an out-of-state or private college, he or she may receive only some of the benefits. If you want to transfer the amount to a sibling, some plans may disallow it. Even worse, if your child decides not to go to college at all, or for whatever reason you choose to withdraw money for some other expenditure, you may face very strict refund policies. Many plans impose a heavy penalty for withdrawing money for any reason other than college tuition. Although newer plans now offer more flexibility than their earlier counterparts, there are restrictions imposed on how and when you can transfer funds, should your child decide to go to an out-of-state or private college.

Tax Implications

Congress has expanded the tax advantages of these plans to include, among other provisions, the addition of room and board to the category of qualifying expenses. Some state plans offer additional tax advantages.

Assets held in prepaid tuition plans are attributed to the account owner, not the beneficiary (student), which results in a lower impact on need-based financial aid. Additionally, parental assets in retirement plans and the net market value of the family's primary residence are not counted as assets for need-based financial aid.

CollegeSure® CDs

If your state does not offer prepaid tuition plans, a variable-rate CollegeSure® certificate of deposit (CD) offered by College Savings Bank in Princeton, New Jersey, may offer a way to make sure the money you set aside today will be able to finance your future tuition bills. CollegeSure CDs offer an annual percentage yield equal to the prior year's college inflation rate as measured by the College Board's Independent College 500® Index. As a result, the value of your assets could increase at the same rate as which college costs are rising. Available in maturities ranging from 1 to 22 years, they pay interest annually each July 31. However, CollegeSure CDs are subject to a maximum interest rate, which is determined in part by the rate in effect the first year you purchased the CD.

Although prepaid plans may not fit every situation's need, they offer benefits to many parents. It may be to your advantage to learn more about these options.

Points to Remember

- Prepaid tuition plans allow parents to lock in a tuition rate and begin paying the cost of college today.
- If college is still a long-term consideration, parents may get a better rate of return by investing in stocks or a state-sponsored college savings plan that seeks higher returns.
- Many plans do not allow for account transfers or payments to out-of-state colleges.

- Withdrawal of funds for anything other than tuition can result in substantial penalties.
- Assets are attributed to the account owner, not the beneficiary, resulting in a lower impact on need-based financial aid.
- Parents can also purchase CDs that pay an interest rate linked to the rate of inflation for college costs.

Wealth Strategies for Creative, Entrepreneurial and Strategic Business Owners - Twin Cities & Bay Area
T: (888) 544 3250 E: ashley@arete-ws.com URL: arete-ws.com @aretewealth