INDIVIDUALS

SURVIVING FINANCIAL DOWNTURNS

Wolters Kluwer

INDIVIDUALS: Surviving Financial Downturns

When the economy takes a turn for the worse, everyone and every household feels the impact in some way. Most individuals and families look for ways to tighten their purse strings by spending less and saving more where they can. However, many individuals often overlook the benefits of proper tax planning during financial downturns. Proper tax and financial planning can help you wade through the murky waters of an economic downturn.

This guide highlights some important tax-related strategies for individuals to help weather rough economic storms, whether on a national, regional or personal level. In this booklet, we will look at:

- Making a budget and managing debt;
- Utilizing stock losses;
- Safeguarding your retirement accounts;
- Income timing;
- Taking advantage of credits and deductions; and
- Working with the IRS to pay off a tax debt.

MAKE A BUDGET

There may be no more important – and often for many individuals, challenging – undertaking in an economic downturn then making (and sticking to) a budget and spending plan. Although the word "budget" may seem restricting and at the same time overwhelming, making your way safely through a financial downturn may well require one.

Many people often find tracking expenses too tedious to do on a daily, weekly or even monthly basis. However, when it comes to managing your personal finances in financial downturns, tracking expenses and making a budget is imperative.

Average cost per month. Often, individuals look in terms of the "average cost per month" they can spend on various items and expenses. In any given month, however, people spend different amounts of money on different things. Instead, break down and organize your monthly expenses into categories. How

much and on what do you spend each month? These categories should include "fixed payments" as well as your discretionary spending.

Fixed payments. First, look at your "fixed" payments you incur each month, such as:

- Rent or mortgage payments;
- Loan payments (for example, lease payments and student loans);
- Insurance;
- Daycare;
- Cable, internet, phone bills;
- Utilities (gas, electricity, water, etc.); and
- Food.

On contemplating fixed payments, don't forget about federal and state income taxes. You need to have enough tax withheld from your wages and/or pay estimated tax in quarterly installments to make sure there is not a big balance due – with possible interest – if there is a shortfall when you file your tax return for that year.

On the flip side, if you usually receive a big refund, you might want to cut back on withholding and estimated tax and have more money available each month for other expenses. A refund usually represents an interest-free loan to the government of your money.

After adding up all your fixed costs, subtract them from your monthly take-home pay. The amount left after is "discretionary income." It is what you do with, and how you budget, this income that plays a fundamental role in your financial stability and health during a financial downturn.

Take control of discretionary spending

Tough economic times call for making lifestyle changes for many individuals. This includes limiting your discretionary spending and making better use of your discretionary income. Discretionary income is the amount of income available for spending after you pay for all your necessities, like mortgage payments, rent, and utilities.

> **Comment.** Discretionary income is different than disposable income, which is an individual's net personal income (gross income) after paying taxes and other payments to the government. Discretionary income is a component of disposable income.

PAY DOWN DEBT

During financial downturns, it's important to get a handle on your finances and debt obligations. If you owe student loans, car loans, or have credit card debt, gather your records and assess what you owe. Put a game plan in place for paying down these and other debts.

Look not only at the interest rate you are paying on each loan, but also whether it is deductible from your taxable income, thereby giving you a lower after-tax effective interest rate. Mortgage interest, student loan interest, and certain investment interest, can fall into this category.

Credit cards

During difficult financial periods, people tend to rely on their credit cards. Many individuals and households mistakenly rely on credit cards during financial downturns, especially when they lack enough in savings. Despite the temptation, however, put away the credit card. During financial downturns, your credit card should only be used for emergencies, and only when you otherwise do not have the cash in hand to make those purchases. And if you *must* charge something, use your card with the lowest interest rate.

Tackle high interest. If you have multiple credit cards, pay off credit cards with the highest interest rates first. Tackling high interest credit card, and other, debt is essential to gaining some financial stability during economic downturns.

> **Caution.** Sometimes, people think that closing credit cards to avoid using them is a financial must-do. However, this can sometimes backfire because individuals who make timely payments on those lines of credit can actually be strengthening their credit score. You may want to consult a financial advisor before deciding what to do with, and how to pay, those cards.

Pay on time

It is important in both the short- and long-run for you to pay your bills and other debt payments on time, and in full if possible. In the short-term, this will ensure that you don't pay interest, late fees or penalties. For example, late payment fees for credit cards can run as much as $40 or more. This is $40 better spent elsewhere.

In the long-run, paying your bills and other payments on time helps maintain a good credit score.

Put some money into savings

Often, people believe they must use most or all of their disposable income to pay off a credit card or other debt. However, it may be financially wise to divvy up that money between paying off debt (with an eye to prioritizing high interest

debt) and socking some of that cash away in a savings account or retirement plan. Savings accounts often double as an "emergency fund" for many individuals and families.

Generally, the rule of thumb is that individuals have enough put away in a savings account (or emergency fund) to provide for their current standard of living for at least six months. If you have not done so already, don't panic. Start now. It's always better late, then never.

> ***Comment.*** In evaluating savings options, think long-term as well as short-term. How much savings should go into a tax-deferred retirement account and how much should be contributed after-tax to a Roth account? Some, but not all, tax-deferred accounts allow withdrawals for financial emergencies.

Cancellation of debt income

Generally, debt that is forgiven or cancelled by a lender must be included in your taxable income. Debt that is cancelled or discharged by a lender is commonly referred to as "cancellation of debt income" or COD income. A lender's cancellation of your debt will typically result in income to you unless a specific exception under the Tax Code applies.

Therefore, if your credit card issuer forgives payment of your outstanding balance, or your mortgage lender forgives part of the unpaid balance of your mortgage, it is imperative that you understand the tax consequences of the transaction.

Nontaxable cancelled debt. The IRS generally recognizes four situations where cancelled debt does not result in taxable income and therefore does not have to be reported as income:

- The debt has already been discharged through a bankruptcy proceeding under title 11 of the Bankruptcy Code;
- You are insolvent (your total debts exceed your total assets) when the cancellation of debt occurs;
- The indebtedness is due to a qualified farm expense; or
- The indebtedness is due to certain real property business losses.

However, certain exceptions apply, including the forgiveness of certain mortgage debt, discussed in further detail below.

Credits cards and car loans. The Tax Code does ***not*** exclude from an individual's gross income credit card debt that is forgiven by a lender, or any outstanding and unpaid debt on a car loan forgiven by a lender. The amount of forgiven debt is reported by the lender on Form 1099-C, Cancellation of Debt, which is sent to the individual. The amount of forgiven debt from Form 1099-C must be reported as income.

Example. You have an outstanding credit card bill of $7,000. You are unable to pay the total amount but reach a compromise with your credit card company in which you settle the debt for $3,500. The Tax Code treats you as having realized a personal net gain of $3,500, even though you have not actually received any money, because you received the benefit of the $3,500 in payments. You will have to report this amount as income.

Mortgage debt exception. Certain mortgage debt that is forgiven by the lender, through 2013, is excluded from COD income and, therefore, does not result in taxable income to certain homeowners. This means that income from a discharge, in whole or in part, of "qualified principal residence indebtedness," can be excluded from your income.

Comment. This provision is Congress's response to the subprime mortgage crisis. It is intended to provide tax relief so that a taxpayer whose mortgage is forgiven in whole or in part does not recognize income from that forgiveness.

This exclusion from COD income is limited to $2 million of indebtedness that is secured by a principal residence (i.e. no vacation homes or second homes), and was incurred in order to acquire or construct the principal residence, or make a substantial improvement to it (sometimes referred to as "acquisition indebtedness").

Example. Carl's principal residence is subject to a $350,000 mortgage debt. Carl's creditor forecloses on the property in 2013. Due to declining real estate values, the residence is sold for $275,000 later that year, all of which is paid to the mortgage lender at the closing. Carl has discharge of indebtedness income totaling $75,000 ($350,000 - $275,000) for the 2013 tax year.

Additionally, this relief from COD income also includes refinancing of such debt to the extent that the refinancing does not exceed the amount of the original indebtedness. However, if you engaged in "cash-out" refinancing, in which the funds were not put back into your home for improvements but instead were used to pay off your credit card debt, tuition, medical expenses, or other expenses, this is not covered by the mortgage debt relief provision. This type of indebtedness is fully taxable COD income, unless one of the previously mentioned exceptions applies.

Congress has not yet extended this exclusion to 2014.

Student loans. Complete or partial cancellation of some student loans does not generate forgiveness of indebtedness income. This exception applies where the loan agreement provides for cancellation of the student loan in exchange for the individual's commitment to work for a

certain period of time in certain professions for any of a broad class of employers. A student loan is a loan made to an individual for the purpose of attending an educational institution. The loan must be made by a qualifying institution, such as the educational institution itself (provided certain requirements are met) or the U.S. government or one of its agencies or instrumentalities, among others, to enable the individual to be eligible for the loan forgiveness.

> **Comment.** Certain student loan refinancings are also considered student loans. A refinancing is a student loan if it is made to refinance a loan to an individual to assist in attending an educational organization.

MANAGING YOUR INVESTMENT PORTFOLIO

As financial markets fluctuate in a downturn, many investors will watch the value of their stocks seesaw, or unfortunately plummet. You should examine your investments to determine whether your tax position would benefit from selling certain stocks or securities. However, don't make hasty decisions. Always speak with your financial advisor or tax advisor for advice.

Stock losses

A downturn in the market will undoubtedly lead to a downturn in your investment portfolio. While most stock values will turn around as the market

eventually recovers, you may want to use some of those losses to offset gains from other stock you may want to sell, or from your ordinary wage income.

Capital losses. You can use both your long-term and short-term capital losses to offset any capital gains you recognize during the tax year. Moreover, you can use up to $3,000 of any net capital losses ($1,500 for married individuals filing separately) you have left after reducing your capital gains by capital losses in order to offset ordinary income in any one year.

And if your net capital losses exceed this $3,000 annual deduction limit, the Tax Code lets you carry over the excess losses to the next year. The excess losses that you carry over can then be netted against capital gains in that year, with any excess loss again deductible against your ordinary income up to $3,000.

> **Example.** During the tax year, Maggie earned $40,000 from her job as a teacher. She also sold shares of stock with the

resulting long-term and short-term gains and losses: A total of $15,000 long-term gain, $8,000 in long-term losses, $14,000 in total short-term losses and $2,000 in short term gain.

Because net long-term gains are a gain and net short-term losses are a loss, the amounts are netted. Maggie has a net $5,000 short-term capital loss ($12,000 net short-term capital loss less $7,000 net long-term capital gain). She can claim a $3,000 short-term capital loss against her regular wage income, resulting in net income of $37,000 ($40,000 income less $3,000 short-term capital loss). She can carry forward the remaining $2,000 loss ($5,000 total loss less $3,000 allowed).

Comment. Unlike business losses, personal capital losses, such as from the sale of stock, can only be carried forward. Although no carrybacks are allowed for personal capital losses, losses that are the result of natural disaster can be carried back to a limited extent.

Beware of the wash sale rule. From a tax standpoint, you cannot sell stock at a loss and then turn around and immediately buy it back if you think at some point the value will go back up. This transaction is considered a "wash sale." A wash sale occurs where you sell a security (e.g. stocks or bonds) at a loss and then buy back substantially the same security within 30 days. The wash sale rule also prevents you from buying stock and then selling the same stock at a loss within 30 days. The IRS will seek to eliminate the ability to deduct the current losses on these transactions. Instead, the IRS will allow a basis adjustment to the new securities purchased, which in effect defers recognition of the earlier loss.

Worthless stock deduction

If the value of your shares of stock are trading at very low prices, or have no value at all, you may be wondering if you can claim a worthless stock deduction. You can only deduct loss on worthless securities if the loss is incurred in a trade or business, in a transaction entered into for profit, or as the result of a fire, storm or other casualty. It is generally assumed that individuals acquire securities for profit.

Most importantly, you can only take a worthless stock deduction when your securities have become *totally* worthless. You cannot take the deduction for stock that has become only partially worthless. In the IRS's eyes, a company's stock is not going to be automatically considered worthless just because it has plummeted in value and is now trading for mere dollars or pennies.

With market turmoil, many stocks take big hits and drop significantly in value, some even trading for less than a dollar a share, but are still alive and trading on an exchange. Thus, you can't take

a worthless stock deduction for a mere decline in the value of the stock if it has any recognizable value.

Alternatively, you may be better off selling the stock and simply taking the capital loss. You can use these losses, as mentioned, to offset any gains you recognize on the sale of other securities, or to offset up to $3,000 of your ordinary income.

RETIREMENT PLANNING MUST CONTINUE

Financial downturns will undoubtedly force individuals to make many difficult decisions, including where to stop spending money and when to continue making certain expenditures.

Planning and saving for retirement should definitely be an area where you continue to put your dollars. There are a number of retirement vehicles where you can put your dollars that provide lucrative tax savings. Whether you buy Treasury bonds, CDs, or investment in the market, socking away money for retirement should not be overlooked.

Making a contribution to a traditional IRA or employer sponsored retirement plans, such as 401(k) plans, can reduce your taxable income now since the funds are contributed before tax. For 2013 and 2014, the contribution limit to a traditional IRA is $5,500 (or $6,500 for individuals age 50 or older who qualify for catch-up contributions). Of course, the price for contributing pre-tax now is that you must pay tax on that amount, plus earnings, when you withdraw it in retirement. However, you are usually in a lower tax bracket at that time, so you still come out ahead.

Leave retirement savings alone

Whether you are looking for ways to pay off your credit card debt and other common monthly bills, or obtain a mortgage in times of a "credit crunch" or "economic downturn," you may be contemplating alternative sources of financing to reach your goals or make these payments, including tapping your retirement account.

Unless you have absolutely no other means to finance a transaction or pay a bill, you should leave the funds in your retirement account alone. Premature withdrawals (those that are made before you reach age 59½ and don't fit within a statutory exception) are subject to a 10 percent penalty fee, in addition to the normal federal and state income taxes levied on any withdrawal. These are severe tax and financial consequences.

Generally, there are three ways you can withdraw funds from your 401(k): regular distributions, hardship withdrawals or a plan loan. The latter two ways are possible, however, only if allowed by the plan documents themselves. Many employers have adopted 401(k) plan provisions allowing employees to borrow from their retirement account.

401(k) plan loans. The amount you can borrow from a 401(k) plan is limited to 50 percent of the value of your vested benefit or $50,000, whichever is less. Generally, you must repay the loan within five years, subject to only one exception for a loan used to buy a principal residence. This "residence exception" allows for a loan term as long as 30 years. Loan repayments must be made at least every quarter and are generally automatically deducted from your paycheck.

If you leave or lose your job, most plan terms require you to repay the loan within 60 days.

If certain requirements are not met, the loan from your 401(k) will be treated as a premature distribution for tax purposes, subjecting you to current income tax at ordinary rates, plus a 10 percent early withdrawal penalty on the amount distributed.

Additionally, the interest you pay on the loan is taken from your paycheck, after taxes. While it is not an additional cost you'd pay to a bank (because you're paying yourself), it is money you may effectively be paying tax on twice. This is because the money you pay yourself interest with is taxed in your paycheck currently, then later when distributed to you from the plan in retirement as ordinary income.

There are many other significant

drawbacks to dipping into your 401(k). For example, many plans prohibit you or your employer from making contributions to your 401(k) until you repay the loan or for up to 12 months after the distribution. Talk with your tax advisor before making this move.

60-day IRA loan. You can "borrow" money from your Individual Retirement Account (IRA), tax and penalty free, for up to 60 days. Taking this short-term loan should only be done in dire financial situations in light of the serious tax consequences that can result from an improper withdrawal or untimely rollover of the funds back to the IRA.

If funds are not returned within 60 days, the withdrawal will not only be treated as a taxable distribution for individuals under age 59½, but you will also face an additional 10 percent penalty tax on the amount withdrawn as well as possible state income tax.

You can only take a 60-day loan from your IRA once during a 12 month

period. You must also report the "loan" on your Form 1040 in the year in which you took the withdrawal.

Hardship distribution. A 401(k) plan may allow you to take a "hardship distribution" up to the amount of your elective deferrals. (While many 401(k) plans contain hardship-distribution provisions, they are not required under the tax code.) A hardship distribution is one that (1) is made because of the employee's immediate and heavy financial need and (2) does not exceed the amount necessary to satisfy that need. A hardship distribution is included in the employee's income and is subject to the 10 percent penalty on early distributions unless an exception applies.

Types of expenses that satisfy the requirement of immediate and heavy financial need include:

- Medical expenses of the employee, spouse and dependents;
- Expenditures (excluding mortgage payments) to purchase a principal residence for the employee, but only up to $10,000 generally;
- Post-secondary tuition for the employee, spouse, children or dependents;
- Expenditures to stave off eviction or foreclosure with respect to the employee's principal residence;
- Burial or funeral expenses for the employee's deceased parent, spouse, children or dependents; and
- Expenses for the repair of casualty damage to the employee's principal residence.

An immediate and heavy financial need also includes any amounts necessary to pay any income taxes or penalties reasonably anticipated to result from the distribution.

Roth recharacterizations

If you converted your traditional IRA into a Roth IRA when the market was doing well and values were higher, paid a significant amount of tax on the conversion, then watched as the value of your Roth IRA account plummeted amid the market turmoil, you may want to consider undoing the conversion. You can void or significantly lower your tax bill by recharacterizing the conversion, then reconverting your IRA back to a Roth at a later date. You must do the recharacterization by the due date (with extensions) for your Form 1040 filed for the year of the conversion. Careful timing is required for this strategy.

> ***Comment.*** If you want to utilize this strategy in 2014 for a 2013 conversion, for example, you generally have until October 15, 2014 to undo a Roth conversion if your tax return would be due by the normal due date (typically April 15).

Recharacterizing a Roth conversion may be appropriate for several reasons, especially if your Roth has lost a lot of value but you have a large tax bill for the conversion. Perhaps that tax bill is even more than the amount currently in your account. Other reasons for undoing a conversion: you can't afford the tax bill due, the conversion will propel you into a higher tax bracket, or subject you to the alternative minimum tax (AMT).

The recharacterization of a Roth conversion must meet certain requirements, including being completed by your tax filing deadline.

INCOME TIMING

Although known for being a traditional year-end tax planning move to save tax dollars, the tax strategy of accelerating or deferring taxable income can help in any economic climate.

Deferring income

If you anticipate being in a higher tax bracket this year than you expect to be in 2015, you may want to delay the receipt of taxable income, if feasible, until next year. Consider whether deferring income until 2015 is economically sound under your particular circumstances, or whether delaying income could help prevent you from losing lucrative tax breaks that could be reduced or altogether eliminated as your income level rises.

Accelerating income

On the other hand, it may be more beneficial in your particular situation to accelerate income into 2014, rather than deferring it until 2015. For example, one issue to consider is whether you need additional income this year in order to take advantage of offsetting deductions or credits that may expire at the end of the year.

Deduction planning

Another year-end traditional tax planning technique that may be particularly helpful in an economic downturn is deciding whether accelerating or deferring deductible expenses will mean overall tax savings. Deduction planning can be complex. Remember that your ability to take deductions depends on your income level and filing status, as well as whether you plan to take the standard deduction. For example, if you are well within the standard deduction limit for deductions, postponing expenses that would generate deductions until the following year usually makes sense.

CREDITS AND DEDUCTIONS

In a financial downturn, you want to leave no stone unturned when looking for ways to save money. Don't overlook the value of common deductions and credits you may be eligible for that, in economic crunch time, can mean tax savings for you.

Deductions can reduce your taxable income, while credits can reduce your ultimate tax bill, dollar for dollar. This means savings for you, and perhaps a refund.

Look to see if the following common credits and deductions apply to you (but remember, some of these can be subject to adjusted gross income (AGI) limits, so talk with your tax professional):

- Teacher expense deduction (up to $250);
- State and local sales tax deduction *or* state and local income tax deduction (Congress has not yet extended the sales tax deduction into 2014);
- Deduction for mortgage and investment interest;
- Child tax credit (phase-out starts at $75,000 AGI for individuals, $110,000 for joint filers, and $55,000 for married taxpayers filing separately);
- American Opportunity higher education tax credit, (phase-out starts at $80,000 AGI for individuals and $160,000 for married joint filers);
- Lifetime Learning Credit (phase-out starts in 2013 at $53,000 AGI for individuals and $107,000 AGI for joint filers) ($54,000 and $108,000 for 2014);
- Energy tax incentives (for example, residential energy efficiency improvements) (one of the residential energy credits expired at the end of 2013 and has not yet been extended by Congress);

- Deduction for job search expenses;
- Nonbusiness casualty and theft loss deduction; and
- Charitable contribution deduction.

Transportation fringe benefits

Don't forget that a good way to potentially reduce your taxable income is to participate in your employer's transportation fringe benefit program, if a plan has been established. Qualified transportation fringe benefits for parking, transit and commuter highway transportation are available. For 2013, monthly benefits are set at $245 for transit, vanpooling, and parking benefits. For 2014, the monthly parking benefit increases to $250; however, absent additional legislation, the transit and vanpooling benefit falls to $130 per month.

These benefits may be funded through contributions by your employer that are excluded from your income. Alternatively, benefits may be funded through pre-tax salary reduction contributions

you provide through the employer or a third-party vendor.

In either case, the benefits are excluded from your wages. If you are not already utilizing these benefits, and you commute to work, now is a great time to start. These benefits can reduce your taxable income.

Withholding

It's also important to make sure you're employer is not over – or under – withholding from your paycheck. If you are being overwithheld, not only are you giving Uncle Sam a tax-free loan with your hard-earned dollars, but you are losing the ability to use that money if the additional dollars are needed.

However, having too little withheld can also create significant headaches and anxiety when it comes time to pay your tax bill. These are unnecessary pains, and you can avoid them by reviewing your withholding and making adjustments if necessary. It can provide peace of mind during difficult economic times to know that you aren't losing the opportunity to use money when it's needed or that you may face a larger then expected tax bill at the end of the year.

TALK TO THE IRS

Due to the current financial downturn, the IRS has pledged to work with taxpayers with a history of past compliance who cannot meet their federal tax obligations because of job loss or other problems magnified by the state of the economy.

For example, IRS personnel have been given the authority to suspend collection activities. Help may also take the form of flexibility for missed installment agreement payments, additional review of offers-in-compromise, and expedited levy releases.

There are a number of payment options offered by the IRS, that you may be able to utilize. Talk with your tax professional. Here is a run down of a few payment options:

Extension of time to pay. Taxpayers may be eligible for a short extension of time to pay of up to 120 days. Taxpayers should request an extension if they would be able to pay their taxes in full within this extended timeframe.

Delaying collection. If the IRS determines that a taxpayer is unable to pay, it may delay collection until the taxpayer's financial condition improves.

Installment payments. You may be able to enter into a written agreement with the IRS. For your installment proposal to be automatically approved, certain requirements must be met, such as the total liability cannot exceed $10,000. However, the IRS

recently has approved amounts considerably higher as a matter of course because of the economic downturn. Although installment terms can be as long as five years, the prevailing interest rate plus 0.50 percent each month as a failure to pay penalty continues to accrue, making an extended payment period undesirable for many taxpayers.

Installment agreements can be paid directly from a bank account or payroll deduction from wages.

Offer-in-Compromise. Some taxpayers are able to settle their tax bill for less than the amount they owe by submitting an offer-in-compromise (OIC). However, the criteria for accepting an offer are strict and relatively few offers are accepted each year.

An OIC may be considered only after all other payment options have been exhausted.

CONCLUSION

Solutions to financial difficulties, including the tax problems that they can bring, frequently require considerations that involve multiple alternatives. Weighing all the benefits and pitfalls of each is often complex. But weathering a financial downturn requires thought and sacrifice. There are many tax and nontax ways to help you through economic downturns. Examine all your options and put your plans into effect as soon as you can.