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Will You Be in the 1%? Surviving an IRS Audit

The IRS audited approximately 1.6 million individual tax returns filed in 2011.[1] That amounts to just over 1.1% of 141 million individual returns filed that year. However, just over one-quarter of those audits involved face-to-face meetings with IRS auditors. The rest were conducted through the mail.

Filers earning less than $100,000 had a 1% chance of being audited. Among filers with income exceeding $200,000, the audit rate was 3.93%; for those earning more than $1 million, it climbed to 12.5%. Self-employed taxpayers who filed a Schedule C and reported gross receipts of at least $100,000 were audited at a 4% rate.

What Triggers an Audit

The following are some of the red flags that could alert the IRS, aside from earning a lot of money:

1. Running a cash business
2. Claiming the home-office deduction
3. Self-employment
4. Deducting business meals, travel, and entertainment
5. Failing to report all taxable income
6. Claiming 100% business use of a vehicle
7. Making large charitable contributions
8. Claiming a rental loss
9. Taking larger than usual deductions

What the IRS Looks For

Whether the IRS requests a face-to-face meeting or chooses to conduct its audit through correspondence, the following issues may arise:

- **Unreported income** -- The IRS will assess taxes on any "missing" amount plus interest and penalty charges -- regardless of whether the omission was accidental or intentional. A finding of significant fraud could even result in criminal prosecution and jail time.
- **Personal expenses vs. business expenses** -- Be prepared to prove that expenses you've claimed for business purposes were not actually personal expenses. Auditors pay particular attention to deductions related to entertainment, meals, travel, and transportation. If you own a business, keep all receipts and be ready to answer questions about the connection between each expense and your business.
- **Industry insights** -- Business owners should also keep in mind that the IRS has a Market Segment Specialization Program (MSSP) designed to train its employees about the intricacies of dozens of specific business niches, ranging from Alaskan commercial fishing to car washes and the scrap metal industry. Fortunately, the MSSPs Audit Technique Guides are available online (www.irs.gov; look under the "Businesses" heading), so you can check to see whether your industry is included in the program. If it is, studying the relevant guide might help you get inside the head of your auditor, so to speak.

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Even if you don't expect the worst during your audit, there are several reasons it's still a good idea to enlist the services of an experienced tax professional to help you navigate the process. For example, a professional is probably more familiar with the complexities of ever-changing tax laws than you, and is also less likely to let emotions cloud his or her judgment. In addition, letting a pro speak on your behalf reduces the chance that you will accidentally volunteer information that could hurt your case.

This communication is not intended to provide tax advice and should not be treated as such. Each individual's tax situation is different. You should contact your tax professional to discuss your personal situation.

Source/Disclaimer:
[1]Source: IRS, March 2012.

Incentive Trusts: Setting Guidelines for Your Heirs

An incentive trust is an estate planning tool that allows the trust grantor to reward heirs for desired behavior. It also allows the grantor to impose appropriate penalties for undesirable activities.

Some common themes contained in incentive trusts:

- **Education:** Incentive trusts have been used to provide extra support to those heirs who pursue advanced degrees, focus on designated fields of study, or attend specified institutions. Some trusts are designed to reward instances of outstanding scholarship and academic achievement. Some permit withholding support from those who fail to meet minimum levels of accomplishment.
- **Moral and family values:** Some trusts are intended to promote family life by providing income support payments to heirs who choose to stay at home with children. Some trusts offer beneficiaries bonuses for childbearing, foster care, or adoption. Some withhold benefits from those heirs who might be convicted of a crime or fail a prescribed drug or alcohol screening test.
- **Business and vocational choices:** Entrepreneurs can use trusts to provide incentives to those heirs who commit to helping carry on a family business. Trusts can be designed to encourage or discourage career choices specified by the trust creator. Trusts can also be used to offer focused financial support to those beneficiaries who opt to follow paths that are personally and socially rewarding yet generally less lucrative.
- **Charitable and religious opportunities:** Some trusts are designed to encourage religious behavior by requiring specific observances. Some trusts provide funds for dues or other costs associated with religious participation. Some subsidize those heirs who choose missionary work or other religious vocations. Some provide matching funds for heirs' contributions to favored organizations.

Incentive trusts can provide many of the same benefits as other trust structures. For example, by placing assets in a properly designed trust, you can move them out of your estate in order to manage tax liabilities more efficiently. You can also ensure that assets will be managed professionally and held in safe custody through a stable financial institution.

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Key Limitations
Just as you have broad discretion as a parent or guardian, you have great latitude when you create an incentive trust. But there are limits. The trust cannot, of course, require blatantly illegal activity; neither can it provide incentives for actions that might be deemed contrary to public policy -- violating the unwritten laws of the community. For example, a trust generally cannot provide incentives for a beneficiary to divorce an unpopular mate, nor can it be used to undercut existing voluntary separation, child support, or other domestic arrangements generally permitted by law in your state.

Incentive trusts may be subject to what is called the rule of perpetuities, a legal concept that says trusts must be liquidated at some definite interval after their creation. This rule is enforced in many, but not all, states. It applies to trusts that are created in the state where the rule is enforced (you may generally create a trust in any state, not just the state in which you reside). As a consequence, you'll want to be sure that any trust you do create can last for as long as needed to achieve your goals.

Certain types of incentive trusts may also be subject to the generation skipping transfer (GST) tax. Where an incentive trust fits the complex definition of a GST, the rules limit the aggregate amounts that can be placed in the trust without incurring a tax of about half of the value in the trust. In some trust scenarios, life insurance can augment the amounts permitted under GST rules.

Creating an effective incentive trust involves complex legal, tax, and investment management choices. This article offers only an outline; it is not a definitive guide to all possible consequences and implications of any specific trust option. For this reason, be sure to seek advice from knowledgeable legal and financial professionals.

Investing in Sectors: Risks and Returns

Sector funds target specific industries and economic niches to seek above-average returns.[1] With the opportunity for greater returns comes greater risk, as these funds typically are prone to fluctuate in value more than diversified, multisector funds.[2]

Sector funds may invest solely in specific industries, such as utilities, technology, financial services, health care, and manufacturing. They may also invest in commodities, such as oil and gold. Additionally, there are sector funds that invest in specific international markets, such as Germany and China.

Many investors look to sector funds to gain exposure to industries that may appear to offer exceptional potential. Top-down investors and market timers look first for industries that often perform well in certain economic cycles and then seek to predict which industry will be next in the "rotation." Because of their higher potential volatility, it may be prudent to limit investments in individual sectors to no more than 10% of an overall equity portfolio.

Some investors choose a contrarian strategy, seeking value in sectors that have been passed over by the rest of the market. Another strategy is the tilted index. Passive investors will invest in a market index seeking to avoid the inefficiencies of picking individual stocks. By adding shares of sector funds that outperform the market, you may outperform the index overall.

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Evaluating Sector Funds
Whatever strategy you use in choosing a sector fund, be careful not to chase past returns. A high-flying sector may be at its peak. The table below shows the top three performing sectors from the S&P 500 for the past five years.[3] As you can see, it's rare for one sector to lead the pack year after year.

2008	2009	2010	2011	2012
Consumer Staples	Information Technology	Consumer Discretionary	Telecommunications	Financials
Health Care	Materials	Industrials	Utilities	Consumer Discretionary
Utilities	Consumer Discretionary	Materials	Health Care	Telecommunications

You should also be aware that even if the name of the fund is the same, not all sector funds are alike. Stock/cash allocations, sector segment weights, top holdings, portfolio size, past performance, yield, and portfolio turnover are among the criteria used to compare funds that invest in the same sector.

- **Stock/cash allocations** refer to the percentage of a fund's assets that is actually invested in the chosen sector. In addition to cash, funds may invest in bonds, or even stocks from other sectors. Although these investments may increase performance or decrease risk, you should be aware of the portfolio's composition.
- Many sectors can be divided into subsectors and industries, and **sector weight** refers to the percentage of assets invested in each.
- **Portfolio turnover** measures trading aggressiveness and often exceeds 100% in a single year.
- Although **past performance** is no guarantee of future results, the longer the return period the better. Look at returns over at least a five-year period, if available. Investors should ideally compare how funds performed in a variety of different market climates and be prepared for the volatility inherent in many sector funds.
- **Yield** is just one component of total return, but high yield can mean less reliance on capital gains. This often points to lower volatility.

As with any investment, be sure to get a copy of the fund's annual report and prospectus before investing. You should also consult with your financial professional to help determine the suitability of sector funds in your overall portfolio.

Source/Disclaimer:
[1]Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so you may lose money. Past performance is no guarantee of future results. For more complete information about any mutual fund, including risk, charges, and expenses, please obtain a prospectus. Please read the prospectus carefully before you invest. Call the appropriate mutual fund company for the most recent month-end performance results. Investment return and principal value will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Investing in mutual funds involves risk, including loss of principal.

[2]Diversification does not ensure a profit or protect against a loss.

[3]Source: S&P Capital IQ Financial Communications. Sector performance is represented by the total returns of the sectors within Standard & Poor's Composite Index of 500 Stocks, an unmanaged index that is generally considered representative of the U.S. stock market. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

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Six Retirement Planning Tips for Those Over Age 50

Entering your 50s and behind in your retirement planning goals? Don't fret. You've still got time to get your financial plan back on track.

There are many steps that older investors can take to better prepare themselves financially for retirement. Here are six tips that may help you make the most of your final working years.

1. **Catch up.** If you have access to a 401(k) or other workplace-sponsored plan at work, make the $5,500 catch-up contribution that is available to participants aged 50 and older. Note that you are first required to contribute the annual employee maximum, $17,500 for 2013, before making the catch-up contribution.
2. **Fund an IRA.** Investors aged 50 and older can contribute $6,500 annually (the $5,500 annual contribution plus an additional catch-up contribution of $1,000). An investor in his or her 50s who contributes the maximum amounts to both a 401(k) and an IRA could accelerate retirement savings by more than $25,000 a year.
3. **Consider dividends.** If you do not have access to a workplace-sponsored retirement plan, or you already contribute the maximum to your qualified retirement accounts, consider stocks that offer dividend reinvestment.[1] Reinvesting your dividends can help to grow your account balance over time.
4. **Make little cuts.** Consider how you can trim expenses while continuing to enjoy life. Some suggestions for quick savings: eliminate or reduce premium cable channels that you do not watch, memberships that you do not use regularly, and frequent splurges on dining out or coffee runs. An extra $100 a month saved today could make a big difference down the road.
5. **Review strategies for postponing retirement.** You may be able to learn new skills that could increase your marketability to potential employers. Even a part-time job could reduce your need to deplete retirement assets.
6. **Don't give up.** Many pre-retirees falsely believe that there is nothing they can do to build retirement assets and, as a result, do nothing. Remember that you control how much you invest and, in many areas, how much you spend. Make a plan -- and stick with it.

Source/Disclaimer:
[1]Investing in stocks involves risk, including loss of principal.

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