Second Quarter 2023

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FINANCIAL IDEAS FOR TODAY AND TOMORROW

Footnotes

Never Take on the IRS Alone!

Here are reasons you should seek professional help as soon as you receive a letter from the IRS:

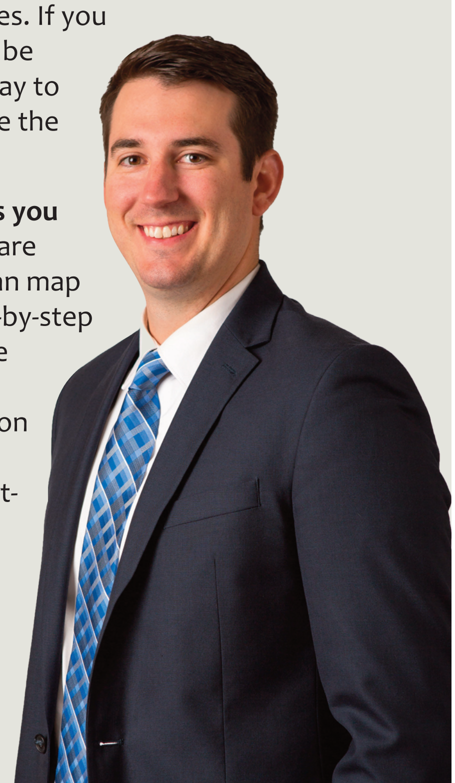
IRS auditors do this for a living - you don't. Seasoned IRS agents have seen your situation many times and know the rules better than you. Just like a defendant needs the help of a lawyer in court, you need someone in your corner that knows your rights and understands the correct tax code to apply in correspondence with the IRS.

Insufficient records will cost you. When selected for an audit, the IRS will typically make a written request for specific documents they want to see. The list may include receipts, bills, legal documents, loan agreements and other records. If you are missing something from the list, things get dicey. It may be possible to reconstruct some of your records, but you might have to rely on a good explanation to avoid additional taxes plus a possible 20% negligence penalty.

Too much information can add audit risk. While most audits are limited in scope, the IRS agent has the authority to increase that scope based on what they find in their original analysis. That means that if they find a document or hear something you say that sounds suspicious, they can extend the audit to additional areas. Being prepared with the proper support and concise, smart answers to their questions is the best approach to limiting further audit risk.

Missing an audit deadline can lead to trouble. When you receive the original audit request, it will include a response deadline (typically 30 days). If you miss the deadline, the IRS will change your tax return using their interpretation of findings, not yours. This typically means assessing new taxes, interest and penalties. If you wish your point of view to be heard — get help right away to prepare a plan and manage the IRS deadlines.

Relying on an expert gives you peace of mind. Tax audits are never fun. Together, we can map out a plan and take it step-by-step to ensure the best possible outcome. You'll rest easy knowing your audit situation is being handled by someone with the proper expertise that also has your best interests in mind.



Eric Hanna, CPA, is the partner in our Waterloo office

FROM THE PEN OF A PARTNER

Answers to 401(k) Questions

Here are a few answers to less-common questions about 401(k) retirement accounts.

QUESTION ONE: What can I do with company stock in my 401(k)?

ANSWER: Companies will often incentivize employees by allowing them to purchase stock in the company through their 401(k). This has the mutual benefit of allowing the employee to have ownership in the company while also allowing any appreciation of the stock to occur tax deferred. Typically, when an employee decides to take proceeds from his or her 401(k), it is taxed at ordinary income rates since the contributions were made to the plan using pre-tax dollars (basically, they haven't been taxed yet).

What is unique about company stock, however, is that employees have an added option to utilize what is known as net unrealized appreciation to potentially liquidate the company stock and receive those proceeds at a lower tax rate. This is achieved by first transferring the shares of company stock to a taxable brokerage account, paying income tax on the cost basis of the stock, then selling the stock and paying capital gains tax on any appreciation rather than regular income tax rates. While the original cost basis of the stock is considered ordinary income, in this situation, any added value the stock has achieved is taxed at long-term capital gains rates.

For example, if an individual transferred $200,000 of company stock from a 401(k) to a brokerage account that originally had a cost basis of $50,000, the individual would have $50,000 of ordinary income once the stock is transferred to the brokerage account. If the employee then sold the stock, he or she would recognize $150,000 of long-term capital gains. If the stock had instead been sold within the 401(k) and the proceeds transferred to an IRA and then distributed as cash, the full $200,000 would be taxable at ordinary income tax rates. Keep in mind that individuals under the age of 59½ will be subject to a 10% early withdrawal penalty on distributions from an IRA.

QUESTION TWO: Should I borrow against my 401(k)?

ANSWER: Most 401(k) providers allow plan participants to take out loans against their 401(k) based on the total market value of the account at any given time. While this can be a valid option for some employees, there are a few considerations to be aware of prior to borrowing funds using a 401(k) as collateral.

First, the interest rates for loans against a 401(k) may vary and should be carefully considered when determining if the employee will be able to make the required payments on the loan. Be sure to look at other types of personal loans to determine if rates may be better.

Second, interest and principal payments on the loan are made with after-tax dollars, defeating much of the purpose of having a tax-deferred account for retirement. Third, and most importantly, repayment rules can be strict. If an employee leaves for any reason (voluntarily or involuntarily), the loan may need to be repaid immediately. Some companies give plan participants up to 60 days to repay their loans and others may allow them to set up loan payments outside of their 401(k).

If the full balance of the loan can't be paid, then any amount due will come out of the 401(k) account, which is then not only considered taxable income to the employee but also subject to a 10% penalty if the employee is under age 59½.

QUESTION THREE: What happens to my 401(k) when I move jobs or when I retire?

ANSWER: When an employee decides to change companies or retires, there are a few different options for their 401(k) plan. First, the employee may elect to keep money in the former employer's plan, but there may be limitations based on the plan's rules as to whether an account balance is large enough, how the funds are invested and whether additional funds may be added.

Second, moving the 401(k) to a new employer's 401(k) may be an option by "rolling it over." Again, this may be subject to limitations or rules of the new plan.

Third, the old 401(k) plan may be moved to an IRA or a Roth IRA via a rollover. IRAs and Roth IRAs have different rules on the taxability of distributions, so talking to an advisor about those ramifications is important.

Finally, there is the option of taking a distribution of the 401(k) balance in cash. While this option has the benefit of providing the employee with liquidity, it has several downsides. Distributions may be considered taxable income and may be subject to a 10% penalty if the employee is less than 59½ years old.

QUESTION FOUR: What are some limitations of a 401(k) I should know about?

ANSWER: While the tax-deferred benefits of a 401(k) plan and any matching employer contributions can be beneficial, there are a few limitations with plans that should be noted. First, the maximum amount that can be contributed to a 401(k) in 2023 is $22,500 and that amount increases to $30,000 for individuals over the age of 50 ($7,500 in catch-up contributions allowed for those age 50 or older).

Second, in the event that an employee leaves work or retires and elects to roll over a 401(k), he or she has 60 days from the date of the distribution to deposit the funds in a new account. If proceeds are not deposited in time, they will be considered taxable income to the employee.

Finally, remember that 401(k) proceeds can only be moved via a rollover once a year, so if an employee leaves a company and wants to roll over his or her funds, he or she can only do so at one time during the calendar year.

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"7 Things You Need to Know if You're Considering a 401(k) Loan," fool.com; "Rolling Over Company Stock," Investopedia; and "Retirement Topics-Contributions," irs.gov.

Calling All Taxpayers: Plan Now or Pay Later

Procrastination is easy, especially when it comes to summertime tax planning. But waiting to implement strategies to reduce your 2023 tax obligations could cost you money. Here are some suggestions to help jump-start your midyear review:

Safeguard your deductions. Ensure you can take deductions by keeping great records throughout the year. You'll need proof if you want tax breaks for things like childcare expenses, charitable contributions, gambling losses, vehicle costs and travel expenses so create a system to keep track of these expenses.

Save more for retirement. You can save more for retirement in 2023 thanks to inflation increasing annual contribution limits. You've even got time to increase the amount you set aside over the remainder of 2023. This year you can deposit up to $22,500 in your 401(k) and $6,500 into your IRA (additional catch-up contributions apply if you're 50 or older). You can also contribute to both a 401(k) and an IRA, though tax deductibility on IRA contributions may be limited depending on your income.

Be tax-savvy about school savings. If you're setting aside money in a taxable account to pay for your child's school expenses, you could realize tax savings by opening a 529 education savings account. The sooner you do this, the sooner your earnings will start growing tax-deferred. Your earnings will also generally be tax-free when withdrawals are used for qualified education expenses.

Adjust your withholdings and estimated payments. If you haven't already, update your withholdings and estimated tax payments to reflect any changes needed since last year. Updates may be in order if you experience a big life event, such as marriage, divorce or a new job. Overpaying your 2023 tax reduces the cash you have on hand throughout the year, and underpaying can lead to penalties and interest.

Please call if you have questions about tax planning for your 2023 tax return.

HOGAN ♦ HANSEN
A Professional Corporation
Certified Public Accountants and Consultants
Accountants with Personality

1601 Golden Aspen Drive, Suite 107
Ames, IA 50010

1201 SW State Street, Suite 101
Ankeny, IA 50023

2750 First Avenue, NE, Suite 150
Cedar Rapids, IA 52402

200 North Adams Avenue
Mason City, IA 50401

3128 Brockway Road
Waterloo, IA 50701

www.hoganhansen.com

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NOTABLE QUOTES

I speak to everyone in the same way, whether he is the garbage man or the president of the university.

- ALBERT EINSTEIN

It ain't the heat, it's the humility.

- YOGI BERRA

Take vacations. Go as many places as you can. You can always make money. You can't always make memories.

- UNKNOWN

A perfect summer day is when the sun is shining, the breeze is blowing, the birds are singing and the lawnmower is broken.

- JAMES DENT

Spread love everywhere you go. Let no one ever come to you without leaving happier.

- MOTHER TERESA

You're off to Great Places! Today is your day! Your mountain is waiting. So...get on your way!

- DR. SEUSS

This newsletter is issued quarterly to provide you with an informative summary of current business, financial and tax planning news and opportunities. Do not apply this general information to your specific situation without additional details and/or professional assistance.

Nick Aarsen
Principal

Jennifer Decker
Principal

Steve Duggan
Principal

Eric Hanna
Principal

Damian Hurmence
Principal

Laura Monaghan
Principal

Dennis Muyskens
Principal

Lisa Wall
Principal

Kristi Wick
Principal

Ames
Ankeny
Cedar Rapids
Mason City
Waterloo