

CPA

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AUGUST 2009

Client Bulletin

BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

For College Costs, Pick Your Tax Breaks

Many colleges start their 2009–2010 academic year in August—and many parents of college students start paying five-figure bills. Fortunately, most families can use tax benefits to pare their after-tax costs.

If you use some of the tax breaks for higher education, you can't use certain others. By knowing the rules, you can get an idea of what your actual costs will be, now or in future years.

American opportunity tax credit

The Hope scholarship tax credit was created by the Taxpayer Relief Act of 1997. Earlier this year, the American Recovery and Reinvestment Act of 2009 (Recovery Act) effectively replaced the Hope tax credit with the American opportunity tax credit, which is available in 2009 and 2010 (see *CPA Client Bulletin*, May 2009). With the new credit, taxpayers who pay at least \$2,000 for tuition, fees, books, and materials for higher education can get a dollar-for-dollar tax credit, saving \$2,000 in tax. Above \$2,000, the tax credit is 25 cents on the dollar. When a taxpayer reaches \$4,000 of expenses, he or she will qualify for the maximum credit of \$2,500.

This tax credit is per student. If you have a college freshman and senior this year, for example, and you spend more than \$4,000 for each of them, you may be able to claim two \$2,500 American opportunity tax credits, for a total tax savings of \$5,000.

In addition, the American opportunity tax credit is refundable, up to 40% of the amount for which you qualify.

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Example: Wayne Wallace spends \$3,000 on his daughter's college tuition and other expenses in 2009. Therefore, he qualifies for an American opportunity tax credit of \$2,250: \$2,000 plus \$250 (25% of \$1,000). However, Wayne's federal income tax liability (the amount that he owes on his 2009 tax return before taking this credit) is only \$1,200 this year. The American opportunity tax credit completely offsets his tax liability, with \$1,050 left over: the \$2,250 tax credit for which he qualifies minus his \$1,200 in tax savings. Wayne will receive a \$900 refund (40% of \$2,250) from the IRS.

The American opportunity tax credit is subject to a phaseout for taxpayers with modified adjusted gross income (MAGI) between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married couples filing jointly).

Lifetime learning credit

You can claim the American opportunity tax credit only for expenses incurred in the first four years of post-high school education. In contrast, you may claim the lifetime learning credit for any year of higher education, including graduate or professional education.

In order to qualify for the American opportunity tax credit, the student must be enrolled at least half time. By comparison, you can take a lifetime learning credit for any course of study that is designed to help you acquire or improve job skills as long as you pay the fees to an accredited school.

The lifetime learning credit is 20 cents on the dollar. Therefore, if you spend at least \$10,000 for tuition and related expenses this year, you can save the maximum—\$2,000 in

Did You Know?

FICO credit scores, developed by Fair Isaac Corporation, range from 300 to 850. 40% of FICO scores are 750 or higher; 42% are under 700. The national median score is 723.

Source: myfico.com

CPASM

America Counts on CPAs

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tax. The lifetime learning credit is not refundable.

While the American opportunity credit is per student, the lifetime learning credit is per taxpayer. Thus, no matter how many people in your family take higher education courses, the most you can save with this credit is \$2,000 in tax on \$10,000 or more in expenses. You cannot use the American opportunity credit and the lifetime learning credit for the same student in the same year, but you can use different credits for different students' educational expenses in the same year.



The phaseout for the lifetime learning credit is stricter than for the American opportunity tax credit: \$50,000–\$60,000 of MAGI for single taxpayers and \$100,000–\$120,000 for married couples filing jointly. Nevertheless, if you or someone you know has lost a job and experienced a drop in income, the lifetime learning credit can help defray the cost of going back to school to improve career prospects.

Tuition and fees deduction

Both the American opportunity and

lifetime learning tax breaks are tax credits. That is, you calculate your federal income tax obligation and then subtract tax credits. A \$1,000 credit, for example, trims your tax bill by \$1,000.

If you're paying college bills, you have yet another option—a deduction for tuition and related fees. Like any deduction, it cuts your taxable income rather than your tax bill. For example, if you take a \$1,000 deduction and are in the 25% federal tax bracket, you will reduce your tax obligation by \$250: 25% of your \$1,000 deduction. Also, you take the tuition and fees deduction "above the line," on page one of your tax return. Therefore, even if you don't itemize deductions, such as mortgage interest and charitable donations, you can take this deduction. Moreover, an above-the-line deduction reduces your adjusted gross income (AGI), which can increase your ability to take other deductions and tax credits.

The tuition and fees tax break is a "cliff" rather than a phaseout deduction. A taxpayer paying college tuition can take a \$4,000 deduction as long as his or her MAGI is no more than \$65,000 (\$130,000 for married couples filing jointly). If your MAGI is even \$1 above those numbers, you fall off a metaphorical cliff to a \$2,000 deduction. What's

more, if your MAGI is even \$1 above \$80,000 (\$160,000 in joint returns), you fall off another cliff and get no tuition deduction.

You can't claim this deduction in the same year you claim the American opportunity or lifetime learning tax credit for the same student. In addition, you can't claim the tuition and fees deduction for expenses paid with earnings from a Section 529 plan or withdrawals from a Coverdell Education Savings Account.

How they compare

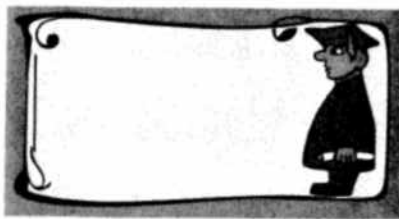
If you qualify for an American opportunity tax credit, with tax savings up to \$2,500 per student per year, that probably will be your best choice. However, if you are paying bills for students who already have four years of higher education, you can only claim a lifetime learning credit or a tuition and fees deduction. Although the credit might provide more tax savings, the deduction is available to families with higher incomes.

Our office can help you sort through your choices. We also can let you know if it makes sense to forgo claiming a student as a dependent in order to let the student take a higher education tax benefit on his or her own tax return.

Dropping Out of a 529 Plan

Section 529 plans are popular tax benefits. Although you contribute after-tax dollars, you don't owe tax on earnings within these plans. You won't owe tax on withdrawals, either, as long as you spend the money on higher education.

Many 529 accounts are invested heavily in stock funds. Because stocks are much lower now than they were in 2007 and early 2008, your 529 account might be showing a loss.



If you have a loss on a 529 account, you may be able to get a tax break. To do so, you must take steps that are

similar to those for taking a loss on a Roth IRA (see *CPA Client Bulletin*, July 2009). You must close the 529 account and withdraw the funds. According to the IRS, you can claim a loss "only when all amounts from that account have been distributed." Although the IRS has not spelled out the meaning of the phrase quoted in the previous sentence, some observers believe that you must liquidate all of the 529

holdings that you have in a particular state's plan for the same beneficiary. If the amount you withdraw is less than your contributions, you have a loss.

Deducting the loss

Example: Teri Thomson has contributed \$20,000 to a 529 account for her daughter Victoria. This account is now worth only \$12,000, and Teri decides to close it. She has an \$8,000 loss.

Teri can claim her \$8,000 loss as a miscellaneous itemized deduction on her federal income tax return for the year. She will add this 529 loss to her investment expenses, unreimbursed employee business expenses, tax preparation fees, and Roth IRA losses. If the total of these miscellaneous deductions exceeds 2% of her adjusted gross income, Teri can deduct the amount over 2%.

However, you won't benefit from the deduction if you owe the alter-

native minimum tax (AMT). Thus, you may not want to close a 529 account if you usually are subject to the AMT.

Also, if you took a state income tax deduction or credit when you invested in a state's 529 plan, you might have to declare income on your state tax return or repay a tax credit after closing the account. Our office can calculate whether the state tax cost will outweigh the federal tax benefit.

If you decide to close a 529 account for tax savings, don't reinvest in any 529 plan within 61 days of the liquidation. The IRS may treat such a move as a rollover from one 529 account to another, leaving you without a loss to deduct.

Prepaying instead of investing

For future 529 contributions, you may decide to avoid stock market risks.

To do so, you can invest in a prepaid tuition plan. With these 529 plans, your account grows in step with the cost of college tuition, relieving you from dependence on investment returns. In recent years, college tuition has been increasing around 6% per year.

Several states offer prepaid tuition 529 plans, but they generally require student beneficiaries to attend college in that state. You also can contribute to the Independent 529 Plan (independent529plan.org), which allows students to choose from among more than 270 private colleges across the U.S. With the Independent 529 Plan, your student must gain admission to one of those colleges, then the student can tap his or her account in the plan for tuition at that school.

Are Target Date Funds Off Target?

Bull market or bear, investors seem to love target date mutual funds. As Mary Schapiro, Chairman of the SEC, noted in a recent speech, assets in these funds have increased from \$66 billion at the end of 2005 to \$152 billion in March 2009. In the first quarter of 2009, although many investors pulled their money from mutual funds, target date funds posted net inflows of about \$10 billion.

Why they're popular

Target date funds have prospered ever since passage of the Pension Protection Act of 2006. That federal law created several Qualified Default Investment Alternatives (QDIAs) for defined contribution plans such as 401(k)s. Target date funds are on the list of QDIAs; thus, employers that sponsor retirement plans can make such a fund the default option. As long as the employer has carefully researched and monitored the fund, the employer won't bear responsibility for poor performance.

Example: Patrick Rogers, who works for ABC, Inc., signs up for the com-

pany's 401(k) plan. Patrick, age 43, declines to choose any of the investment options offered to participants.

ABC's 401(k) plan offers target date funds dated every five years, from 2010 through 2050. Patrick will be 65 in 2031. Therefore, ABC automatically puts Patrick's 401(k) contributions into the 2030 target date fund, the one closest to his 65th birthday. Under federal law, ABC can avoid liability to Patrick or his beneficiary, even if this fund lags other funds.

Backed by such protection, over 75% of all employers offer target date funds in their 401(k) plans, and other employers say they will add such funds. With target date funds so widely available, many employees either choose them or default into them.

How they work

As mentioned, a target date mutual fund has a single year in its name. Someone who expects to retire around 2020 might invest in a 2020 fund, someone who expects to retire around 2030 might

invest in a 2030 fund, and so on. Each of these funds has a "glide path," moving from aggressive to conservative as its target date gets closer. A 2030 fund, for example, might now hold most of its assets in stocks, where long-term returns have been highest. As this fund approaches the year 2030, it probably will shift away from stocks and put more assets into bonds and cash equivalents, increasing current income and reducing the risk of severe losses.

Many target date funds are "funds of funds." A fund family, such as Fidelity or Vanguard, will offer a series of target date funds. Each of those target date funds, in turn, will hold some Fidelity or Vanguard stock funds and some Fidelity or Vanguard bond funds. Over the years, the target date funds will allocate more assets to the underlying bond funds and fewer assets to the underlying stock funds.

Risks raise eyebrows

Thus, target date funds have a straightforward concept. If you invest in one,

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the fund manager will change your asset allocation as the target date nears. As an investor, you'll take more risks while you're young and fewer risks as you near retirement. That manager will thus relieve you of having to handle such investment decisions on your own.

If that's the background, why did the SEC's Schapiro recently express concern about target date funds? Because these funds "have produced some troubling investment results," as she put it.

Last year was terrible for stocks, so it's not surprising that stock-heavy funds maturing in, say, 2030 or 2040 did poorly. However, the supposedly conservative near-term funds plunged too. There are 31 funds with a 2010 target date; last year, their average loss was almost 25%.

Perhaps just as worrying, target date funds vary widely in their makeup. Of those 31 funds with a 2010 target date, some lost less than 4% in 2008 while others lost as much as 41%. Some of those funds had a much larger allocation to stocks (and less to bonds and

cash equivalents) than others in the same category. Generally, larger stock market allocations led to much larger losses.

Off-target perceptions

Many investors were surprised that purportedly conservative near-term target date funds lost heavily in 2008. According to Schapiro, one explanation for this performance is that many target date funds are not meant to become wealth preservation funds at the target date. Rather, the plans' glide paths anticipate that investors will hold onto their funds for a number of years after retirement. Accordingly, fund managers maintain a substantial allocation to stocks, anticipating historic returns. Of course, any fund with a substantial exposure to the stock market suffered last year.

Keeping control

You may have the opportunity to invest in a target date fund in your 401(k) plan; you also can buy such a fund on your own and hold it in your

IRA or a taxable account. In any case, you should investigate carefully before making a decision.



Different target date funds have different philosophies and different asset allocations. If you're considering such a fund, read the marketing materials and other documents such as the fund's prospectus and latest annual report. See if you understand how the fund will invest and whether you're comfortable with that strategy.

Moreover, investing in a target date fund should not be a once-in-a-lifetime decision. Monitor your fund and be prepared to switch if you lose your faith in the manager's judgment.

Tax Calendar

AUGUST 2009

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

August 17

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

SEPTEMBER 2009

September 15

Individuals. If you are not paying your 2009 income tax through withholding (or will not pay enough during the year tax that way), pay the third installment of your 2009 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2008 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2009. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2008 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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