

CPA

JUNE 2009

Client Bulletin

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

IRS Issues Ponzi Procedures

The April 2009 *CPA Client Bulletin* included an article on the tax relief available to victims of investment fraud. Since that issue went to press, the IRS has issued guidance for investors who have lost money in such schemes and has provided a safe harbor for determining the amount of the investor's loss and the year of the loss. Under this safe harbor, such investors can claim a theft loss deduction for the year in which they became aware of the fraud. They can deduct an amount based on their entire investment, including any fictitious income reported, no matter how long ago such income was reported. The following example illustrates the safe harbor announced by the IRS.

Example: Hugh Harris invested \$1 million in 2001 with a spurious promoter. From 2002–2007, Hugh received \$400,000 in "distributions" from this promoter, paying income tax on the reported \$400,000. Hugh withdrew \$100,000 of those distributions and reinvested the other \$300,000. In 2009, Hugh learns that the promoter was running a Ponzi scheme and his investment is worth nothing.

Thus, Hugh's loss is \$1,300,000: his \$1 million initial investment, plus \$400,000 of reported income, minus \$100,000 in cash withdrawn. If Hugh does not intend to pursue claims against third parties, such as a bank or another broker, his deduction might be 95% of his \$1.3 million loss: \$1,235,000. If Hugh does intend to pursue claims against third parties, his deduction might be 75% of his \$1.3 million loss: \$975,000. The IRS has announced that investors can use those

IN THIS ISSUE

**IRS Issues Ponzi
Procedures**
P. 1

**Maximize Tax Breaks for
Charitable Contributions**
PP. 2–3

**Reexamine Your
Estimated Tax**
PP. 3–4

Battling the Bear
P. 4

75% and 95% portions in claiming theft loss deductions resulting from fraudulent investment schemes.

Anticipating recoveries

Hugh's deduction will be reduced by an estimate of any recovery under his insurance policies and from the Securities Investor Protection Corporation (SIPC). In our example, assume that Hugh has no insurance for such a loss. However, Hugh's securities supposedly were held at a brokerage firm that was an SIPC member. Thus, Hugh expects to receive \$500,000 from the SIPC—the maximum coverage per account. Therefore, Hugh reduces his loss deduction by the expected \$500,000 from the SIPC. He can claim a loss of either \$735,000 (\$1,235,000 minus \$500,000) or \$475,000 (\$975,000 minus \$500,000), depending on whether he intends to pursue claims against third parties. This loss will be an ordinary loss, meaning that Hugh will be able to take the deduction against his other income.

Investors who lost large sums may have losses that exceed their annual income. If so, the loss may be carried back five years, in most cases. Thus, investors can receive refunds on taxes they paid in the previous five years. If they still have losses in excess of reported income, taxpayers can carry forward those excess losses for 20 years to shelter future income from tax.

The IRS's guidance is generally favorable to victims of investment fraud. Although the procedure for filing claims may be complicated, our office will be able to help you comply with the prescribed procedures.

Did You Know?

The Consumer Price Index for All Urban Consumers rose 0.1% in 2008. This was the lowest rate of inflation since a 0.7% decline in 1954.

Source: United States Department of Labor

CPASM

America Counts on CPAs

Client Bulletin

Maximize Tax Breaks for Charitable Contributions

Good times or bad, many Americans contribute generously to charity. Charitable donations are tax deductible—but some strategies work better than others. Often, you will gain the greatest tax advantage by donating appreciated securities.

Example #1: Doug Davis decides to donate \$5,000 to his alma mater. He owns shares of ABC Corp., which he bought years ago for \$10 a share. Now those shares trade for \$50. Doug decides to give 100 shares to his alma mater.

Doug gets a \$5,000 tax deduction for this donation. His alma mater is a tax-exempt organization, so it can sell the shares and use the entire \$5,000 of sale proceeds. To Doug, however, those shares were ultimately worth only \$4,400: he would have owed \$600 in capital gains tax (15% of his \$4,000 profit) on a sale. Therefore, this strategy gives Doug a \$5,000 tax benefit for relinquishing a \$4,400 asset.

Lack of appreciation

Unfortunately, many taxpayers don't have appreciated securities to donate now. You shouldn't donate depreciated securities. Instead, you should sell first and donate the cash.

Example #2: Ellie Evans also wants to donate \$5,000 to her alma mater. She owns shares of XYZ Corp., which she bought for \$50 a share. Now those shares trade at \$20 apiece.

Ellie can sell 250 shares to raise \$5,000 for the donation. Not only will she get a \$5,000 tax deduction, Ellie will have a \$7,500 capital loss: \$30 per share on 250 shares. Her capital loss can offset the tax on realized capital gains, now and in the future. If she doesn't have enough capital gains to offset this capital loss, she can use the loss to offset

ordinary income up to \$3,000 per year until the loss is used in full.

Seniors' strategy

If you will be at least 70½ years old this year, you have yet another tactic to consider. That's true for your parents or anyone else of that age, too. In 2009, seniors can make qualified charitable distributions (QCDs) directly from their IRA to charity. IRA owners who authorize QCDs will get no tax deduction but will pick up no taxable income (see *CPA Client Bulletin*, Jan. 2009 for details on IRA charitable transfers).

In most years, seniors with charitable intentions should take advantage of the opportunity to make QCDs. After age 70½, you usually have to take required minimum distributions (RMDs) from your IRA. Any QCDs you make will count towards your RMD, yet won't swell your adjusted gross income (AGI). By holding down your AGI, you may increase your ability to use various tax deductions and credits.

However, 2009 is not like most years. The RMD rules are suspended this year (see *CPA Client Bulletin*, Mar. 2009 for details on RMD relief). If you don't have to take RMD this year for living expenses, you may prefer to let the money stay in your IRA, where any growth will be tax deferred. This year, you can make tax deductible charitable donations from other cash on hand, perhaps after selling depreciated securities.

Rollovers still rock

In a year without RMDs, seniors may be less inclined to make so-called IRA charitable rollovers. Nevertheless, there are some situations in which taxpayers over 70½ will come out ahead by using their IRAs for charitable contributions.

- **Standard deduction.** If you take the standard deduction on your tax return rather than itemizing deductions, you will get no tax benefit from a charitable contribution. If there's no tax deduction, you might as well remove money from your IRA, tax free, when donating to charity. In effect, you'll be making the donation with pretax dollars, which is virtually the same as a tax-deductible donation.



Indeed, many seniors who are eligible to make QCDs won't be itemizing deductions. A married couple who are both over 65 and own a home generally can take a \$14,600 standard deduction in 2009. If this couple owns their home free and clear and lives in a state with little or no income tax, the standard deduction may beat itemizing. Such a couple might find that making, for example, \$5,000 or \$10,000 worth of QCDs from their IRAs this year puts them in a better tax position than making nondeductible donations from other sources.

Seniors who use their IRAs for donations can retain appreciated assets or assets that may appreciate in their taxable accounts. They can pass such assets to heirs with a basis step-up so there will be no tax on the appreciation during the decedent's lifetime.

- **Low tax brackets.** Even seniors who itemize deductions may prefer to make QCDs if they are in a low tax bracket this year.

Example #3: Fred Franklin is 80 years old and in a 15% tax bracket. He won't save very much in tax by taking an itemized deduction for a charitable contribution. If he uses his IRA for charitable contributions this year, he'll reduce the amount of the IRA that will be inherited by his children, who are in higher tax brackets.

- **High tax brackets.** The rules on IRA charitable rollovers provide that QCDs come from pretax before

after-tax dollars. Pretax dollars in IRAs come from nondeductible contributions. When taxpayers have made nondeductible contributions, they'll usually owe partial income tax on subsequent withdrawals.

Some high income taxpayers have made nondeductible contributions to traditional IRAs because their incomes have prevented them from making deductible contributions to traditional IRAs or any contributions to Roth IRAs. Those taxpayers may choose to make QCDs this year.

Example #4: Gina Graham, age 72, has a \$40,000 traditional IRA, includ-

ing \$25,000 in nondeductible contributions. If Gina directs her IRA custodian to transfer \$15,000 from the IRA to charity, that will be \$15,000 of pretax money (deductible contributions and untaxed investment earnings), so she'll be left with a \$25,000 IRA holding only after-tax money. Then Gina can convert her IRA to a Roth IRA, tax free. Even if Gina's income is over \$100,000 this year, preventing a Roth IRA conversion, she can execute a conversion in 2010, when there will be no income limit. After converting her traditional IRA to a Roth IRA, Gina will have a virtually tax-free retirement account.

Reexamine Your Estimated Tax

Most Americans pay their income tax through paycheck withholding. However, that's not the case for self-employed individuals and others who don't get regular paychecks, including people who receive substantial amounts of investment income. In general, if you'll owe \$1,000 or more in tax in any calendar year, over and above your payroll withholding, you must make estimated tax payments. If you're required to pay estimated tax, you must make payments by the 15th of April, June, September, and January.

If you don't estimate your income tax accurately and consequently underpay your tax, you'll owe a penalty. Fortunately, the IRS provides several safe harbors for avoiding this penalty.

How to stay safe

1. You won't owe the IRS a penalty if the total amount of tax you pay (via withholding and estimated payments) is at least 90% of the tax you ultimately owe.

Example: Bob Brown is a self-employed sole proprietor who does not receive regular paychecks. His federal income tax obligation for 2009 is \$20,000. As long as Bob's quarterly estimated tax payments add up to \$18,000 or more, he won't

owe a penalty.

2. However, it may be difficult to know in April, June, or even September 2009 how much tax you'll ultimately owe for the year. A second safe harbor allows you to set your quarterly estimated tax payments at 100% of your tax obligation for the prior year.



Example: Carly Clark owed a total of \$24,000 to the IRS for 2008. For 2009, Carly sends the IRS \$6,000 with each quarterly estimated tax payment.

3. If your adjusted gross income (AGI) for one year was over \$150,000, you'll usually have to pay 110% of that year's tax to sail into a safe harbor for the next year.

Example: David Dare's AGI in 2008 was over \$600,000, and he paid \$250,000 to the IRS. For David to be sure of avoiding a penalty, he can set his 2009 tax payments to the IRS at \$275,000: 110% of \$250,000.

Cutting back

In today's turbulent economy, your income may drop. If so, you might want to cut your estimated tax payments. If you expect your income to drop this year, you may be able to reduce your estimated tax payments, increase your cash flow, and avoid a penalty.

Example: Eileen Epps owed the IRS \$24,000 in 2008; therefore, she could choose to make \$6,000 quarterly estimated tax payments. However, if her income falls in 2009, she might ultimately owe only \$20,000. If so, Eileen will have overpaid her tax and lessened her cash flow throughout the year. If she had accurately projected her 2009 income and resulting tax bill, she could have sent the IRS only \$18,000 in estimated tax and avoided a penalty.

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provides further relief. Some taxpayers will be able to avoid a penalty for 2009 as long as their tax payments are at least 90% of their 2008 tax obligation, rather than 100% or 110% of their 2008 tax obligation. To qualify, your 2008 AGI must have been less than \$500,000. You also must certify that more than half of your 2008 income came from a small business; typically,

continued on page 4

continued from page 3 — **Reexamine Your Estimated Tax**

that's a business with fewer than 500 employees.

The Recovery Act also includes a making work pay tax credit up to \$400, or \$800 for married couples (see *CPA*

Client Bulletin, May 2009 for details). If you expect to get this credit and you don't receive regular paychecks, you can reduce your estimated tax by the amount of the anticipated tax credit. Our

office can help you go over your projected income for 2009 and determine what you should pay in estimated tax.

Battling the Bear

Stock market investors have suffered through a difficult decade. After a spectacular bull market in the late 1990s, investors have encountered two of the worst bear markets on record, in 2000–2002 and from late 2007 to the present. For the 10 years ending in the first quarter of 2009, the average domestic stock fund had an annualized loss of 0.40%, according to Morningstar.

Investors who ventured overseas did somewhat better, with annualized returns just over 2% during that period. Thus, investors willing to take the risks of unfamiliar markets and currency fluctuations enjoyed better returns than investors who focused solely on domestic equities. Digging deeper, you can see further evidence that some risk takers were rewarded. Some foreign stock funds mainly hold the shares of large

companies such as Roche and Nestle. Those funds generally had scant gains or modest losses in the last 10 years. By comparison, funds investing in small and medium-sized foreign companies had annualized gains over 4%.

Going for growth

Some mutual funds invest in securities from emerging markets. You might believe that investments in China, India, Russia, Brazil, etc. are riskier than investments in the developed nations of Western Europe and Japan. Nevertheless, diversified emerging markets stock funds returned almost 8% per year in this tumultuous decade, while funds investing in emerging markets bonds returned nearly 10% per year.

No one knows what the next decade will bring. However, the following basic

principles may be useful as you assess your investment strategy:

Diversification can help. If you include some international securities in your portfolio, you'll reduce your exposure to the fortunes of one country: the U.S. A small allocation to emerging markets funds will give you access to some of the fastest-growing economies in the world.

Risks can be rewarding. Asset diversity, like geographic diversity, may improve your returns. Bank accounts and high-quality bonds offer safety and stability. If you want to enjoy greater returns, your portfolio may benefit from some small company stocks and perhaps some securities from unfamiliar places.

Tax Calendar

JUNE 2009

June 15

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

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2008. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2009.

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

JULY 2009

July 15

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

July 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2009. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than \$500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2008.

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.

The *CPA Client Bulletin* (ISSN 1942-7271) is prepared by AICPA staff for the clients of its members and other practitioners. The *Bulletin* carries no official authority, and its contents should not be acted upon without professional advice. Copyright © 2009 by the American Institute of Certified Public Accountants, Inc., New York, NY 10036-8775. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service call (888) 777-7077 or visit www.cpa2biz.com.

Tax Time, Always

April 15 is gone, but planning should continue

MICHELLE SINGLETARY

SYNDICATED COLUMNIST



It's over. The red-flag April 15 tax-filing deadline has passed. But the truth is that throughout the year, you have to make decisions that affect your tax situation.

So it's not over. It's already time to start considering what moves this year will have an impact on your tax return next year.

If you are thinking about making a purchase, it's smart to see if there are tax breaks associated with the buy. For example, here's a question I received during a recent online chat: "I'm considering installing a new furnace and heat pump to take advantage of the 2009 tax incentive. What are the tax implications?"

Before I answer that question, I need to first point out that you should never make a financial decision based solely on the tax implications. Certainly, how the move will affect your tax liability should be considered. But it shouldn't drive your decision.

As for installing qualified energy efficiency products in your principal residence, the American Recovery and Reinvestment Act of 2009 extended the tax credits available for such purchases. The credits for energy-efficient appliances and products were increased from 10 percent of cost to 30 percent, with a new maximum credit of \$1,500. The credits are available for products installed Jan. 1, 2009, through Dec. 31, 2010.

So if you were planning to upgrade your furnace and heat pump, you might as well take advantage of the tax break, which isn't slated to last for too long. I should add that a credit is much more valuable than a deduction. A tax credit reduces dollar-for-dollar the taxes you owe. A deduction only eliminates a percentage of the tax that is owed.

Here's another online question: "I am considering rolling my student loan into my mortgage refinance to take advantage of the lower interest rate. I plan on continuing to pay my student loan at the same rate (not stretching it out over 30 years). Are there any tax implications for this? I assume not, since both are tax deductible. And are there any other considerations?"

Let's look at the difference in the interest deduction for a mortgage versus a student loan.

Generally, the personal interest you pay is not deductible on your tax return. However, there is an exception for interest on student loans. For 2009, the student loan interest deduction up to \$2,500 is eliminat-

ed if your modified adjusted gross income is \$150,000 or more (if filing a joint return). For all other filing statuses you can't take the deduction if your modified AGI is \$75,000 or more.

That \$2,500 deduction is a nice break. But the deduction for mortgage interest is probably the most coveted tax deduction available. Still, there are some limitations you need to keep in mind. You can only deduct the interest on the first \$1 million (\$500,000 if married filing separately) in home loans on a first and second home.

If you refinance, only the interest on the amount you borrow to pay off the old mortgage is deductible. The IRS classifies this as home acquisition debt. Any debt not used to buy, build or substantially improve a qualified home is not considered home acquisition debt. This debt qualifies as home equity debt. The interest deduction on home equity debt is limited to \$100,000 (\$50,000 if married filing separately).

So it would appear that refinancing and paying off student loan debt are the better tax moves because of the larger deduction. But is it the best financial move?

Typically, student loans come with a hardship provision. Should you have difficulty paying your student loan because of a job loss or illness, you may qualify for a deferment or forbearance for up to three years. You won't get that kind of break with your mortgage.

A deferment is a temporary suspension of loan payments for specific situations such as re-enrollment in school, unemployment or economic hardship. You don't have to pay interest on the loan during deferment if you have a subsidized federal student loan or a federal Perkins Loan. With forbearance, your payments can be temporarily postponed or reduced. Unlike deferment, whether your loans are subsidized or unsubsidized, interest accrues. Various hardship payment options are also available for private student loans.

Too often I find people pile debt onto their mortgage because the interest is deductible. But long term, this may not be wisest financial decision. If the recession has taught us anything, it's that your mortgage should not be used as a dumping ground for other consumer debt.

Sure, you may plan on making extra payments, but what if you can't because your financial situation changes. Then you've placed your home in jeopardy.

Tell youngsters that it's OK to make mistakes, as long as they learn from them and are accountable. If your daughter chips away at her savings and can't afford the outfit she's been planning to buy or your son spends most of his allowance on junk food in one day and doesn't have enough to last the entire week, don't bail them out.

Instead, explain how they can rebuild their savings and stay on budget. Rather than making youngsters feel guilty about their mistakes, encourage them to do better next time. By choosing your words carefully, rather than scolding, you can help your children feel comfortable coming to you about their money issues in the future.



HE CONTINUED ACCOUNTING RIGHT THROUGH HIS COFFEE BREAK... THEN HIS LUNCH BREAK. CLEARLY, MYRON WAS "IN THE ZONE."