

CPA CLIENT TAXLETTER



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For Now, a Zero Percent Tax Rate

A tax law passed in 2003 established a 15% tax rate for most long-term capital gains and for qualified dividend income. For lower income taxpayers, the rate was set at 5%. As of January 2008, that rate will be lower still. While higher income taxpayers will continue to pay 15%, lower income taxpayers will owe 0%. That is, they will include qualified dividends and long-term gains as income, but pay a 0% rate on that taxable income, instead of 5%. Current law calls for this 0% rate to remain in effect through 2010.

Setting the ceiling

The 0% rate applies to taxpayers who are in the 10% or 15% tax brackets for ordinary income. Those brackets include single filers with taxable income up to \$32,550 in 2008. For married couples filing a joint return, the 0% tax rate will be in effect up to \$65,100 in 2008. Those numbers are for *taxable* income, not gross income. A married couple might have \$70,000 or \$80,000 in gross income and still have less than \$65,100 in taxable income. In that case, they would owe no tax on qualified dividends and long-term gains.

Moreover, tax-exempt income from municipal bonds and municipal funds (funds that hold municipal bonds) does not count towards taxable income. Thus, the couple described above could have substantial holdings of municipal bonds and still get the 0% rate on qualified dividends and long-term gains.

Blended rates

The 0% rate is not all or nothing. As long as your taxable income (excluding long-term

capital gains) is below the thresholds mentioned above, your long-term gains may be taxed partially at 0% and partially at 15%.

To see how this might work, suppose a hypothetical John and Mary Smith own no dividend-paying stocks or mutual funds. They take no long-term capital gains in 2008, through November. In December 2008, the Smiths consult with their CPA, who estimates their taxable income for the year will be \$45,000 if they do nothing else. After the meeting, the Smiths sell assets and realize \$60,000 in long-term gains by the end of the year. Of that \$60,000 gain, \$20,100 will be taxed at 0%. That's the spread between their \$45,000 in taxable income, not including the gain, and the \$65,100 ceiling for the 0% rate. The other \$39,900 of long-term gains (\$60,000 minus \$20,100) will be taxed at 15%.

Planning points

If those are the ground rules, how can you make the most of the 0% tax rate?

- **Hold dividend-paying stocks and stock funds.** Such holdings may work well for retired couples with modest taxable income. The dividend income will be tax free as long as taxable income is under the limit. At many dividend-paying companies, payouts increase periodically, which will help investors keep up with inflation. Higher dividends may also help share prices rise.
- **Take long-term gains, if that's desirable.** As long as your other taxable income is under the \$32,550 and \$65,100 ceilings, you can take capital gains and owe no tax this year. You



America Counts on CPAs

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must be careful not to sell just for tax purposes—you may be relinquishing further gains if you sell too soon. Nevertheless, if you are thinking of taking some portfolio profits, this is a good opportunity.

- **Implement income-shifting strategies.** Suppose you are helping to support an elderly parent. You could give your parent appreciated stocks or fund shares to sell. Your parent would retain your basis in the shares and your holding period but might owe no tax on a sale. A similar outcome could result if you are helping

a grown son or daughter to buy a home, if the recipient is just beginning a career and has low earnings.

For any income-shifting strategy of this nature, keep gift taxes in mind. If you give over \$12,000 in assets to a recipient this year, you must file a gift tax return. If you already have used up your \$1 million gift tax exemption, you will have to pay gift tax.

- **Keep the “Kiddie Tax” in mind.** Complicated new rules take effect in 2008. Generally, full-time students under the age of 24 can have only

\$1,800 in low-taxed income this year, with excess amounts taxed at the parents’ rate. Therefore, you might want to give students enough appreciated securities so they can sell them and have the full \$1,800 worth of investment income this year, taxed at bargain rates.

Beyond \$1,800, there is no immediate tax payoff to be gained from giving appreciated securities to “kiddies.” You might, though, give appreciated assets to your 23-year-old graduate student this year, planning for a 0% sale in 2009, at age 24.

Tax Breaks for Long-Term Care Insurance

In some respects, the facts of life are encouraging. The number of Americans over age 80 is expected to quadruple in the next 15 years, according to Alfred Clapp Jr., president of Financial Strategies & Services Corporation in New York City. Unfortunately, perhaps 40% of the men in that age group and 50% of the women will need custodial care, at home or in an institution. Moreover, little growth is expected in the number of caregivers.

As a result, the cost of care is likely to keep rising, as it has in the past. In the next 30 years, 3 years of private care may cost as much as \$1 million in some high-cost areas of the U.S. “That could be the price of a nursing home stay or two shifts of full-time home care,” says Clapp.

Relying on insurance

In light of these facts, many people will want to prepare in order to avoid such a financial catastrophe. One answer is to buy long-term care (LTC) insurance.

These policies may not be perfect, but they can help pay the bills—if you look carefully for the most effective policies. There may be huge

differences from one policy to another. “Some are very limiting,” says Clapp, “while others offer more flexibility.”

Tax breaks trim the cost

Although policies can be expensive, federal law offers tax benefits that may reduce the effective cost of LTC insurance. Some states provide tax benefits too. On the federal level, the 1996 Federal Health Insurance Portability and Accountability Act (HIPAA) defined “tax-qualified” LTC policies. Such policies may generate tax-free benefits and tax-deductible premiums.

To qualify for tax-free benefits, the insured individual must be certified by a licensed health care professional to be either:

- unable to perform without substantial assistance at least two of six activities of daily living: bathing, dressing, transferring from a bed, toileting, feeding, and continence; or
- seriously cognitively impaired, perhaps from Alzheimer’s disease or a stroke.

“According to HIPAA,” says Clapp, “for a tax-qualified policy to generate

tax-favored benefits, a condition must be diagnosed as requiring care for over 90 days.” Recovery from a hip replacement, for example, is not likely to qualify for tax-free benefits. Regardless of whether any benefits are received, some or all of an LTC policy’s premiums may be federally tax deductible. That deduction depends on the insured person’s age group, the total of other deductible medical expenses, and adjusted gross income (AGI) for the year. Maximum deductions for various age groups increase from year to year.

Here are the 2008 amounts:

Age at Year End	Maximum Deduction
40 or younger	\$310
41–50	\$580
51–60	\$1,150
61–70	\$3,080
71 or older	\$3,850

Individuals can include LTC insurance premiums—up to the maximum for their age bracket—when calculating

total medical expenses. If those total medical expenses exceed 7.5% of their AGI, they may be able to deduct all or some of their premiums. (For individuals who owe the alternative minimum tax, the threshold is 10% of AGI.)

“Self-employed individuals, LLC members, partners, and 2% shareholders of S corporations may be



taxed on the amount of premiums paid on their behalf,” says Clapp, “but they can take deductions as indicated previously.” C corporations can pay and deduct the full amount of LTC insurance paid.

No matter what your personal situation, our office can help you find the most tax-effective way to fund LTC insurance.

The Payoff From Tax-Loss Harvesting

Considering how volatile the market has been recently, you may own stocks or stock funds trading at a loss. If so, realizing those losses can provide valuable tax advantages.

Realized capital losses can offset capital gains realized during the year. Net capital losses can be deducted, up to \$3,000 per year, against ordinary income. In addition, any net losses you can't deduct can be carried forward indefinitely to offset capital gains and provide more deductions in future years.

Watch out for wash sales

You must follow certain rules to get the tax advantages of a realized capital loss. For starters, losses you take in a tax-deferred or tax-free account won't generate any tax benefit. You can get tax benefits if you take a loss in a taxable account. However, you can't count the loss if you enter into a “wash sale.” A wash sale occurs if you buy the same security you've sold within 30 days of that sale. You count

the 30 days before and the 30 days after the sale that generates a loss.

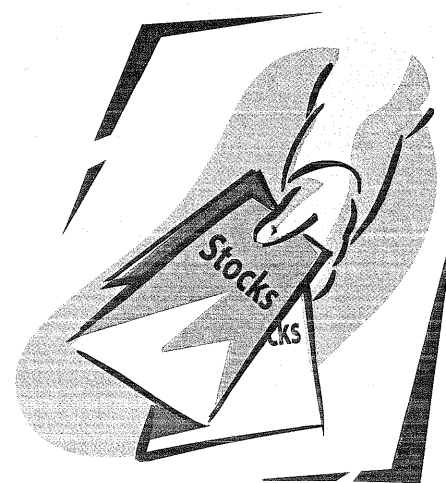
Doubling up

One way to avoid a wash sale is to buy the same security at least 31 days before you sell it.

Suppose, for example, you own 100 shares of a mortgage real estate investment trust (REIT) that has tumbled in price as a result of concerns over subprime loans. You think the market has overreacted and you expect the price to rebound sharply, perhaps in the next few weeks. You could buy another 100 shares of the same mortgage REIT. Thirty-one (or more) days later, you can sell the 100 shares you originally owned. If the original 100 shares are still trading at a loss, you will have a valid capital loss. You'll also own 100 shares of that mortgage REIT from your double-up purchase, and you will not have been on the sidelines.

Other tactics

There are other tactics you can use to avoid a wash sale. One approach is to



simply take a loss and park the money in cash for more than 30 days. Then you can buy any security you'd like.

Another method is to immediately buy a similar, but not identical, investment. You might sell one mortgage REIT and buy a different mortgage REIT. That won't be a wash sale, and you'll be in position to benefit from any resurgence in that market sector.

Use the Annual Gift Tax Exclusion

If you think your estate will be large enough to be subject to federal estate tax, a simple bit of planning can pay off for your heirs. Be sure to fully use the annual gift tax exclusion each year. The earlier in the year you make such gifts, the sooner the growth of those assets will be removed from your taxable estate.

Gift tax ground rules

Generally, gifts you make will be charged

against your lifetime gift tax exemption, which is now \$1 million. The way the federal estate tax is calculated, those gifts will effectively reduce your estate tax exemption. Moreover, lifetime gifts over \$1 million will be taxed at rates that now go as high as 45%.

Exceptions to the rules

Some gifts, including transfers between spouses and charitable donations,

escape gift and estate tax consequences. You also can pay others' medical and education bills. As long as the payments go directly to the health care provider or the school, there won't be a gift tax.

Embracing the exclusion

In addition, you are allowed to give up to \$12,000 worth of assets to any number of recipients in 2008. No gift tax

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return need be filed, no gift tax need be paid, and there will be no reduction in your estate tax shelter. This annual gift tax exclusion goes up periodically to keep pace with inflation. It will rise to \$13,000, \$14,000, and so on.

A hypothetical John Smith could give \$12,000 to each of his 3 children this year with no tax consequences. Between John and his wife Jane, they could transfer \$72,000 to their kids this year. If they do this every year, they could remove hundreds of thousands of dollars from their taxable estates. All future growth of the assets given away also would escape tax at their deaths. Even more tax shelter is possible if you want to make such gifts to sons- and daughters-in-law, grandchildren, and other beneficiaries.

Carryover basis

It's easy enough to say, "Give \$12,000 worth of assets to your children." However, you'll have to decide which assets to give them. If you give your children appreciated assets, you also give away your basis in those assets. Therefore, they'll owe tax on a sale.

Suppose, for example, you bought \$5,000 worth of mutual fund shares a

few years ago, and those shares are now worth \$12,000. You give them to your son. If your son sells those shares right away for \$12,000, he'll owe tax on a \$7,000 long-term gain.

Winning the giveaway game

Considering the tax treatment, which assets should you consider for gifts to use the annual exclusion?

- **Cash.** This is probably your best choice. Such gifts are simple to make and generate no tax issues for the recipient.
- **Appreciated securities.** Generally, it's better to give away assets that have appreciated only modestly so that the recipient will have a small tax obligation on a sale.

If you are making gifts to a minor or to a student no older than 23, it may make sense to give away assets with some appreciation. In 2008, such recipients may owe no tax on up to \$1,800 of investment income. Thus, they could sell assets with small built-in gains and owe little or no tax.

The situation is different if you're making gifts to a 25-year-old graduate student with scant income. Such a recipient may owe no tax on around \$30,000 of long-term capital gains in

each of those years, so gifts of highly-appreciated securities might be advisable. Our office can help you make the most of the complicated new "Kiddie Tax" rules.

For the most part, giving away highly appreciated assets is not a tax-efficient tactic. If possible, try to hold onto such assets and bequeath them to your heirs, who will inherit with a basis step-up that can eliminate a capital gain obligation.

- **Depreciated assets.** For assets selling below their cost basis, you're better off selling them yourself to realize a tax loss. Then you can give away the cash you receive from the sale.

Gift Tax Rule—2008

Cumulative Lifetime Gifts in Excess of Annual Exclusion Amount*	Tax Rate
Up to \$1,000,000	N/A
\$1,000,000–\$1,250,000	41%
\$1,250,000–\$1,500,000	43%
\$1,500,000+	45%

* Not including spousal and charitable gifts
Sources: IRS, savewealth.com

Smart Handling of Intra-Family Loans

Even though the housing market has cooled off, home prices are still high in many areas of the country. To help your son or daughter buy a starter home, you might want to make a loan. If you do, be careful. You may face surprising and painful tax consequences if you charge no interest or a below-market rate.

Imputed interest

Say your son wants to buy a home. You loan him \$300,000, payable in 9 years, and you don't charge him any interest.

The IRS will impute interest on such loans at an applicable federal rate (AFR). AFRs are published every month at www.irs.gov. Currently, the AFR on loans from 3 to 9 years is about 4.4% (see table below). In the example above, therefore, the imputed interest would be around \$13,200 (4.4% of \$300,000).

Tax treatment

In this scenario you would have to recognize \$13,200 in interest income each year. You would owe income tax on

that \$13,200 even though you didn't collect it. Moreover, the IRS would say that you had made your son a \$13,200 gift for each year of the loan. You would have to file a gift tax return. (You wouldn't have to pay gift tax unless you had used up your \$1 million lifetime gift tax exclusion, but your estate tax exemption would be reduced.)

At the same time, your son might be able to take a \$13,200 deduction for the imputed interest on a loan secured by his residence.

Below-market loans

What if the loan called for a 2% interest rate, which your son paid? This rate would be 2.4% below the 4.4% AFR. In that case, the tax consequences described above would apply to the 2% actually paid—as well as 2.4% of imputed interest.

The \$10,000 exception

There are ways to avoid imputed interest. If the money you loan to a relative doesn't exceed \$10,000, the IRS will not impute any interest. To qualify for this exception, such loans can't be used for income-producing investments. Thus, you might make a small loan to help a child make a down payment.

The \$100,000 exception

Loans up to \$100,000 also won't generate imputed interest if the borrower's net investment income is no more than \$1,000 in a given year.

Suppose you lend your daughter \$100,000 to help her buy a house. If her investment income this year is \$500, the IRS will not impute any income for the interest. If her net investment income next year is \$1,100, some or all of the interest will be imputed income. The amount of imputed income to you the lender would be her net investment income or the amount derived from the AFR rate, whichever is lower. Say the AFR rate is 4.4%, which would be \$4,400 on a \$100,000 loan. Your daughter's \$1,100 in net investment income would be lower than \$4,400, so that year's imputed interest would be \$1,100.

Keep in mind that the \$10,000 and \$100,000 exceptions apply only to income tax. Such interest-free loans or below-market loans still will have gift tax consequences.

Charge at least the AFR

In order to avoid income and gift tax problems, for all types of intra-family loans the best tax strategy is to charge a rate that's at least as high as the AFR. All parties should sign a written agreement spelling out the terms of the loan, and then follow its terms. If there is no formal loan agreement and the borrower

pays no interest, the IRS may re-cast the transaction as a gift rather than a loan. Then the entire amount could be treated as a gift, triggering a gift tax.

November 2007* AFRs, Interest Compounded Annually	
Loan Term	Applicable Federal Rate
Less Than Three Years	4.11%
Three To Nine Years	4.39%
Longer Than Nine Years	4.89%

Source: www.irs.gov
*Most recent available.

Safe-Harbor 401(k) Plans

The benefits of 401(k) plans are widely known: These plans allow workers to defer some current income and the tax on that income. Earnings on the untaxed income also escape current tax. The deferred tax is due when money is withdrawn from the plan.

Build a safe harbor

The maximum 401(k) contribution in 2008 is \$15,500, or \$20,500 for workers at least 50 years old. However, if a company's lower-paid workers don't defer enough income, highly compensated employees might not be able to reach those limits. 401(k) plans are subject to two tests. The first applies to pretax contributions and the second applies to after-tax and employer-matching contributions. These tests are intended to prevent discrimination in favor of highly compensated employees.

In some cases, higher income workers might be shut out altogether from a 401(k) contribution. If this issue might be a concern at your company, consider a safe-harbor 401(k) plan. With such a plan, highly compensated employees can maximize their contributions, even if non-discrimination tests can't be met. To shelter in a safe harbor, employers must make certain minimum contributions.

There are two ways to proceed:

The 4% solution. One tactic is for a company to match each worker's contribution at 100% for the first 3% contributed and 50% for the next 2%. Assuming a worker contributes at least 5% of his compensation, the company's matching amount equals 4% of the worker's compensation. Say a worker who earns \$40,000 per year contributes \$2,000 to her 401(k) account. The company must match at least \$1,600 (4% of \$40,000).

If the company meets that condition, all of its highly-paid employees can maximize their 401(k) contributions. In addition, the company can match up to \$9,200 per year for each of its highly-paid employees. The \$9,200 maximum match is 4% of \$230,000, which is the most compensation that can be considered in 2008 when figuring a retirement plan contribution.

The 3% solution. The other tactic is for the company to contribute 3% of pay for each eligible worker, regardless of whether he or she makes a 401(k) contribution. Suppose another employee also earns \$40,000 per year but doesn't put anything into his 401(k) account. The company could contribute \$1,200 (3% of compensation) to a 401(k) account for him. The employer's contribution would be the same if the worker earning \$40,000 made a \$1,000 contribution, a \$500 contribution, or no contribution at all.

Again, highly compensated employees could maximize their 401(k) contributions. In addition, the company contribution could be as much as \$6,900 apiece—3% of \$230,000—for those earning that much or more.

Additional requirements

Companies must use one of the two contribution methods described above to qualify their plan as a safe-harbor 401(k). Other requirements may also apply.

All contributions must be 100% vested immediately. That includes employee contributions, employer matches, and any investment earnings. Thus, employees can take all the money in their accounts

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Safe-Harbor 401(k) Plans

whenever they leave the company. In addition, eligible employees must receive a written notice each year. These notices, circulated at least 30 days before the start of the plan year, must spell out employee rights and employer obligations.

Retirement Plans—2008 Update

Business owners, professionals, and self-employed individuals can choose among several tax-sheltered retirement plans. In most of these plans, contributions are tax deductible, investment income is untaxed, and withdrawals are taxable. Besides income tax, withdrawals usually are subject to a 10% penalty tax before age 59½. The penalty period ends at age 55, for those leaving a company.

Here are the most common retirement plans:

Traditional 401(k)s

Participants can make contributions of as much as 100% of their income, up to \$15,500 in 2008, the same as in 2007. Those who are 50 or older can contribute up to \$20,500. Many employers match some employee contributions.

Roth 401(k)s

A company that offers a traditional 401(k) can offer a Roth 401(k) as well. The contribution limits are the same,

but there is no tax deduction. Participants can choose either version or split their contributions between the two. Overall, the \$15,500 or \$20,500 limits apply.

Why choose a non-deductible Roth 401(k)? Because all withdrawals are tax free after five years and after you reach age 59½. The younger you are and the lower your current tax rate, the more appealing a Roth 401(k) choice will be.

Profit-sharing plans

Here, employers make contributions to employees' accounts. The contribution, which can vary from year to year, may be up to 25% of each participant's compensation. In 2008, the contribution limit for any participant is \$46,000.

Profit-sharing/401(k) plans

This combination includes salary deferrals by employees and contributions by employers. The total in 2008 can be as high as \$46,000 for a participant, or \$51,000 for employees who are at least 50 years old.

Solo 401(k)s

These plans permit self-employed individuals to duplicate a profit sharing/401(k) plan, with contributions up to \$46,000 or \$51,000 this year. Spouses who are on the payroll also can participate.

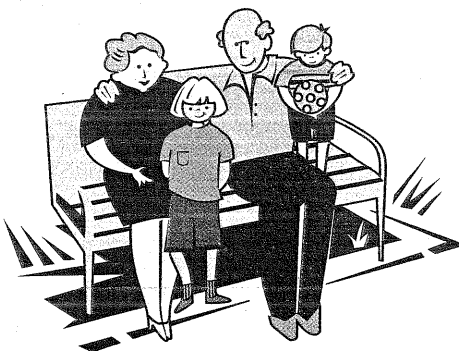
SIMPLE plans

Employees can defer some or all of their earned income, and employers must make a match. As the name suggests, paperwork is minimal. Limits are lower, though. Employees can contribute up to \$10,500 in 2008, while those who are 50 or older can make a catch-up contribution of up to \$2,500 and contribute up to \$13,000.

The maximum contribution in 2008 is \$23,500. That is a \$10,500 regular contribution, a \$2,500 catch-up contribution, and a \$10,500 employer match. Because the employer match is limited to 3% of compensation per year, only participants earning \$350,000 or more may get the maximum match.

Simplified employee pension (SEP) plans

These plans are even simpler than SIMPLE plans. They can be used by either self-employed individuals or employers. Either way, the maximum contribution this year is \$46,000. What's more, you have until October 15, 2008 to make a tax-deductible contribution for 2007, when the upper limit was \$45,000.



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