

CPA CLIENT

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TAXLETTER

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How to Tell If Munis Are Right for You

Some investors will receive higher after-tax yields from tax-exempt municipal (muni) bonds than from taxable bonds. To find out what's best for you, you must crunch some numbers.

Try an online calculator

One option is to use one of several online calculators to help you determine your personalized tax-exempt yield.

Example 1: Ashley Burns enters her federal tax rate of 33% into an online calculator. She also enters her North Carolina state tax rate of 7.75%. Ashley enters 4% as the current tax-exempt yield from a hypothetical muni bond fund. The calculator shows her "tax-equivalent" yield to be 6.49%. That is, if Ashley earns 6.49% on a taxable bond and pays federal as well as state income tax on her interest income, she'll net the same 4% interest she can get from the muni bond fund she is considering.

Real world math

A second option is to compare the after-tax yield you'd receive on a taxable bond with the yield of a tax-exempt bond using real world numbers.

Example 2: Suppose Ashley can earn 5% interest from a hypothetical mutual fund that invests in Treasury bonds or 4% interest from a hypothetical fund that invests in high quality tax-exempt muni bonds. Because both funds hold intermediate term bonds, their exposure to interest rate risk is similar.

If Ashley receives 5% interest from this Treasury bond fund and pays 33% of it to the IRS, she will net 3.35%. She will owe

no tax to North Carolina because Treasury bond interest is exempt from state and local income tax. Thus, Ashley will earn more, after tax, from this muni bond fund than from this Treasury bond fund.

Example 3: Ashley's son Eric is in a 15% federal tax bracket. If Eric invests in the Treasury bond fund yielding 5% and pays 15% to the IRS, he will net 4.25% after tax. Therefore, Eric will earn more after tax from the Treasury bond fund than from the muni bond fund.

Example 4: Ashley also is considering a bond fund that holds high quality intermediate term corporate bonds. It yields 6%. However, Ashley would owe income tax to North Carolina as well as to the IRS on that 6% interest. She can deduct the tax she'll pay to North Carolina on her federal tax return, which will reduce the effective federal tax she'll pay. Ultimately, Ashley will owe about 38% in tax on that 6% yield, so she'll net about 3.7% after tax. Her after-tax yield would be lower than the muni fund's 4%. (The math would be different if Ashley were subject to the alternative minimum tax and, consequently, could not deduct state tax payments on her federal tax return.)

Typically, the higher your tax bracket, the greater the advantage of muni bonds and muni funds. Many observers expect tax rates to increase in the next few years, especially for high-bracket taxpayers. Our office can help you determine whether you will earn higher yields, after tax, from taxable or tax-exempt investments.

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America Counts on CPAs

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2009 Tax Brackets		
Tax Rate	Single filers taxable income	Married filing jointly taxable income
10%	Not over \$8,375	Not over \$16,750
15%	\$8,376–\$34,000	\$16,751–\$68,090
25%	\$34,001–\$82,400	\$68,091–\$137,300
28%	\$82,401–\$171,850	\$137,301–\$209,250
33%	\$171,851–\$373,650	\$209,251–\$373,650
35%	\$373,651 or more	\$373,651 or more

Source: IRS

Gifts to Trusts Must Be Handled With Care

You can reduce your beneficiaries' exposure to future estate tax by giving away assets you don't need. Those assets and any future appreciation will be removed from your taxable estate. Giving money to your daughter Kristi can be a simple process. But what if Kristi is young and you feel she'll be tempted to spend that money unwisely? Or what if Kristi is married to someone you fear will gamble away your gifts? For any number of reasons, you might prefer to put money into an irrevocable trust for Kristi rather than make an outright gift to her.

Dealing with the gift tax

Unfortunately, transfers to an irrevocable trust may not qualify for the annual gift tax exclusion, which is \$13,000 per recipient in 2010. To qualify, such gifts must offer a "present interest." That is, the recipient must be able to get his or her hands on the asset. However, often the reason for making gifts in trust is to keep the assets out of the trust beneficiary's easy reach.

If you give \$13,000 to an irrevocable trust for your daughter, that transfer may trigger gift tax. You might have to file gift tax returns and, if you already have used up your \$1 million gift tax exemption, you might have to pay gift tax. As of this writing, the maximum gift tax rate is 35% of the amount transferred, in 2010.

To make gifts in trust and avoid gift tax consequences, you can follow the "Crummey" procedure. This process is named after a precedent-setting court decision in which the taxpayer prevailed over the IRS. Here is how the Crummey procedure might work:

Example: Ben Richards creates an irrevocable trust and names his two children as trust beneficiaries. Ben names his sister Meg, a CPA, as the trustee. Ben transfers \$26,000 into the trust. Meg sends notices to both trust beneficiaries that state they have 30 days to withdraw up to \$13,000 apiece.

Therefore, both beneficiaries have the opportunity to access the assets



transferred to the trust. This gives them a present interest in the transfer and qualifies the gifts for the annual exclusion. After 30 days, if no withdrawals have been made, the \$26,000 can stay in the trust or be used by the trustee, with no gift tax consequences. If Ben's wife Lara joins in the gift, the couple can move up to \$52,000 worth of assets (twice \$26,000) into the trust this year, tax free.

Past Mutual Fund Losses Can Shelter Future Gains

During the bear market of late 2008 and early 2009, virtually all stock mutual funds posted large losses. Those losses, although painful, may provide mutual fund investors a crucial tax benefit in 2010 and perhaps in later years. To take advantage of this tax break, you should understand how mutual fund taxes work.

Example 1: Shareholders of stock fund ABC own a total of one million shares. During a given year, ABC buys and sells various stocks in hopes of increasing returns and to generate cash for investors who redeem shares of the fund. As ABC reaches the end of its tax year, it finds that its trades for the year have resulted in net gains of \$10

million. In order to avoid owing taxes itself, ABC makes a \$10-per-share capital gains distribution to its shareholders.

For those shareholders who hold ABC in a taxable account, these distributions are taxable events. If Heather Gray owns 100 shares of ABC, she will report \$1,000 of capital gains on

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CPA CLIENT TAXLETTER

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her tax return and owe income tax on those gains. She will owe this tax regardless of whether she pockets the \$1,000 distribution or chooses to reinvest it in more ABC shares.

Tax-free gains

In the recent bear market, many mutual funds incurred more losses than gains on their stock trades. Unlike gains, funds can't pass through those losses to shareholders.

Example 2: Stock fund XYZ also has one million shares in the hands of investors. As XYZ reached the end of its 2009 tax year, it determined that its trades for the year had resulted in \$10 million of net losses. Therefore, XYZ made no capital gains distributions for the year. XYZ did not distribute its losses either. Instead, it carried a \$10 million "capital loss carryforward" on its books.

Such losses can carry forward to as many as eight future years. Suppose that XYZ has \$7 million in realized capital gains in 2010. The fund's \$10 million loss carryforward would completely offset the \$7 million gain, so shareholders would owe no tax for that year. The other \$3 million net loss would carry forward for up to eight years after the original loss, to offset tax on up to \$3 million of realized gains by XYZ.

The bottom line is that mutual fund losses from the 2008–2009 bear market might shelter future mutual fund gains for several years. However, this tax shelter applies only to investors who buy mutual funds and continue to hold them. As long as you hold onto mutual fund shares, you don't have to report any gains except those that the mutual fund distributes from its own transactions. When you sell mutual fund shares in a taxable

account, however, you have to report a gain or loss.

For example, if you buy XYZ at \$12 a share in 2010 and sell for \$18 a share in 2011, you'd have to report a gain of \$6 a share, even if XYZ still has loss carryforwards.

Realized or unrealized?

Mutual fund losses fall into two categories:

1. **Realized losses.** If fund XYZ lost \$10 million in trades in its 2009 tax year, those losses are locked in. Investors know that they'll be able to offset \$10 million of future gains realized by XYZ and owe no income tax.
2. **Unrealized losses.** Suppose XYZ holds stocks currently valued at \$20 million. XYZ bought those stocks for \$32 million. Therefore, XYZ has unrealized losses of \$12 million. Some observers will combine the two numbers and say that XYZ's potential capital losses total \$22 million: \$10 million realized plus \$12 million unrealized.

Is this viewpoint valid? There are two schools of thought on this issue. Some people say that a realized, locked-in capital loss is the only one to count. You know you have \$10 million of tax shelter in the XYZ example. On the other hand, depending on how the stock market does today, that \$12 million unrealized loss could be an \$11 million unrealized loss or a \$13 million unrealized loss tomorrow. There's no knowing if those unrealized losses will ever be realized and offset future gains.

Others insist that an unrealized loss has value, too. If you invest when XYZ has an unrealized loss of \$12 million, you probably will not see taxable capital gains distributions for several years. When XYZ makes a trade, going forward, that trade is far more likely to result in a taxable loss than a taxable gain.

As an investor, you might want to consider both realized and unrealized losses but give greater weight to realized losses. In any case, the magnitude of the losses is less important than the ratio of losses to the fund's assets. If XYZ has \$10 million of realized losses and \$20 million of assets (50%), it probably will offer a longer holiday from tax than a fund with \$10 million of realized losses and \$100 million of assets (10%).

Evaluate the dog, not the tail

Both realized and unrealized losses can be hard to discover from a mutual fund's financial statements. Our office can help you determine the capital loss position of a particular fund. However, you should not forget the traditional advice: Don't let the tax tail wag the investment dog. When you're deciding whether to buy or hold onto a mutual fund, your key concerns may include the fund's investment philosophy, the manager's performance record, and its expenses. Nevertheless, capital loss carryforwards can be important, too, especially if you're choosing between funds that are otherwise equally appealing.



For College Costs, Pick Your Tax Breaks

In 2010, many parents of college students will pay five-figure bills for higher education. 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. The American Recovery and Reinvestment Act of 2009 (Recovery Act) effectively replaced the Hope tax credit with the American opportunity tax credit for 2009 and 2010 (see *CPA Client Tax Letter*, July/August/September 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.

Example: Wayne Wallace spends \$3,000 on his daughter's college tuition and other expenses in 2010. 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 2010 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 tax. The lifetime learning credit is not refundable.

While the American opportunity tax 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

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