

# CPA CLIENT

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# TAXLETTER

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## Supreme Court Affirms State Taxation of Municipal Bonds

In May 2008, the United States Supreme Court overturned a Kentucky appeals court's decision in *Department of Revenue of Kentucky v. Davis*. The high court's verdict means that state taxation of municipal bonds can continue. The interest on municipal bonds is generally exempt from federal income tax, but this tax exemption does not always apply to state and local income tax. Typically, investors owe state tax on interest from municipal bonds issued in another state. Municipal bonds from in-state issuers usually are completely tax exempt.

**Example #1:** Patrick McGurk is a New York City resident. If he invests in municipal bonds issued by New Jersey, he will owe New York state and New York City income tax on the interest from those bonds, even though he owes no tax on that interest to the IRS. However, if Patrick invests in municipal bonds issued by New York, the interest income will be completely tax exempt.

The Supreme Court's decision means that such tax treatment can continue throughout the U.S.

### Making a choice

If that's the tax treatment, are you better off with in-state or out-of-state municipal bonds (munis)? The answer depends on the yield from in-state bonds, the yield from out-of-state bonds, and your state tax bracket. Here's how to make the comparison.

As of this writing, Vanguard's New York Long-Term Tax-Exempt Fund, which holds only munis issued in New York, yields 4.54%, according to Morningstar.

Vanguard's Long-Term Tax-Exempt Fund, which holds munis from across the U.S., yields 4.84%. (Vanguard funds are useful for illustration purposes because they have low expenses. The same method of comparison can be used for funds from other families, for funds focusing on other states, and for individual municipal bonds.)



**Example #2:** Patrick McGurk pays the top income tax rates to New York state (6.85%) and New York City (3.648%) for a total of 10.5% (rounded). If he invests in the Vanguard national muni fund and receives 4.84% in income, he would owe approximately .51% (4.84% times 10.5%) in state and local income tax. Thus, his net income from that fund, after tax, would be 4.33%.

As you can see, Patrick would have more after-tax income from the Vanguard New York fund. Even though the yield on the New York fund is only 4.54%, none of that income is taxable.

### Adjusting to the AMT

The example above assumes that Patrick is subject to the alternative minimum tax (AMT). Thus, he gets no deduction for

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America Counts on CPAs

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the state and local income tax he pays. The calculation is more complicated for taxpayers not in the AMT.

**Example #3:** Emily Oakes is in the same tax brackets as Patrick, but she does not owe the AMT. She gets to deduct on her federal income tax return the 10.5% tax (both state and local) she pays. Assuming that Emily is in a 35% federal income tax bracket, this deduction saves her 3.675% (35% of 10.5%), so her effective state and local tax rate is 6.825%.

If Emily collects 4.84% from the Vanguard national municipal bond fund and pays an effective 6.825% rate in state and local income tax, those taxes cost her about 0.33% (4.84% times 6.825%). Therefore, she nets 4.51%

(4.84% minus 0.33%). Her effective after-tax return from the national fund (4.51%) is only slightly lower than her 4.54% after-tax return from the New York fund.

The AMT affects muni investors in another way: Certain "private purpose" municipal bonds pay interest that is *not* federally tax exempt. If you'll owe the AMT, you should avoid such bonds as well as funds holding those bonds. Our office can advise you about whether you'll owe the AMT and help you make calculations for your specific circumstances.

#### **Don't forget diversification**

As an investor, you'd probably prefer an after-tax return of 4.54% from a

fully tax-exempt bond or fund to 4.33% or even 4.51% from a holding that's partially taxable. However, the actual difference may not be that great.

For each \$100,000 that you invest in munis, the difference between a 4.54% return and a 4.33% return is \$210 per year (\$30 if the difference is between 4.54% and 4.51%). For that amount, you are taking on the risk that bonds in your home state will suffer from a local economic crisis that does not affect the entire nation. You have to decide whether the added yield is worth the added risk, and knowing how the alternatives compare can help you make your decision.

## Life Insurance Can Provide Estate Liquidity

The federal estate tax exemption is scheduled to rise to \$3.5 million in 2009. Beyond 2009, the future of estate tax legislation is uncertain, but it appears likely that some estates will owe tax. Their estate tax bills, federal and state, may run into six or even seven figures. This may not be a problem for large estates with a lot of marketable securities. The estate can simply sell off enough assets to pay the tax.

However, many large estates are illiquid. Your assets may consist mainly of real estate and shares in a family business. In addition, you may have a large IRA that you'd like to leave intact so your beneficiaries can enjoy extended tax deferral. If your estate holds those sorts of assets, finding cash for estate tax may rob your heirs of valuable wealth building opportunities.

#### **Policy payoff**

One way to be sure of having enough liquidity in your estate is to buy life insurance.

**Example:** Sophie Anderson is a widow with a \$5 million estate. She owns real estate, shares in a closely held corporation, and a \$1 million IRA. Assuming Sophie dies with this estate when the federal tax exemption is \$3.5 million, she will be \$1.5 million over the limit.

Assume that federal and state estate tax rates add up to 50% at the time of Sophie's death. Her estate will owe \$750,000 in tax, yet there is no easy way to raise this cash. A hurried real estate sale probably will result in a low selling price, and Sophie's heirs would like to retain their interest in the closely held company. Sophie's executor could empty her IRA to pay the tax bill. However, withdrawing all \$1 million might trigger a \$400,000

income tax bill (assuming 35% federal and 5% state and local tax rates), leaving only \$600,000 to pay estate tax. Even worse, depleting the IRA would deprive the heirs of an account that could grow much larger over the years.

If Sophie plans well, she will be aware of this possible problem. Thus, she could buy a \$750,000 insurance policy on her life. At her death, the policy proceeds could pay the tax bill so Sophie's other assets remain for her heirs.

#### **Tax trap**

The strategy outlined above will not be effective if Sophie owns the policy herself, because the \$750,000 death benefit will be included in her taxable estate. At a 50% rate, \$375,000 will be lost to estate tax. Thus, only \$375,000 will be available to pay the estate tax generated by Sophie's other

assets. With good planning, Sophie could create an irrevocable life insurance trust (ILIT). The trustee could apply for a \$750,000 policy on Sophie's life, pay the premiums, and then own the policy. At Sophie's death, the \$750,000 received by the trust would be excluded from Sophie's estate, as long as the ILIT and the policy are

handled properly. The trustee would have \$750,000 in cash, tax free, that could be loaned to the estate or used to buy assets from the estate. Either way, all \$750,000 would be available to pay estate tax, eliminating the need to liquidate estate assets.

Often, the key challenge to making an ILIT work is getting money

into the trust so insurance premiums can be paid. A savvy plan can use your gift tax exemption and gift tax exclusions to keep such transfers from being taxed. Our office can help you determine how to best use life insurance to provide cash your estate might need.

## Compensation Should Be Neither Too High Nor Too Low

Business owners can avoid tax problems by paying attention to the amount of money they receive for working for the company. That's true whether you run your business as a C corporation or an S corporation.

### C corporation challenges

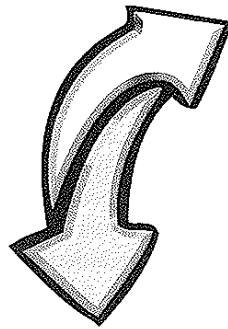
If you run your company as a regular C corporation, you'll find yourself exposed to two layers of tax. First, money you receive from the company will be subject to personal income tax. Second, corporate income tax will be due on the net income of the business. Some business owners attempt to get around this problem by "zeroing out" corporate income. If the company makes \$100,000, for example, it pays a \$100,000 bonus to its sole owner. Now the company has zero taxable income and owes no corporate income tax.

That might be a viable strategy, but it might not. The IRS will look at the total compensation package of a C corporation owner (salary, bonus, benefits) to see if it's reasonable. Amounts deemed unreasonable will be recast as dividends, which are taxable to the individual but not deductible by the company.

**Example #1:** Nancy Green is the sole owner of a C corporation. She zeroes out corporate income by paying herself a \$100,000 bonus, bringing her total compensation for the year to \$500,000. The IRS, examining the company's tax return, asserts that reasonable compensation for Nancy would be \$400,000, judging by her experience, corporate performance, and industry norms.

Thus, Nancy's \$100,000 bonus is characterized as a dividend, which is

not deductible from her company's income. The corporation winds up owing tax on \$100,000 in profits, while Nancy owes income tax on the \$100,000 bonus as well as her salary. In effect, that \$100,000 bonus is taxed twice, on a personal and on a corporate tax return.



### S corporation snag

One way to avoid this type of double taxation is to make an S corporation election for your company, assuming it will qualify. (A number of tests must be passed, including having no more than 100 shareholders, all of whom are individuals, their estates, other S corporations, or certain types of trusts.) All S corporation income flows through to the owners, so there is no corporate income tax to pay. Therefore, unreasonably *high* compensation won't be an issue.

Here, a problem may result if the IRS finds an S corporation owner is taking unreasonably *low* compensation. Only earned income is subject to Social Security and Medicare tax. In 2009, Social Security tax of 15.3% (counting employer and employee contributions) is imposed on compensation up to \$106,800, while all

earnings are subject to a 2.9% Medicare tax. Corporate profits are subject to neither payroll tax.

**Example #2:** Andy Parker owns 100% of an S corporation. He pays himself a \$40,000 salary this year and takes \$100,000 from his company as profits. The IRS might say that Andy has \$140,000 in compensation, driving up the Social Security and Medicare tax he must pay. Indeed, the IRS increasingly has been raising the issue of inadequate compensation with S corporations and their shareholders.

### Up to the minutes

These tax traps can be averted with astute planning. Whether your business is a C or an S corporation, regular meetings of shareholders and directors should occur. You should keep minutes of what's discussed at those meetings, and those minutes can explain your compensation arrangement.

If you run a C corporation and want to justify high compensation to the owner or owners, you might cite some outstanding accomplishments that can be traced to management decisions. You also might say that the current level of compensation makes up for sacrifices in prior years, if that's the case.

S corporations, as explained, may want to keep executive salaries low. In that situation, your minutes might mention an uncertain economic climate or increased competition as a reason for keeping down compensation.

Our office can help design a reasonable pay package to reduce the risks to you and your company.

# CPA CLIENT TAX LETTER

## Take Care With the Child Care Credit

For working parents, a child and dependent care credit can be a valuable tax break. However, in some situations it makes sense to minimize use of the credit—or to skip it altogether.

### Help at home

The tax credit can be used to offset expenses you incur for care for children under age 13 or for disabled relatives. To qualify for the credit, you must pay a caregiver so that you can go to work or school full-time. Married couples can take the credit only if the care enables both spouses to work or go to school.

You can qualify for the credit if you're paying an individual, a day care center, or even a day camp. However, you can't claim the credit for paying someone whom you can claim as a dependent.

### Taking credit

If you're paying for care, a certain percentage of the money you spend qualifies for the credit. The higher your income, the lower the percentage. Once your adjusted gross income (AGI) goes over \$43,000, the rate is 20%. The maximum amount of money to which this credit can be applied is \$3,000, if you have one young or disabled dependent. For two or more such dependents, the maximum is \$6,000.

**Example #1:** Mark and Elizabeth Dasher have an AGI of \$100,000. They

pay \$8,000 to caregivers for their two young children this year. Both spouses have full-time jobs. Of the \$8,000 they spend, \$6,000 is eligible for the credit. At their 20% rate for this credit, the Dashers save \$1,200 in tax this year: 20% of \$6,000. However, if one of their children had been 13 or older, they could not have taken a \$1,200 credit. Assuming the Dashers spend at least \$3,000 to care for the younger child, they could have taken a \$600 credit: 20% of \$3,000.

### Flex plans

The math may be different for a working parent whose employer offers a dependent care flexible spending arrangement (FSA). With such an FSA, up to \$5,000 can be contributed each year. Any money you contribute to an FSA won't be included in your taxable income. If you pay for dependent care, you can be reimbursed from the FSA, tax free. Thus, you'll pay for care with money that has never been subject to income tax. However, money you leave in your FSA at year-end is forfeited to your employer. (Employers can extend the year-end deadline to the following March 15, but they don't have to.)

### One or the other

Money that you're reimbursed from a dependent care FSA reduces dollar-for-dollar the expenses that can be

offset by the child and dependent care credit. Therefore, you should choose the tax break (credit or FSA) with the greater payoff. Many working couples will have more than \$43,000 in AGI, so the credit will be worth 20 cents on the dollar. If your tax bracket is higher than 20%, you are better off spending untaxed dollars via an FSA. However, if you are in a 15% tax bracket, the 20% credit is a better deal.

In 2009, married couples with taxable income over \$67,900 will be in a 25% tax bracket or higher. Such couples should use an FSA first if they can.

**Example #2:** As above, Mark and Elizabeth Dasher have an AGI of \$100,000; they pay \$8,000 to caregivers for their two young children this year. Elizabeth has a dependent care FSA at work.

The couple is in the 25% tax bracket, so Elizabeth puts the maximum \$5,000 into her FSA. They withdraw all \$5,000 for child care reimbursement. Effectively, this saves them \$1,250 in tax: 25% of \$5,000. By using \$5,000 from an FSA for child care, the Dashers reduce the maximum amount of expenses they can offset with the dependent care credit from \$6,000 to \$1,000. This credit can now save them another \$200 in tax: \$1,000 times their 20% credit rate, as explained above.

## QTIP Trusts Offer Tax Deferral Plus Control

Although the future of the federal estate tax is uncertain, one key feature is likely to survive any future legislation. That's the "unlimited marital deduction." Under the tax code, amounts that one spouse leaves to another can

be deducted from the decedent's estate, for tax purposes. That's true for bequests of any size. (The surviving spouse must be a U.S. citizen.)

**Example #1:** Kevin Richardson dies with a \$10 million estate and

leaves everything to his wife Paula. This brings his taxable estate to zero, so no estate tax is due. Her estate may owe tax upon her death, depending on the assets she retains and current tax law.

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**Long-term concerns**

This tax code provision probably will please Paula, in this example. However, Kevin might not be so happy.

**Example #2:** Kevin and Paula both have children from previous marriages. If Kevin leaves his total estate to Paula, she could ultimately leave those assets to her own children, with Kevin's children getting nothing. Kevin can solve this problem, at least in part, by leaving some of his assets to his own children. If he dies in 2009, he can leave them up to \$3.5 million, free of federal estate tax.

However, larger bequests to his children will trigger estate tax at Kevin's death. Amounts over the exemption ceiling will be taxed at 45%. What's more, leaving large amounts to his children may deprive Paula of a comfortable lifestyle.

In addition to remarriages, other situations may require a balancing act between a surviving spouse and other heirs. Even if Kevin and Paula are in a first marriage, with children of their own, Kevin might worry that Paula would remarry after his death and use the assets to support her children with a subsequent husband.

**The QTIP solution**

For such reasons, married couples might consider a qualified terminable interest property (QTIP) trust in their estate planning.

**Example #3:** Kevin leaves \$3.5 million of his \$10 million estate to his children from a first marriage, expecting it to be exempt from estate tax. This amount is left in trust in order to prevent his children from squandering it. Kevin leaves his remaining \$6.5 million to a QTIP trust. Paula is entitled to all of the income from this trust as long as she lives. If Kevin wishes, he can give the QTIP trustee the discretion to distribute other trust assets to Paula for specified purposes, such as paying for long-term care. No one else can benefit from this trust during Paula's lifetime. At Paula's death, the trust assets will pass to the beneficiaries Kevin has named. He can name his children, confident that they'll eventually inherit his assets.

Under this arrangement, the \$6.5 million left to the QTIP trust will qualify for the unlimited marital deduction, so those assets won't be subject to estate tax upon Kevin's death. Assets left in the QTIP trust, along with Paula's other assets, may be subject to

estate tax at Paula's death, depending on the current tax law.

**Inadequate income**

In order for a QTIP trust to qualify for the unlimited marital deduction from estate tax, the income paid to Paula must be adequate.

**Example #4:** Kevin names his brother Ray as trustee of the QTIP trust. Ray invests all of the trust assets in growth stock mutual funds that pay dividends of only 1%, which he pays to Paula. The growth stocks appreciate for eventual distribution to Kevin's children, the beneficiaries.

The IRS might contend that such an arrangement does not represent a real bequest to Paula, so the unlimited marital deduction does not apply. If so, the assets left to the QTIP may be subject to estate tax at Kevin's death.

Finding the right balance between the interests of the surviving spouse and the remainder beneficiaries can be challenging. One option is to invest for growth while paying out, for example, 5% of the trust fund each year to the surviving spouse, liquidating assets as necessary. Our office can help you develop a suggested investment strategy for the trustee if you want to create a QTIP trust.

**Your Home Office Can Deliver Deductions**

Are you spending a lot to heat your house these days? Have your homeowners insurance premiums shot up? You may be able to cut your effective housing costs by taking partial tax deductions. To do so, you must maintain a qualified home office—and that may be within many taxpayers' reach.

**Example #1:** James Thomas lives in a 2,000 square foot house. He maintains one room as a home office; that room measures 150 square feet. James can deduct 7.5% (150/2000) of his home expenses, which may

include insurance, utilities, security systems, and home repairs. He can also depreciate that portion of his house. If James's house has 10 rooms of approximately the same size and he uses one for business, he can deduct 10% of his household expenses.

**Alternative:** Renters can deduct a portion of the rent they pay, along with other out-of-pocket expenses.

**Principal place of business**

There are several ways to qualify for the home office deduction. For example,

you can maintain part of your home as your "principal place of business." That's where the most important activities of your business are performed. The principal place of business test is easiest to meet if you have self employment income or run a sideline business from your home. However, your home office deductions can't exceed the revenues from your self employment or sideline business. (You can carry over nondeducted expenses to the next tax year, if that will help.) If you file a Schedule C to report self

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employment income on your tax return, you can attach Form 8829 to list home office deductions.

If you work as an employee, taking home office deductions is more difficult. You can qualify if your employer requires you to do administrative or management work but does not supply you with an office. Even if you are an employee whose home office qualifies as your principal place of business, however, the tax benefits may be meager. You must list the resulting expenses as miscellaneous itemized deductions on Schedule A of your tax return and can deduct them only to the extent that they exceed 2% of your adjusted gross income.

### Other opportunities

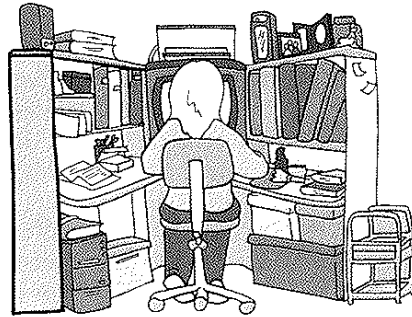
If you can't pass the principal place of business test, here are some other ways to qualify for home office deductions:

- **Meetings.** You must regularly meet with patients, clients, or customers in your home office.
- **Separate structure.** If you have a detached garage with an upstairs room, for example, using that room for business may qualify for home office deductions.

### Regular and exclusive

Assuming you can pass one of the tests described above, home office deductions are possible. To take the deductions, your home office must be used "regularly and exclusively" for

business. The tax code doesn't say what constitutes "regular" use. However, if you have a spare room where you see a client once or twice each year, that probably won't qualify. The more in-house meetings, the better.



In practice, there's some leeway to "exclusive" use of a room. If your kids visit your home office to tell you about school that day, you won't lose your deduction. In fact, a home office needn't be a room; a designated area of your home will do. Moreover, the tax code recognizes some specific exceptions to the exclusivity requirement. If you use a portion of your home to provide day care services or to store business related inventory and samples, exclusive use is not required as long as you meet other conditions. In general, though, it's best to do all

you can to keep nonbusiness activities out of your home office.

### Payback time

As mentioned, taxpayers who qualify for home office deductions can depreciate a portion of their house. Those depreciation deductions will be taxed when the house is sold. Our office can help with these calculations.

**Example #2:** Jeanne Thomas has a qualifying home office and takes \$20,000 worth of depreciation deductions over several years. She sells her house at a \$200,000 profit. As a single taxpayer, Jeanne is entitled to a \$250,000 capital gain exclusion on the sale of her home.

Even though she qualifies for an exclusion that exceeds her gain, Jeanne still must recognize \$20,000 in taxable income on the sale because of her prior depreciation deductions. Generally, that income will be taxed at a 25% rate. Any depreciation allowed or allowable will be subject to this 25% tax bite on a sale. Nevertheless, Jeanne probably should take the depreciation deductions when she can. Even though these deductions eventually will result in taxable income, Jeanne will benefit by deferring income tax. In addition, if Jeanne's federal income tax bracket is higher than 25%, she will benefit through tax reduction. She might, for example, take deductions in a 28% bracket and eventually pay tax at 25%.

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