

Client Bulletin

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

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 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.

IN THIS ISSUE

How to Tell If Munis Are Right for You 1-2

Hopeful Times for Home Buyers 2-3

Higher Costs for Long-Term Care 3

Estate Planning for Blended Families 4

Did You Know?

Six states—California, Florida, Michigan, Nevada, Arizona, and Illinois—accounted for 62% of the nation's total foreclosure activity in August 2009. While first place California's total was down 15% from July 2009, second place Florida saw a 10% increase from July 2009.

Source: RealtyTrac

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.



America Counts on CPAs

Client Bulletin

continued from page 1 — How to Tell If Munis Are Right for You

2009 Tax Brackets		
Tax Rate	Single filers taxable income	Married filing jointly taxable income
10%	Not over \$8,350	Not over \$16,700
15%	\$8,351–\$33,950	\$16,701–\$67,900
25%	\$33,951–\$82,250	\$67,901–\$137,050
28%	\$82,251–\$171,550	\$137,051–\$208,850
33%	\$171,551–\$372,950	\$208,851–\$372,950
35%	\$372,951 or more	\$372,951 or more

Source: IRS

Hopeful Times for Home Buyers

If you are interested in buying a home, you might find a good deal these days. The same may be true if you have children who want to enter the housing market or parents who want to buy a retirement home. Both sellers whose home values have slumped and banks that own homes after foreclosures may offer bargains to buyers.

The National Association of Realtors (NAR) maintains a Housing Affordability Index, which reflects the relationships among household incomes, mortgage interest rates, and housing prices. The index number is compiled by dividing the median household income by the median income a family needs to qualify for a mortgage on a median priced single family home. A higher index number indicates greater housing affordability: The index number rises as family incomes rise in relation to the cost of making mortgage payments on a median priced home.

In 2006, at the peak of the housing boom, the NAR index number was around 108. That is, the median household income was barely enough to qualify for a mortgage on a median priced home. Since then, median family income has climbed from around \$58,400 to over \$60,500. Mortgage

rates have dropped from 6.6% to 5.3%, the NAR reports. Most important, the median price of a single family home has fallen from almost \$222,000 to around \$178,000. As a result, the NAR index number is about 159, as of this writing, and homes are much more affordable for many buyers.



Coming up short

You may find that buying a home today is not a simple process, however. For instance, you may want to buy a home in a "short sale": a transaction in which the agreed-upon purchase price is less than the mortgage balance. If that is the case, the lender will have to approve the deal.

Example 1: Lyn Park finds a home she likes and bids \$180,000. The seller accepts her bid. However, the seller bought the house a few years ago with a \$210,000 home loan, which now has a balance of \$205,000. On a \$180,000 sale, the seller might net only \$165,000 after expenses such as sales commissions. That \$165,000 will be \$40,000 less than the \$205,000 that the seller owes the lender.

In such a transaction, the seller will have to ask the lender for permission to sell for \$180,000. The lender may refuse, thinking that it can do better by foreclosing on the loan, acquiring the house, and selling it for a higher price. Alternatively, the lender may examine the seller's financial situation and earning prospects to negotiate payment of the \$40,000 shortfall.

Generally, the process of getting a short sale approved can take weeks or even months. As a buyer, you may end up obtaining a desirable home at a reasonable price, but you'll probably need to be patient.

Buying from the bank

As home foreclosures increase, lenders own more properties. Such homes are known as REO: real estate owned

by the bank. Generally, banks would rather hold cash than real estate, so they may be motivated to offer an attractive price to generate a quick sale.

When you buy REO property from a lender, you may get a property that's clear of obligations incurred by the prior owner. A bank that's eager to sell the property may have made sure

there are no outstanding liens, property taxes, homeowners' association dues or assessments, and so on.

However, you should not assume that a REO house is trouble free. Typically, these properties are sold "as is." The prior owner, facing foreclosure, may have neglected maintenance or even vandalized the home. If the home has been empty for a while before the

sale, uninvited guests may have caused further damage. Therefore, you should not make any binding commitments to a home purchase—especially a REO purchase—before you have the home inspected and examine the report. If the house will need work, you may want to reduce your bid or even start looking for another place to buy.

Higher Costs for Long-Term Care

People who need long-term care are paying more each year. You may be able to partially protect yourself by buying a long-term care insurance policy when you're relatively young. For added protection, include a cost of living adjustment to the benefits you might receive.

According to the Genworth 2009 Cost of Care Survey, the national average daily rate for a private room in a nursing home is over \$200: around \$6,000 per month. A private one-bedroom unit in an assisted living facility costs over \$2,800 per month, on average, and you'll pay anywhere from \$18.50 to \$46.22 an hour, on average, to have an aide come to your home, depending on the type of agency you retain.

These figures are averages; you'll pay less in some areas of the country, more in others. In Dubuque, Iowa, for example, the median annual cost for assisted living is \$24,000. In Bridgeport, Connecticut, that cost is over \$52,000. For almost any type of long-term care the cost is likely to be substantial.

Acquiring insurance

Many people will seek to buy insurance to cover the possible future cost of long-term care. Although many insurers offer such coverage, there is a catch to buying these policies. The longer you wait to buy coverage, the greater the chance you will be in poor health. If you have a health condition that increases the

chance you'll need care, you will pay more for a policy—and you might not be able to get coverage at any price.

Therefore, you may want to start shopping for a long-term care policy while you're in your 50s or 60s. At that age, you have a good chance of getting coverage at a relatively low cost. But here there's also a catch: you have to plan for possibly receiving benefits far in the future.



Example 1: Bruce Moore buys a long-term care insurance policy at age 62. He selects a policy that will pay a benefit of \$200 per day, whether he needs care at home, in an assisted living facility, or in a nursing home. Bruce is in good health now but fears he'll need care when he is in his 80s or 90s.

According to the Genworth survey, costs for assisted living facilities and nursing homes have been increasing at more than 4% per year. At a 4% rate, costs double in 18 years. Therefore, if

Bruce needs care at age 80, his \$200 daily benefit might pay only half of a \$400 daily nursing home bill.

Coping with COLAs

Consumers who want protection from rising costs can buy a long-term care policy with a cost of living adjustment (COLA).

Example 2: Bruce chooses a 5% simple annual benefit increase as a COLA for his policy. Each year, his daily benefit will increase by \$10: 5% of 200. Therefore, if Bruce needs care at age 80, 18 years after purchasing the policy, he will receive his \$200 original benefit plus \$180 (18 years of \$10 COLAs) for a total of \$380. That amount will cover nearly all of a \$400 daily nursing home bill.

In recent years, insurers have added more choices to the COLA menu. Formerly, consumers typically had three choices: a 5% simple annual benefit increase, a 5% compound increase, or no inflation protection at all. Today, many companies offer a choice between 3%, 4%, or 5% COLAs, simple or compound. You also might be able to buy a COLA that's based on the Consumer Price Index (CPI). The more inflation protection you choose, the more you'll pay. Thus, because the CPI has risen around 4% per year over the past 30 years, on average, a CPI COLA generally will cost less than a 5% COLA.

Estate Planning for Blended Families

Many people don't get serious about estate planning until they are well into middle age. By then, some of them are part of blended families: they are married, and one or both spouses have children from previous families. Estate planning in such families can be tricky because the spouses may want to provide both for each other and their own children. If you're in such a situation, you should proceed cautiously.

Rethinking retirement plans

In a blended family, one or both spouses may have a sizable retirement account such as an IRA. One practice is to name the other spouse as primary beneficiary of the IRA, with the account owner's children as the secondary beneficiaries. This approach is common in first marriages, in which the children are the offspring of both spouses, but it can lead to trouble in a blended family.

Example 1: David Jennings has \$500,000 in his IRA. He names his wife Christine as the primary beneficiary and his two children from a prior marriage as the secondary beneficiaries. Thus, if Christine predeceases the children, they will inherit the IRA. Even if Christine does inherit the account, the balance will pass to David's children at Christine's death.

There are two flaws in this strategy. First, Christine can tap the IRA at will as

long as she takes required minimum distributions. She can take out all \$500,000 at once, pay the income tax, and then either spend the money or give it to, among others, her own children from her previous marriage.

Second, in this example Christine is a surviving spouse and sole beneficiary of David's IRA. Under the tax code, Christine can roll over David's IRA to her own new or existing IRA. (No other beneficiaries can do this.) Then Christine can name any beneficiaries she wishes, such as her own children.

In either scenario, there is no guarantee that David's children will see a penny of his \$500,000 IRA.

How can David avoid this outcome if he wants to provide for Christine and his own children? One tactic is to divide his \$500,000 IRA into two \$250,000 IRAs. He can designate Christine as the beneficiary of one IRA; his children can be co-beneficiaries of the second IRA. Alternatively, David can leave the entire \$500,000 IRA to his children, who can stretch out required minimum distributions over their longer life expectancy and thus enjoy extended tax deferral. If David adopts this plan, he can leave other assets to Christine, depending on the size of his estate and her financial needs.

Trust traps

In blended families, spouses also may use trusts in their estate planning. The first spouse to die might leave assets in trust for the surviving spouse, who will get the trust income and also might have some access to the trust principal. At the surviving spouse's death, remaining trust assets may pass to the children of the spouse who funded the trust. Some trusts of this nature can be qualified terminable interest property (QTIP) trusts and defer estate tax.

Trusts can play a valuable role in estate planning. Again, though, trusts can cause problems in blended families. With the arrangement described previously, the trustee might face a conflict between investing for current income (which would benefit the surviving spouse) and investing for long-term growth (which would benefit the trust creator's children). In addition, the children may have to wait for many years before receiving any inheritance if the first spouse to die leaves all of his or her assets to such a trust.

Dividing the estate might be a better solution. Some assets could be left to the surviving spouse and some to the children, outright or in separate trusts. If the spouses fear that such a plan would leave insufficient amounts to the beneficiaries, they might buy life insurance and increase the total estate value.

Tax Calendar

DECEMBER 2009

December 15

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

Corporations. Deposit the fourth installment of estimated income tax for 2009.

JANUARY 2010

January 15

Individuals. Make a payment of your estimated tax for 2009 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2009 estimated tax. However, you don't have to make this payment if you file your 2009 return and pay any tax due by February 1, 2010.

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

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.