

Client Bulletin

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

For Yield Plus Safety, Build a Bond Ladder

With the stock market under heavy pressure, investors naturally are looking to bonds. In fact, Treasury bonds have been outstanding performers during the bear market in stocks. However, investors' demand for Treasury bonds has pushed up prices, driving down yields. As of this writing, 5-year Treasuries yield less than 2%, and 10-year Treasuries yield just over 3%.

Richer returns

By comparison, other types of bonds have higher yields these days. Investors have shied away from non-Treasury bonds, fearing economic weakness and illiquid credit markets, and the resulting lower bond prices have raised yields. Highly rated municipal bonds (munis) pay 2.25%–3.5% now, and those yields are exempt from federal income tax. You can also avoid state and local income tax by buying munis issued in your home state.

Investment grade corporate bonds now yield 7%–8%. These bonds have high ratings from agencies such as Moody's and Standard & Poor's. (Lower rated "junk" bonds have even higher yields.) Besides relatively high yields, corporate and municipal bonds offer the potential for capital gains if investors gather enough confidence to move from Treasuries to other types of bonds.

Dodging default

Along with potentially high total returns, bonds have risks. Issuers might default, leav-

IN THIS ISSUE

**For Yield Plus Safety,
Build a Bond Ladder**
PP. 1–2

**Learning to Live With
IRA Losses**
P. 2

**Refinance Your Mortgage,
Retain the Tax Breaks**
P. 3–4

Did You Know?

Premiums for new individual long-term care insurance policies dropped 7% from 2007 to 2008. In 2007, buyers of such policies paid nearly \$650 million in premiums. Last year's total was just over \$600 million. A steep slide in sales of new policies during the fourth quarter of 2008 caused the year-to-year decline.

Source:
LIMRA International



America Counts on CPAs

ing bondholders with devalued securities. To avoid this risk, investors can focus on bonds rated A or better. Although the yields on such bonds are lower than the yields on lower rated bonds, highly rated bonds historically have had low default rates, even in difficult economic times.



Stagger for success

Bondholders also face the risk that interest rates will rise in the future. Rising interest rates devalue bonds: The 7% yielding bond you bought a month ago will be worth less than the price you paid for it if a newly issued bond yields 8% or more. To protect yourself against the threat of rising interest rates, you can stagger maturities. That is, you can buy a number of bonds that will mature at different times. If you buy bonds that mature every year or two, you'll have a "bond ladder."

Example: Mark Parker has \$200,000 to invest in corporate bonds. He invests \$25,000 in a highly rated corporate bond that matures in 2010. He invests another \$25,000 in a highly rated corporate bond that matures in 2011. And so on, until Mark has \$200,000 invested in corporate bonds maturing until 2017.

continued on page 2

Client Bulletin

continued from page 1 — For Yield Plus Safety, Build a Bond Ladder

In 2010, one of Mark's bonds will mature. He can spend that \$25,000 if he needs the cash. Otherwise, Mark can reinvest in a bond maturing in 2018. He can continue this process indefinitely, maintaining his bond ladder.

Protection and potential

What does this strategy accomplish? In our example, Mark has \$200,000

invested at today's high yields from corporate bonds. If his bonds appreciate, he can cash them in and realize capital gains. On the other hand, Mark's bonds might lose value. Rising interest rates or a further deterioration of the corporate bond market could cause prices to drop, raising yields. In this scenario, Mark will have a bond maturing each year, so he can reinvest

the proceeds and lock in those higher yields.

In some circumstances, a bond ladder can deliver substantial yields and upside potential while reducing risks to bondholders. Thus, you might prefer to use either municipal bonds or corporate bonds for your ladder now when Treasuries have such low yields.

Learning to Live With IRA Losses

Many investors practice tax-loss harvesting. If you sell securities and realize a capital loss, that loss may provide tax benefits in current and future years. Such losses are valuable only in taxable accounts. Just as you won't owe tax after taking a gain in an IRA, 401(k), or other tax-favored retirement plan, you also will get no tax break from selling an asset at a loss inside such an account. In some cases, you can realize tax breaks from IRA losses, but such situations are rare and the tax benefits may be limited.

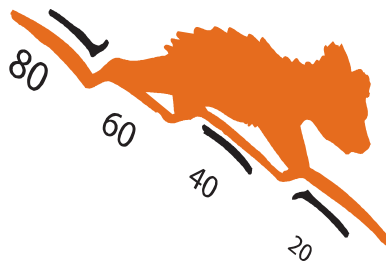
Compounding the damage

If you can't get a tax benefit by selling an asset at a depressed price inside a retirement account, can you get a tax benefit by closing the account? Perhaps, but not usually.

Example #1: Duane Williams has worked at one company for many years. He has deferred a total of \$150,000 of his salary into his 401(k) plan. Thanks to employer matches and investment returns, Duane's 401(k) grew to \$220,000 by 2007. Now that the stock market has plummeted, his 401(k) is worth only \$125,000.

Even if Duane sells all of his losers inside his 401(k), he will get no tax benefit. But what if Duane sells every-

thing he has in his 401(k) and closes the account? He will have contributed \$150,000 of his own money and will walk away with only \$125,000. Can Duane claim a \$25,000 tax loss?



Unfortunately, no. In this example, Duane never paid income tax on his 401(k) contributions. Therefore, if he closes the account and pockets \$125,000, the IRS will treat the transaction as if Duane has received \$125,000 of taxable compensation. In addition to income tax, if Duane is younger than 59½, he probably will owe a 10% surtax on the \$125,000 distribution from the 401(k).

No relief from rollovers

The preceding 401(k) example may help you understand the tax treatment of IRA losses as well.

Example #2: Duane's coworker, Jeanne Miller, also contributed \$150,000 of compensation to her 401(k), which

grew to \$220,000. At that point, Jeanne left the company and rolled her 401(k) balance into a traditional (as opposed to Roth) IRA, extending the tax deferral.

Suppose that Jeanne's IRA has suffered a similar drop and now is worth only \$125,000. Can she close the account and claim a \$25,000 tax loss because she invested \$150,000 in her IRA and received \$125,000 on termination?

Again, the answer is no. Like Duane, Jeanne has only pretax money in her IRA. To the IRS, she has no "cost basis" for tax purposes. If Jeanne has no cost basis and receives \$125,000 from an IRA, she will have \$125,000 of taxable income, and she probably will owe a 10% surtax, too, if she is younger than 59½.

Basis buildup

In some situations, you'll be eligible to claim a loss after terminating your IRA.

Example #3: Larry Harrison has made \$25,000 worth of nondeductible contributions to a traditional IRA over several years. This IRA is now worth only \$15,000 because of stock market losses. If he closes the IRA, Larry will have a \$10,000 loss. His nondeductible contributions have given him \$25,000 of cost basis, and he received only \$15,000 when he terminated the IRA.

To be able to deduct this \$10,000 loss, Larry must close this traditional IRA. He also must close any other traditional IRAs he owns, under IRS rules, to deduct a loss. Once all of his traditional IRAs have been closed, Larry can deduct the amount of his total nondeductible contributions, minus the amount he received.

Example #4: As stated, Larry made \$25,000 of nondeductible contributions to a traditional IRA, closed the account, and received \$15,000. Assume Larry has one other traditional IRA, holding only pretax money. Larry closes that account and receives \$4,000. Altogether, Larry has made \$25,000 of nondeductible contributions and received \$19,000, so he has a \$6,000 loss.

Larry will not have a \$6,000 capital loss, though. Instead, he will have a \$6,000 miscellaneous itemized deduction. If all of his miscellaneous deductions (which include items such as investment expenses, unreimbursed employee business expenses, and tax

preparation fees) exceed 2% of his adjusted gross income (AGI), Larry can deduct the amount over 2%. Also, if he is subject to the alternative minimum tax (AMT), such miscellaneous deductions won't count, so he'll get no benefit from the \$6,000 IRA loss. (The tax treatment described in this paragraph also applies to Larry's \$10,000 loss in Example #3.)

Similar rules for Roth IRAs

If you have a Roth IRA, you will face the same tax treatment as you would for nondeductible contributions to a traditional IRA. Because your Roth IRA also has been funded with after-tax dollars, your contributions give you cost basis. If you close all your Roth IRAs and walk away with less than your cost basis, your loss is a miscellaneous itemized deduction. Such items are deductible to the extent they exceed 2% of your AGI but are not deductible if you're subject to the AMT.

Traditional tactics

As you can see, you might get some tax relief if you've lost money in a Roth IRA or a traditional IRA with substantial nondeductible contributions. Typically, you won't get any tax benefits from losses in a traditional IRA that was funded mainly with pretax dollars.

If your traditional IRA has lost money, your best strategy may be to convert it to a Roth IRA. You'll owe tax on the conversion, but your tax bill will be lower now that the account value is down. If your 2009 income is no more than \$100,000, you can execute a Roth IRA conversion this year. Alternatively, you can wait until 2010, when there will be no income limits on Roth IRA conversions. Roth IRA conversions generally are taxable in the year of the transaction. However, if you convert to a Roth IRA in 2010, you can defer the tax bill and pay half on each of your 2011 and 2012 tax returns.

Refinance Your Mortgage, Retain the Tax Breaks

Mortgage rates have fallen to their lowest levels since the 1950s. As of this writing, the average rate on a 30 year, fixed rate mortgage is around 5%. Many lenders offer lower rates. Therefore, if you have a home loan with an interest rate of 6% or higher, this may be a good time to refinance.

To refinance your loan, you may have to clear several hurdles. You'll have to show that your home's value is high enough to provide the lender with adequate security. Additionally, you'll probably have to demonstrate that you have enough income to make the loan payments and a solid credit history.

Tax tactics

Assuming you qualify to refinance your home mortgage, you'll want to make sure you maximize the available tax benefits. The simplest way to do this is to get a straight replacement loan.

Example #1: Patrick Rogers has a 6.5% mortgage with a balance of \$250,000. He refinances with a 5%,

\$250,000 mortgage. Patrick's mortgage interest on the new loan (about \$12,500 per year) will be tax deductible as long as the total of all of his home loans is \$1 million or less.

The situation is trickier, however, if you refinance with a larger loan.



Example #2: Richard and Sarah Tucker refinance a mortgage with a \$250,000 balance. Their new loan is \$300,000. After paying off their old loan, the Tuckers keep \$50,000 in cash. They spend \$20,000 to install a powder room in their home and use the other \$30,000 to pay college tuition for their son Adam.

Under the tax code, the \$250,000 the Tuckers use to replace their old mortgage and the \$20,000 they spend on improvements is all considered "home acquisition debt." The interest on that \$270,000 will be tax deductible as long as the Tuckers' home loans are no larger than \$1 million.

However, the \$30,000 used for Adam's schooling is "home equity debt." The Tuckers can deduct the interest on no more than \$100,000 of such debt. Therefore, in order for the Tuckers to deduct the interest paid on that \$30,000, they can have no more than \$70,000 of other home equity debt, such as an existing balance on a home equity line of credit. Also, for the interest on home equity debt to be fully deductible, the total mortgage debt on the house cannot exceed the home's value. The total mortgage debt includes all acquisition debt and all home equity debt.

What's more, taxpayers who are subject to the alternative minimum tax (AMT) can deduct the interest on

continued on page 4

continued from page 3 — **Refinance Your Mortgage, Retain the Tax Breaks**

home equity debt only if the money is used for home improvements. (The \$100,000 cap still applies.) If you are subject to the AMT, take care in how you use the proceeds of cash-out refinancing and how you report the interest on your tax return.

Paying points

Homeowners frequently pay “points” when they refinance a mortgage.

Example #3: Jerry and Kay Martin refinance a \$300,000 loan and pay two points (2%), or \$6,000. Paying these points reduces the interest rate on their loan.

The Martins can deduct these points over the life of the loan. If they get a 30-year (360 month) loan, they can deduct \$16.67 (\$6,000 divided by 360) every month that this loan is outstanding, or \$200 each calendar year (\$16.67 times 12).

What’s more, when the loan is paid off, all of the not-yet-deducted points can be deducted. This might occur if they refinance the loan again or sell the house.

Example #4: The Martins refinance their mortgage in mid 2009 and deduct \$100 worth of points that year—for the six months since they got the new loan. In 2010, 2011, and 2012, they deduct \$200 worth of points each year. In 2013, they sell their home and pay off their loan. On their 2013 tax return, the Martins can take a \$5,300 deduction: the \$6,000 of points they paid upfront minus the \$700 they’ve already deducted.

However, if you refinance with the same lender, you can’t deduct the old points. Instead, the old and new points are combined and deducted over the life of the new loan.

Example #5: As mentioned, the Martins take out a 30-year loan and pay \$6,000 in points. Suppose they had \$2,000 worth of nondeducted points from their old mortgage, and they refinance with the same lender. Now the Martins have \$8,000 in points to deduct over their 30-year loan: about \$22 per month.

In another situation, suppose you refinance with a cash-out mortgage and

use some of the proceeds to improve your principal residence. Then some of the points you pay can be deducted upfront, pro rata.

Example #6: Diane Jensen refinances a loan secured by her principal residence, borrowing \$200,000 and paying \$4,000 in points. Of the \$200,000, she uses \$50,000 (25%) for home improvements. In this situation, Diane can deduct \$1,000 (25% of \$4,000) immediately because she used \$50,000 (25% of her loan) for home improvements. She can deduct the other \$3,000 worth of points over the life of her new loan.

You can deduct home improvement points immediately only for work on your principal residence. If Diane had spent the \$50,000 on her vacation home, she would have to deduct all \$4,000 worth of points over the life of the loan.

If you contact our office when you refinance your mortgage, we can help you take all legitimate tax deductions.

Tax Calendar

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.

AUGUST 2009

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

August 17

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July 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.

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