

SEPTEMBER 2008

# Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

## Living With Stock Market Volatility

Following the stock market these days has been painful. Substantial daily declines are common. Every time stocks put together a winning streak, it seems that oil prices shoot up or a major financial firm announces a huge loss, and the broad market retreats again. Will this weakness be temporary, followed by a rebound? Or is this the beginning of a long, steep decline? No one can say for sure. But before you make any decisions regarding your investments, you should be aware of the stock market's historical trends. They may help you put today's volatility in perspective.

### Recent reversals

The Standard & Poor's 500 Index (S&P 500) is a benchmark that financial professionals use to track the U.S. stock market. The S&P 500 had its highest close in history (1,565) in October 2007. Since then, the index is down about 15%, and many investors have watched their net worths shrink. This recent decline, however, followed five years of steady gains. In October 2002, the S&P 500 hit a low of 777. In the next five years, the index doubled. During the intervening calendar years (2003–2007) the S&P 500's returns ranged from 5% to 29%, counting reinvested dividends. Therefore, a 15% correction may not be surprising.

In fact, a 15% correction is not huge by recent standards. The S&P 500 lost about 50% of its value from early 2000 to late 2002, following 5 straight years of 21% or greater returns from 1995–1999.

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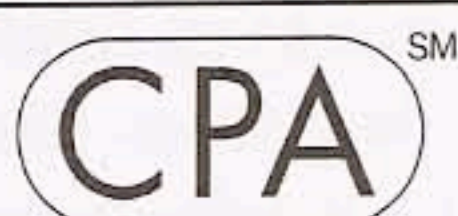
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### Did You Know?

**The last several months have seen a massive decline in sales volume for commercial real estate. The number of transactions involving significant office, apartment, and retail properties plunged by at least 79% from April 2007 to April 2008, while industrial property sales fell by 67%.**

Source: PricewaterhouseCoopers



America Counts on CPAs

*Bottom line:* Stocks have gone up and gone down. They may well go down further. What we're seeing now is nothing new.

### Looking at the long term

Active traders seeking short-term profits may find the current bear market in stocks maddening. Many investors, however, have long time frames for their investments—like a 45 year old saving for retirement. If you're in the market for the long term, you should know the long-term results.



According to Ibbotson Associates, a subsidiary of Morningstar, U.S. large company stocks (the S&P 500 and predecessor indexes) have returned an average of 10.4% per year from the beginning of 1926 through 2007. That period spans the Depression of the 1930s and World War II, in addition to the ups and downs of recent decades. By comparison, long-term government bonds returned an average of 5.5% per year during that 82 year time period.

If stocks earned 10.4% and bonds returned 5.5%, did investors do twice as well in stocks? Not exactly. According to Ibbotson, one dollar invested in large company stocks at the beginning of 1926 and continually reinvested would have grown to more than \$3,200 by the end of 2007. That amount includes reinvested dividends, without any reduction for

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taxes or sales costs. That same one dollar, invested and reinvested in long-term government bonds, subject to the same conditions, would have grown to less than \$80. Over the very long term, slight differences in returns can make an enormous difference in wealth accumulation because of the power of compounding.

### Decade by decade

Eighty-two years may be too long a time frame for you to consider. In the past 10 years, U.S. large company stocks returned only 5.9% per year, on average, far below the long-term trend.

However, going back 20 years—from 1988 through 2007—the annualized return moves up to 11.8%, and the 30 year annualized return is 13.0%. Few would have predicted that 30 year return at the start of 1978, when the S&P 500 stood at 94 (down more than 12% in five years), oil prices were rising, and inflation was at record levels.

If you're a long-term investor who can endure some trying times, don't let the daily headlines keep you from including stocks in your investment portfolio. Over time, the stock market is a sound place to be.

Large company stocks	13.0%
Small company stocks	15.3%
Long-term government bonds	9.3%
Intermediate-term government bonds	8.3%
Long-term corporate bonds	9.1%
Treasury bills	6.0%

*Source: Morningstar*

## 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.

### 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 2008, he can leave them up

to \$2 million, free of federal estate tax. In 2009, this federal estate tax exemption rises to \$3.5 million.

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 free from estate tax by the exemption that takes effect in 2009. 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 then 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.

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**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 cool 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 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 two percent 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

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\$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. Therefore, Jeanne 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%.

Tax Calendar

SEPTEMBER 2008

OCTOBER 2008

**September 10**

**Employees who work for tips.** If you received \$20 or more in tips during August, report them to your employer. You can use Form 4070.

**September 15**

**Individuals.** If you are not paying your 2008 income tax through withholding (or will not pay in enough during the year tax that way), pay the third installment of your 2008 estimated tax. Use Form 1040-ES.

**Employers.** For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in August if the monthly rule applies.

**Corporations.** File a 2007 calendar year income tax return (Form 1120 or 1120-A) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six month extension.

Deposit the third installment of estimated income tax for 2008. Use the worksheet Form 1120-W to help estimate tax for the year.

**S corporations.** File a 2007 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

**October 10**

**Employees who work for tips.** If you received \$20 or more in tips during September, report them to your employer. You can use Form 4070.

**October 15**

**Individuals.** If you have an automatic six month extension to file your income tax return for 2007, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalty due.

**Employers.** For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in September if the monthly rule applies.

**Partnerships.** If you were given an additional six month extension, file a 2007 calendar year tax (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute K-1.

**Electing large partnerships.** If you were given an additional six month extension, file a 2007 calendar year tax (Form 1065).

**October 31**

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2008. 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 November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than \$500.

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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