CPA Client Bulletin
APRIL 2009
BUSINESS & TAX PLANNING IDEAS *for* OUR CLIENTS *and* FRIENDS

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How the Bear Market Affects Your Retirement

For investors, 2008 was one of the worst years since the 1930s. How this market dive affects your retirement plans depends largely on your stage in life.

Young workers

If you are 15 or more years from retirement, recent market turmoil actually may be beneficial. There are several reasons for this counterintuitive result:

1. **Modest losses.** Many young workers have used their earnings to repay student loans, save up to buy a house, and pay the expenses of starting a family. As a result, they may have only small investment portfolios. The less you had invested prior to last year's crash, the less you have lost, in absolute dollars.

2. **More time for recovery.** With 15 or more years to retirement, you probably will have ample time for your investments to recover before you'll tap your portfolio. If markets stay down for some time, you'll have an extended opportunity to invest at low prices. By investing regularly, perhaps through a 401(k) plan, you can build up a low-cost portfolio in anticipation of the next bull market.

3. **Lessons learned.** Investment markets' performance in 2008 illustrates the importance of diversification. You should not load up on shares of your employer because that company stock could fall sharply. Also, you should include not only stocks but also high quality bonds or bond funds in your portfolio because such bonds provided a valuable cushion last year.

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Correction

The Tax Calendar of the March 2009 *CPA Client Bulletin* stated that partnerships can apply for a six-month extension by filing Form 7004. In fact, due to a recent change in the regulations, the extension would be for **five** months. Accordingly, the deadline for filing Form 1065 would be **September 15**, not October 15, as printed. We apologize for any inconvenience or confusion this error may have caused.

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Preretirees

The closer you are to retirement, the more you'll feel the impact of a plummeting portfolio. You may have suffered greater losses after many years of investing, and you'll have fewer years to rebuild your retirement fund. As you approach retirement, your planning becomes a numbers game. Will you be able to stop working and still afford your customary lifestyle? One way to approach this calculation is to assume you'll need as much spending money in retirement as you need before retirement. You won't have to save for retirement, however.

Example #1: Kim Grant, age 62, earns $100,000 per year and contributes $20,000 to her 401(k) plan. Once Kim stops working, she won't continue those contributions. Thus, Kim figures she can retire comfortably on $80,000 per year. Kim calculates how much she can expect from Social Security by looking at the estimates of benefits she receives each year from the Social Security Administration. Then Kim eyes other likely sources of retirement income: a pension, earnings from part-time

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consulting, and so on.

Kim then can estimate the amount she can safely withdraw from her investment portfolio. Many financial advisors tell people retiring in their mid-60s to start with a 4% withdrawal. Then retirees can increase the annual withdrawal amount to keep pace with inflation. Such a strategy probably will keep an investment portfolio intact for 25–30 years.

Example #2: Suppose that Kim Grant estimates she will receive $30,000 per year from Social Security and other nonportfolio sources of income. Her retirement fund is now $500,000. Withdrawing 4% of $500,000 in Year 1 of her retirement would give her $20,000. Altogether, Kim can count on $50,000 of cash flow when she retires. Assuming she wants $80,000 of cash flow to maintain her lifestyle in retirement, Kim might have to keep working for several more years. Extending her career may increase Kim's Social Security benefits and allow her to make substantial contributions to her retirement fund.

Example #3: Assume the same facts as in Example 2, except that Kim has a $1 million portfolio. If she retires now and withdraws $40,000 (4%), Kim will have $70,000 of cash flow in Year 1, close to her $80,000 target. Thus, Kim may be able to retire in a few years if she puts more money into her retirement fund and her investments recover to some extent.

If you are thinking about retiring soon, our office can go over your specific situation and help you decide if you need to keep working in order to build a larger retirement fund.

Retirees

If you already are retired, you may have been tapping your portfolio for spending money. Your previous actions probably will influence what you can do in the future.

Example #4: Larry and Jill Martin retired a few years ago with $1 million in investments. They started with a $40,000 (4%) portfolio withdrawal and have increased that withdrawal each year to match annual inflation rates. After last year's bear market, the Martins' portfolio is down sharply. If they keep up their practice of increasing withdrawals to match inflation, their 2009 withdrawal will be about 5.5% of their portfolio. Although cutting their withdrawals may help in the long run, the Martins can maintain their spending if they'd like. The so-called "4% rule," based on historic patterns of investment returns, generates a high probability that a portfolio will remain intact for 25–30 years.

On the other hand, suppose that the Martins started with a $70,000 (7%) withdrawal and have made similar withdrawals during their retirement. With their depleted portfolio, keeping up this pace of withdrawals might mean spending over 10% of what's left this year. If they continue to spend at that level, the Martins run a risk of depleting their retirement fund.

Again, our office can help you determine a reasonable level of portfolio withdrawals during your retirement.

Employing the Expanded Estate Tax Exemption

If you're reading this, you may have qualified for a tax break worth hundreds of thousands of dollars. No, the previous sentence is not an Internet come-on. It refers to the laws on federal estate taxes, which changed when 2009 began. In 2009, the federal estate tax exemption rose from $2 million to $3.5 million per person. The federal estate tax rate remains at 45%. President Obama has indicated that he would like to keep the exemption and tax rate at current levels. If that proves to be the case, many families will benefit from huge tax savings.

Example #1: Bill Wilson is a widower with a $4 million estate. He has been seriously ill. If Bill had died in late 2008 and left everything to his children, his estate would have been $2 million over the limit. At a 45% rate, his estate would have owed $900,000 in federal estate tax. Suppose, instead, that Bill did not die until January 2009, when he had that same $4 million estate. This year, Bill's estate is only $500,000 over the $3.5 million limit, so it will owe only $225,000 in federal estate tax. Extending his life from one year to the next saved Bill's heirs $675,000 in tax.

Prudent planning

Your estate plan should incorporate the increased exemption.

Example #2: Joanne Adams is a widow with a $3 million estate. Her estate will owe no federal estate tax when she dies. Thus, she can plan the distribution of her assets without considering the impact of federal estate tax.

The estates of single taxpayers worth over $3.5 million may owe federal estate tax. If such people won't need all of those assets during their lifetimes, they might shrink their estates by making gifts. In 2009, the annual gift tax exclusion increased from $12,000 to $13,000 per recipient. Within that $13,000 limit, a gift has no tax consequences as long as the recipient has a present interest in

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the gift: he or she must have immediate access to the transferred assets.

Example #3: Michael and Dayna Young have an estate that's far in excess of $7 million. Therefore, they have transferred assets between them so that both spouses have more than $3.5 million in assets. Each spouse can leave at least $3.5 million to their children (or to trusts for the children). Therefore, the Youngs can leave $7 million to their children, free of federal estate tax.

Caught in the middle

"Such married couples should look at formula clauses in their wills and trusts," says Steve Siegel, president of The Siegel Group in Morristown, NJ, a consulting firm specializing in tax and estate planning. "A document drafted in the last 10 years may have been intended to create a trust holding $600,000–$2 million at the death of the first spouse. Now this trust might hold $3.5 million."

Couples with estates in this range may want to revise their estate plans. They can decide how much should be left to the surviving spouse and how much might be left to other heirs in order to use the estate tax exemption of the first spouse to die.

Siegel also notes that some states have estate taxes with lower exemptions. "Someone might leave an estate that generates no federal estate tax," he says, "but that estate could owe hundreds of thousands of dollars in state death tax." Therefore, a married couple might construct their estate plan so that the first spouse to die leaves to nonspousal heirs the amount of assets that will be exempt from federal and state estate tax, with the balance going to the surviving spouse.

Why? Assets left to a spouse avoid estate tax, so no estate tax will be due at the first spouse's death. The surviving spouse, who probably will have ample assets for living expenses, can spend down or give away assets to reduce estate tax at the second death, if that is a concern.

Tax Relief Might Provide a Partial Ponzi Recovery

Bernie Madoff has admitted to defrauding investors of billions of dollars in a "Ponzi scheme." This expression refers to a venture in which early investors are paid phantom "profits" from later investors' contributions. In truth, the promoter is the only one investing money—he's putting other people's money into his own accounts. Contemporary scams of this sort are by no means limited to the Madoff affair. In recent months, the SEC and federal prosecutors have charged others with similar schemes, albeit on a smaller scale. When investment markets fall and investors request cash to move into safer assets, promoters can't make the payments, and frauds are exposed.

Tax tactics

If you have been ripped off by a phony promoter, you may be entitled to tax relief. Based on IRS pronouncements and various court decisions, the safest way to get that relief is to rely on Internal Revenue Code (IRC) § 165(c)(3), which applies to theft losses. After such a theft loss, you can write off the amount of the loss that exceeds 10% of your adjusted gross income (AGI), minus $100.

Example #1: Jim Jackson lost $60,000 in a Ponzi scheme. If his AGI is $100,000, 10% of his AGI is $10,000. Jim subtracts $10,000 from his $60,000 loss to get $50,000; then he subtracts another $100 to get $49,900. Jim can take a theft loss deduction of $49,900.

Typically, you can claim a theft loss only if someone—usually the perpetuator of the Ponzi scheme—could be prosecuted under state law, so check with our office to see if you have a valid tax deduction under 165(c)(3). If your investment fraud loss exceeds your income in the year you report this loss, you can apply the excess against the taxable income that you reported in the past three years. You can file amended returns to get refunds. Moreover, any losses you still are not able to deduct can be deducted against your income for the next 20 years.

Other approaches

Victims of Ponzi schemes may try two other tactics to get tax benefits. Be aware, however, that these tactics may not succeed.

- **Lack of income.** You might have reported interest, dividends, or capital gains from nonexistent investments. Therefore, you might assert that you didn't really have that income, so you didn't owe tax.

Example #2: Andrew Long gave $50,000 to a promoter who promised "10% investment returns." Sure enough, Andrew received $5,000 per year until he discovered that the promoter had skipped town with millions of investors' dollars. Andrew may decide to amend the tax returns he filed in the past three years because the tax code permits him to amend returns filed during that time period. Assuming he could amend three tax returns with $5,000 of this phantom income apiece, Andrew could claim a refund of the taxes he paid on $15,000, stating that they were a return of his investment, not taxable income. If that $15,000 is considered to be a return of principal, his loss from the deal would be $35,000 instead of $50,000. That means he could immediately recover the taxes paid on $15,000. Then he

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would have to wrestle with tax code limits and complexities on a $35,000 theft loss, not a $50,000 theft loss.

As mentioned previously, this approach may not succeed. The IRS has stated that it rarely allows taxpayers to amend tax returns on issues related to reported income.

- **Pursuit of profit.** Taxpayers who have been victimized in Ponzi schemes might claim tax losses under IRC § 165(c)(2) instead of IRC § 165(c)(3). The former section applies to losses in transactions entered into for profit. If you claim a loss under 165(c)(2), you are not subject to the $100 and 10%-of-AGI limitations applicable under 165(c)(3). In Example #1, Jim Jackson could claim a $60,000 loss under 165(c)(2), not the $49,900 loss available under 165(c)(3).

Again, Jim might not be successful in his claim for greater tax relief under 165(c)(2). The IRS often has taken the position that the specific theft loss provision under 165(c)(3), rather than 165(c)(2), applies to investment frauds. In some cases, however, the IRS has found that investors can claim relief under 165(c)(2) rather than 165(c)(3).

For both of these tactics (claiming lack of income or pursuit of profit), your requests for tax relief might be rejected. Alternatively, such requests might be granted initially and then later challenged.

A matter of time

Another thorny question relates to the timing of claiming a loss from a Ponzi scheme. According to the tax code, you can't take a deduction until you're reasonably certain of the amount you've lost. Any recovery (from a lawsuit, for instance, or from the Securities Investor Protection Corp.) would reduce the amount of your actual loss. However, it may be years before such issues are finally resolved. One approach is to claim a tax loss as soon as feasible once a prosecutor or regulator has charged a promoter with fraud. Take a deduction and amend prior returns. If you receive any assets in a subsequent recovery, you can pay income tax on the amount you collect.

Tax Calendar

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April 15

Individuals. File a 2008 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, or you can get an extension by phone or over the Internet. Then file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2009 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2009 estimated tax. Use Form 1040-ES.

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

Household employers. If you paid cash wages of $1,600 or more in 2008 to a household employee, file Schedule H (Form 1040) with your income tax return and report any employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of $1,000 or more in any calendar quarter of 2007 or 2008 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2008 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2008 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2009. A worksheet, Form 1120-W, is available to help you estimate your tax for the year.

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May 11

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

May 15

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