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Client Bulletin

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

For Now, a Zero Percent Tax Rate

A tax law passed in 2003 established a 15% tax rate for most long-term capital gains and for qualified dividend income. For lower income taxpayers, the rate was set at 5%. As of January 2008, that rate will be lower still. While higher income taxpayers will continue to pay 15%, lower income taxpayers will owe 0%. That is, they will include qualified dividends and long-term gains as income, but pay a 0% rate on that taxable income, instead of 5%. Current law calls for this 0% rate to remain in effect through 2010.

Setting the ceiling

The 0% rate applies to taxpayers who are in the 10% or 15% tax brackets for ordinary income. Those brackets include single filers with taxable income up to \$32,550 in 2008. For married couples filing a joint return, the 0% tax rate will be in effect up to \$65,100 in 2008. Those numbers are for *taxable* income, not gross income. A married couple might have \$70,000 or \$80,000 in gross income and still have less than \$65,100 in taxable income. In that case, they would owe no tax on qualified dividends and long-term gains.

Moreover, tax-exempt income from municipal bonds and municipal funds (funds that hold municipal bonds) does not count towards taxable income. Thus, the couple described above could have substantial holdings of municipal bonds and still get the 0% rate on qualified dividends and long-term gains.

Blended rates

The 0% rate is not all or nothing. As long as your taxable income (excluding long-term capital gains) is below the thresholds mentioned above, your long-term gains may be

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Did You Know?

During last summer's turmoil, hedge funds had a mere 0.10% gain in July and lost 1.52% in August. Hedge funds recovered to gain 2.82% in September 2007, their best performance since January 2006.

Source: Hedge Fund Research, Inc.



America Counts on CPAs

taxed partially at 0% and partially at 15%.

To see how this might work, suppose a hypothetical John and Mary Smith own no dividend-paying stocks or mutual funds. They take no long-term capital gains in 2008, through November. In December



2008, the Smiths consult with their CPA, who estimates their taxable income for the year will be \$45,000 if they do nothing else. After the meeting, the Smiths sell assets and realize \$60,000 in long-term gains by the end of the year. Of that \$60,000 gain, \$20,100 will be taxed at 0%. That's the spread between their \$45,000 in taxable income, not including the gain, and the \$65,100 ceiling for the 0% rate. The other \$39,900 of long-term gains (\$60,000 minus \$20,100) will be taxed at 15%.

Planning points

If those are the ground rules, how can you make the most of the 0% tax rate?

- **Hold dividend-paying stocks and stock funds.** Such holdings may work well for retired couples with modest taxable income. The dividend income will be tax free as long as taxable income is under

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Retirement Plans—2008 Update

Business owners, professionals, and self-employed individuals can choose among several tax-sheltered retirement plans. In most of these plans, contributions are tax deductible, investment income is untaxed, and withdrawals are taxable. Besides income tax, withdrawals usually are subject to a 10% penalty tax before age 59½. The penalty period ends at age 55, for those leaving a company.

Here are the most common retirement plans:

Traditional 401(k)s

Participants can make contributions of as much as 100% of their income, up to \$15,500 in 2008, the same as in 2007. Those who are 50 or older can contribute up to \$20,500. Many employers match some employee contributions.

Roth 401(k)s

A company that offers a traditional 401(k) can offer a Roth 401(k) as well. The contribution limits are the same, but there is no tax deduction. Participants can choose either version or split their contributions between the two. Overall, the \$15,500 or \$20,500 limits apply.

Why choose a non-deductible Roth 401(k)? Because all withdrawals are tax free after five years and after you reach

age 59½. The younger you are and the lower your current tax rate, the more appealing a Roth 401(k) choice will be.

Profit-sharing plans

Here, employers make contributions to employees' accounts. The contribution, which can vary from year to year, may



be up to 25% of each participant's compensation. In 2008, the contribution limit for any participant is \$46,000.

Profit-sharing/401(k) plans

This combination includes salary deferrals by employees and contributions by employers. The total in 2008 can be as high as \$46,000 for a participant, or \$51,000 for employees who are at least 50 years old.

Solo 401(k)s

These plans permit self-employed individuals to duplicate a profit sharing/401(k) plan, with contributions up to

\$46,000 or \$51,000 this year. Spouses who are on the payroll also can participate.

SIMPLE plans

Employees can defer some or all of their earned income, and employers must make a match. As the name suggests, paperwork is minimal. Limits are lower, though. Employees can contribute up to \$10,500 in 2008, while those who are 50 or older can make a catch-up contribution of up to \$2,500 and contribute up to \$13,000.

The maximum contribution in 2008 is \$23,500. That is a \$10,500 regular contribution, a \$2,500 catch-up contribution, and a \$10,500 employer match. Because the employer match is limited to 3% of compensation per year, only participants earning \$350,000 or more may get the maximum match.

Simplified employee pension (SEP) plans

These plans are even simpler than SIMPLE plans. They can be used by either self-employed individuals or employers. Either way, the maximum contribution this year is \$46,000. What's more, you have until October 15, 2008 to make a tax-deductible contribution for 2007, when the upper limit was \$45,000.

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the limit. At many dividend-paying companies, payouts increase periodically, which will help investors keep up with inflation. Higher dividends also may help share prices rise.

- **Take long-term gains, if that's desirable.** As long as your other taxable income is under the \$32,550 and \$65,100 ceilings, you can take capital gains and owe no tax this year.

You must be careful not to sell just for tax purposes—you may be relinquishing further gains if you sell too soon. Nevertheless, if you are thinking of taking some portfolio profits, this is a good opportunity.

- **Implement income-shifting strategies.** Suppose you are helping to support an elderly parent. You could give your parent appreciated stocks or fund shares to sell. Your parent would retain your basis in the shares

and your holding period but might owe no tax on a sale. A similar outcome could result if you are helping a grown son or daughter to buy a home, if the recipient is just beginning a career and has low earnings.

For any income-shifting strategy of this nature, keep gift taxes in mind. If you give over \$12,000 in assets to a recipient this year, you must file a gift tax return. If you

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Rough Times for Real Estate

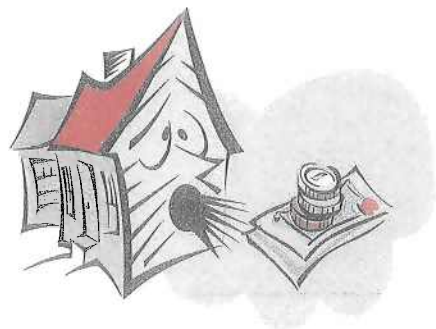
Foreclosures are up and home prices are down. The U.S. housing market is going through its greatest distress in 15 years. Both buyers and sellers are affected by the downturn. And on either side of a home sale, knowing about the current environment can help you come out ahead.

Debt defaults

RealtyTrac, an online marketplace for foreclosure properties, recently reported a total of 223,538 foreclosure filings—default notices, auction sale notices, and bank repossessions—during September 2007. That number is up 99% from the number reported in September 2006. With more foreclosures, more homes are on the market. Thus, a greater supply is available to would-be buyers.

Plunging prices

At the same time, mortgage lenders are tightening their standards. So-called



subprime borrowers (those with marginal credit ratings) are finding it difficult to get loans. What's more, lenders

are cutting back on nothing-down mortgages. Therefore, the U.S. housing market is seeing fewer buyers able to close deals while more homes are up for sale. Falling demand and rising supply is a formula for lower prices.

Indeed, home prices in 20 major U.S. cities were down 4.4%, on average, in the past 12 months, according to the Case-Shiller price index released by Standard & Poor's. That was the average, but some areas experienced larger losses: In Tampa, for example, there was a 10.1% decline.

Help for home buyers

Falling home prices, of course, appeal to buyers. If you or a family member is looking for a place to live, it may be possible to get a better deal now than a few years ago. Mortgage rates are a bit higher than they have been recently but are still low by historic standards. Fifteen- and 30-year fixed-rate mortgages now average 5.5%–6%.

The bottom line, then, is that mortgages are available, at reasonable rates, to buyers who have down payments and solid credit histories. In this environment, parents may want to help their children with a down payment if they need it to buy a home.

Slow times for sellers

Sellers not only must attract buyers who can choose between many homes, they also must attract buyers who can buy outright for cash or qualify for a mortgage. If selling isn't absolutely vital now, you might want to wait for a year or two, when there may be a better balance between buyers and sellers.

Some sellers can't wait, however. If you're in that situation, try to get your house into move-in condition. Buyers

probably will be more inclined to choose your house if they know they won't incur substantial fix-up expenses. You also should be aware that some buyers will have problems getting mortgages now. If possible, look for buyers who have been preapproved for the amount needed to buy your house.

Ladder climbers

What if you need to sell your current house in order to raise money to buy another one? Your best strategy is to focus on selling before making any commitments to buy. If necessary, drop your asking price in order to facilitate a home sale. Although that will put fewer dollars in your pocket, it is very likely you'll be able to save that much and more by shopping around for a replacement home.

Good news, bad news

If you bought your house years ago, you may have a profit on a sale now. That's true even though selling prices have dropped recently. Fortunately, the tax code provides an exemption for up to \$250,000 worth of capital gains on the sale of a principal residence. The exemption goes up to \$500,000 for married couples filing jointly. To qualify, you must have owned the home and used it as your principal residence for at least two of the five years preceding the date of sale.

On the other hand, if you bought your house recently, at the peak of the market, you might have a loss on a sale now. However, this loss does not count as a capital loss. You can't use this loss to offset capital gains, and you can't deduct a housing loss from your ordinary income.

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already have used up your \$1 million gift tax exemption, you will have to pay gift tax.

- **Keep the "Kiddie Tax" in mind.** Complicated new rules take effect in 2008. Generally, full-time students under age 24 can have only \$1,800 in low-taxed income this

year, with excess amounts taxed at the parents' rate. Therefore, you might want to give students enough appreciated securities so they can sell them and have the full \$1,800 worth of investment income this year, taxed at bargain rates.

Beyond \$1,800, there is no immediate tax payoff to be gained from giving appreciated securities to "kiddies." You might, though, give appreciated assets to your 23-year-old graduate student this year, planning for a 0% sale in 2009, at age 24.