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The Pretirement Press

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In This Issue

While tax year 2008 is now behind us, there are some important things to keep in mind for 2009. These include ongoing, inflation-based adjustments to existing key tax numbers, temporary and permanent modifications due to the stimulus package that was passed earlier this year, and the prospect for many changes in the next 18 months as the Bush tax cuts expire, the direction of the new administration takes hold, and Congress looks for long-term solutions that can reduce our current deficit and pay down the massive amount of debt we've amassed. This newsletter will cover these topics in an attempt to keep you informed about those items that are most likely to affect you. While the focus of the Q2 newsletter is tax, it also concludes with the customary PWA quarterly market update as well. Now, onto taxes. ■

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The $787B Stimulus: What's In It For You

On February 17th, President Obama signed into law the "American Recovery and Reinvestment Act of 2009", more widely known as "The Stimulus". This act is much bigger and broader than the stimulus of the previous year which included the $300 and $600 rebate checks to most U.S. families. While the bill was the subject of many heated political debates in the press and in Congress, we'll steer clear of politics and simply let you know what's in the package that may affect you. Much of the bill seeks stimulus through spending, but there are also some tax cuts. There are also income phaseouts for many of the benefits in the stimulus package, so if you're a high-income earner (as defined by Congress and the President), you may not see these benefits directly, but the intent is for them to stimulate the economy and help increase the quality of life for everyone. Here are some of the tax-impacting items in the stimulus:

For Individuals:

- First-Time Homebuyer Credit – a credit for 10% of the price of a home (capped at $8000) purchased prior to 12/1/09. You can only take the credit if you haven't owned a home in the last 3 years and you have to pay it back if you live in the new home for less than 3 years. Income phaseout: $75k individual, $150k couple.

- New Car Sales Tax Deduction – a deduction on your 2009 taxes for sales tax paid on a new auto purchase (new only, not used). If you buy a $30k car and are in an 8% sales tax area, that translates to a $2400 deduction and an ~$800 tax savings. Income phaseout: $125k individual, $250k couple.

- 529 Plan Expenses Broadened – for 2009 and 2010, distributions from a 529 educational fund

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will be tax free if used for computers and computer technology in addition to tuition, room and board which were previously allowed.

- Education Credit – a credit for up to $2,500 per year of undergraduate tuition for you or a dependent in 2009 and 2010. Now called the American Opportunity Tax Credit, this credit enhances and replaces the existing Hope Scholarship Credit which applied to only the first two years of college. Income phaseout: $80k individual, $160k couples.

- Unemployment Compensation – unemployment income is typically taxable income. The stimulus made the first $2400 received non-taxable for 2009.

- COBRA Benefits – a subsidy of up to 65% of the cost of COBRA benefits from Sept 2008 through 2009 if you are laid off and wish to use COBRA to continue your healthcare and other insurance.

- AMT Patch – the AMT exemption amounts have once again been raised to the 2008 levels plus an inflation factor. There is still no permanent fix for the exemption. As it sits now, it will revert back to a much lower number in 2010 which would include ~26M more taxpayers facing AMT. The stimulus also removes the need for AMT payers to include in income any municipal bond interests from "private activity bonds" if the bonds are issued in 2009 or 2010.

- Transit Benefits – an increase in the income exclusion for transit passes and van pooling to $230 / month from $120 / month.

- Energy Property Credit – several enhanced and new credits toward green homes (see www.energystar.gov/index.cfm?c=products.pr_tax_credits for details) and green cars (up to $7500 for purchase of hybrids with qualified batteries).

- Small Business Stock Exclusion – for investments in small business stock made between 2/17/09 and 1/1/2011, if held for more than five years, up to 75% of any gain realized may be excluded from income.

- Making Work Pay Credit – a tax credit calculated at a rate of 6.2% of earned income up to $400 for individuals and $800 for joint filers applied retroactively to the start of 2009 continuing through 2010. For employees, the credit will be claimed through a reduction in wage withholding which has already gone into effect. The credit begins to phase out above adjusted gross income (AGI) of $75,000 ($150,000 in the case of joint filers). If you are a married couple and you both work, or if you work more than one job, your employer's payroll system may not calculate the break properly, which means you could receive the credit during the year and have to pay it back at the end of the year.

- Economic Recovery Payment – a one-time $250 check sent to Social Security recipients and disabled veterans.

For Small Business:

- Sec. 179 Expensing & Bonus Depreciation – allows for depreciating up to $250k of assets placed in service in 2009 (with phaseout beginning at $800k of assets placed in service), and an additional 50% immediate "bonus" depreciation of the rest of the assets.

- Loss Accounting – small businesses can carry back a 2008 net operating loss 3, 4, or 5 years instead of the standard 2.

All of these stimulus tax changes are currently set to expire over the next year and a half. But, there are already talks in Congress over making the Making Work Pay Credit and the enhanced Education Credit permanent. ■

The Top 10: Tax Return Mistakes To Avoid

1) Incorrect bank account and/or routing numbers for direct deposit. If you use the wrong number and that number doesn't exist at the bank, the deposit will bounce back to the IRS and they will eventually send you a check. But, if the routing number and account number match an actual account at the bank, the money will be deposited and you will have to deal directly with the bank and the account holder to try to recover your refund.

2) Contributing to a Roth IRA when you don't qualify. $5k is the maximum contribution allowable (+$1k if you're over age 50), but there are also income limits (see Key Tax Numbers on the PWA website under the resources section). If you over-contribute, it usually means withdrawing the contribution or recharacterizing it, and amending your tax return in some cases.

3) Incorrect cost basis, gain, and loss reporting on investment sales. The average cost method is not allowed for stock basis reporting and estimates are also not allowed. You need statements or other documentation proving your cost basis for everything you sell or the IRS can make you treat the entire sale as a taxable gain!

4) Not following depreciation rules for rental property. If you own rental property you have to depreciate its value for tax purposes which creates more of a loss in each year of the life of the rental (i.e. you pay less tax each year). The downside is that you have to recapture that depreciation at the time of sale and make up for the tax break you got over the years. Even if you don't take the tax break by depreciating the property while you own it, you still have to recapture the depreciation at the time of the sale. If you're doing this wrong it could cost you thousands of dollars in tax!

5) Taking too many "red flag" deductions. You're asking for an audit if you're deducting large amounts of business meals and expenses (especially in an industry where that's not typical), large unsubstantiated charitable donations, or other miscellaneous deductions.

6) Not taking enough deductions. You give $100 to charity here, $50 there, donate a few bags of old clothes, drive somewhere to participate in a charitable event, but don't keep track of it all and don't keep proper records? You could be paying hundreds of dollars of extra tax each year.

7) Attempting to offset gambling winnings for which you received a W-2G, by simply subtracting your other gambling losses from them and reporting the net amount. This will not work and could lead to an audit.

8) Incorrect last name / SSN combination. This is especially possible if you recently changed your name due to a marriage or divorce. If your return is rejected, you may have to use your old (or new) last name.

9) Filing an extension out of laziness especially when you will receive a refund. You're providing Uncle Sam with an interest-free loan for another 6 months instead of using that money for yourself to invest or pay down debt.

10) Blindly using tax software like Turbo Tax for complex tax situations like rental depreciation (see #4), employer investment plan sales (ESPP's stock options, restricted stock), or self-employment income. These programs will do the calculations correctly, but only if you input the information correctly. Without knowing the tax law and terminology, many people incorrectly enter these items and wind up paying extra tax. ■

For Your Information: The 2009 Tax Brackets

If you are:	And your taxable income is more than	But less than:	You pay	Plus	of the amount that your income exceeds:
Single	$ -	$8,350	$ -	10%	$ -
	$8,350	$33,950	$835	15%	$8,350
	$33,950	$82,250	$4,675	25%	$33,950
	$82,250	$171,550	$16,750	28%	$82,250
	$171,550	$372,950	$41,754	33%	$171,550
	$372,950	NA	$108,216	35%	$372,950
Head of Household	$ -	$11,950	$ -	10%	$ -
	$11,950	$45,500	$1,195	15%	$11,950
	$45,500	$117,450	$6,228	25%	$45,500
	$117,450	$190,200	$24,215	28%	$117,450
	$190,200	$372,950	$44,585	33%	$190,200
	$372,950	NA	$104,893	35%	$372,950
Married Filing Jointly	$ -	$16,700	$ -	10%	$ -
	$16,700	$67,900	$1,670	15%	$16,700
	$67,900	$137,050	$9,350	25%	$67,900
	$137,050	$208,850	$26,638	28%	$137,050
	$208,850	$372,950	$46,742	33%	$208,850
	$372,950	NA	$100,895	35%	$372,950

Someone is said to be "in" a federal tax bracket if their taxable income (income after itemized deductions or the standard deduction) is between the low and high income range for that bracket. For example if you are marred and filing jointly, you are in the 28% federal tax bracket if your taxable income is between $137,050 and $208,850.

Tax Facts: Key Info For 2009

We've compiled a list of biggest changes and notable "unchanges" likely to affect the greatest number of people so that you can be aware of those items that might impact how you earn, invest, or spend your money this year.

1) IRA (traditional and Roth) contribution limits remain at $5,000 for 2009 (plus $1,000 catch-up contribution for those over age 50). Please note, there are eligibility requirements concerning the amount of income you make and whether or not you are participating in another retirement plan that may limit your ability to contribute to a traditional or Roth IRA. Discuss it with your advisor before contributing.

2) For those individuals who are in the 10 or 15% Federal income tax bracket, the long-term capital gain tax rate and dividend tax rate remain at 0% in 2009. That means all long-term capital gains and dividends are tax free!

3) The Social Security wage limit has increased to $106,800. This refers to the 6.2% FICA tax that you pay on your wages. If you're an employee and you made over $102,000 last year, you probably noticed that toward the end of the year you stopped having a FICA deduction from your paycheck. This is because of the social security wage limit that caps FICA tax at 6.2% of the first $102,000 of wages. In 2008, that cap is now $106,800.

4) The standard deduction has increased by $250 to $5,700 for single filers and by $500 to $11,400 for married filing jointly. Unless you have itemized deductions (mortgage interest, investment expenses, charitable contributions, non-federal taxes paid, some medical expenses, and miscellaneous deductions) greater that this amount, you will be taking the standard deduction which means you lose the incremental benefit of the itemized deductions.

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5) Personal exemptions (the amount deducted from your income per person and dependent in your family) has increased by $150 per person to $3,650 per person.

6) The deduction for business mileage has decreased to 55 cents per mile. It was 50.5 cents for the first half of 2008, but increased to 58.5 cents for the second half. If you use your car for business purposes (other than commuting), you may be eligible to deduct this amount.

7) The maximum contribution to a 401k plan increased to $16,500 (+$5500 if you're over age 50) for 2009. Contributions to a SIMPLE plan increased to $11,500 (+$2500 if over age 50).

8) See The $787B Stimulus above for additional temporary changes.

As always, you can find all the key tax numbers for 2009 on the PWA Website under the Resources link on the left navigation menu. ■

Did You Know: Adjusted Gross Income & Tax Deductions vs. Tax Credits

Adjusted Gross Income (AGI)

Many tax deductions and credits use income limits (called "phaseouts") as a threshold for who qualifies and who doesn't. In most cases, these phaseouts are based on the taxpayer's AGI (Adjusted Gross Income). So, what is Adjusted Gross Income? It is your gross income minus your deductions for adjusted gross income. For most people gross income is your salary minus your pre-tax deductions on your paystubs (including traditional 401k contributions, health insurance, flexible spending accounts, etc.) plus any interest or dividend income, alimony received, gambling income, profits from self-employment, asset sales, rental income, or farm income. Common deductions for AGI include health savings account contributions, certain moving expenses, 50% of self-employment tax, alimony paid, deductible IRA contributions, and student loan interest. Take all the income minus all the deductions and you have AGI. Note that itemized deductions such as mortgage interest, state and local taxes, property taxes, charitable contributions, and employee expenses, do not reduce AGI. They are deducted after AGI is calculated.

Tax Deductions vs. Tax Credits

Many people are confused about the difference between a tax deduction and a tax credit. To someone who doesn't know how the tax system works, it may seem like the two words are used interchangeably with the same meaning. But, that is not the case. A tax credit is a reduction in your total tax. Let's say after income and deductions, you make $100k and pay $20k in tax for a given year. A $1k tax credit reduces your tax bill to $19k. It doesn't mean you'll necessarily get a $1k tax refund when you file your return, because that's dependent on how your withholdings and/or estimated tax payments compare with your actual tax bill. An example of this type of credit is the child tax credit, which reduces tax for parents up to $1k per child.

> *"… tax credits give a much bigger discount on tax paid than tax deductions do."*

A tax deduction, on the other hand, is a reduction in the income used to determine how much tax you pay in a given year. Using the same example, if you make $100k and pay $20k in tax for a given year, but you have a $1k tax deduction, it would reduce your taxable income to $99k. After applying your tax rate, you would only see a $200-$400 reduction in tax. And example of a tax deduction is a deductible contribution to your traditional IRA. As you can see, tax credits give a much bigger discount on tax paid than tax deductions do. ■

In Focus: We Asked For Change, Here It Comes

The new administration has already made significant changes to the tax code through the stimulus plan described earlier, but there is a lot more to come. Much of the tax code is scheduled to revert back to its 2001 status when the acts commonly known as "the Bush tax cuts" expire. Among these include a return of the long-term capital gains tax rate to 20%, an increase in the dividend tax rates to income tax rates, and an increase in the tax rates for most brackets. Rather than accept a reversion to the 2001 code, Congress and President Obama are likely to work together to keep some of the existing rules and create some new ones, all with the intent of shrinking the budget deficit while paying for some large new programs. While everything is up for debate, here's what it looks like may be on the horizon:

- Taxing some or all of employer-provided health insurance premiums (i.e. the part of health insurance that your employer pays for rather than you) and/or potentially limiting or doing away with flexible spending plans to help pay for a partially nationalized healthcare system. It's likely that increased taxes would only apply to upper-income individuals (AGI > $100k) and couples (AGI > $200k).
- A potentially large ($3k-5k) tax credit for individuals who trade in cars with a low MPG rating for those with a significantly higher one.
- Setting the estate tax exemption amount to $3.5M per individual rather than eliminating the estate tax in 2010 and then reverting the exemption back to $1M in 2011 as is currently scheduled. It is likely the exemption amount will be indexed to inflation so that it will rise as the cost of living rises over the years. There is an outside chance that Congress may also change the exemption from $3.5M per person to $7M per couple. This would eliminate the need for complex estate planning strategies in wills that involve the creation of bypass trusts at the death of the first spouse.
- Keeping the maximum 45% estate tax rate rather than letting it revert back to 55% in 2011. A downside may be tighter controls on estate valuation discount techniques.
- It is likely that the existing 10%, 15%, 25%, and 28% tax brackets will be kept as they are. It is also likely that the 33% and 35% brackets will move up to 36% and 39.6% respectively.
- A reduction in the amount of itemized deductions (mortgage interest, state and property taxes, charitable deductions, etc.) and personal exemptions for individuals in the top 2 tax brackets is likely.
- An increase in the long-term capital gains rate from 15% to 20% for those in the top 2 tax brackets is highly likely.
- An increase in the dividend tax rate from 15% to either 20% or to income tax rates for the top 2 tax brackets (and maybe others) is highly likely
- Additional taxes on alcoholic beverages have been proposed (40-50 cents per six-pack, bottle of wine, or fifth of liquor). Taxes on sugar-sweetened beverages are also a remote possibility.
- The deductibility and maximum amounts of contributions to health savings accounts may be challenged. How health savings accounts fit into a partially nationalized healthcare system remains to be seen.
- The payroll tax credit that the stimulus introduced for individuals earning less than $75k and couples earning less than $150k may be made permanent.
- The $2500 / year tuition deduction that was enhanced by the stimulus may be made permanent.

This is just a peak at some of the potential changes. There is much debate still ahead in Congress and we'll update this information in future PWA newsletters as it becomes more certain. ■

Markets: Spring Brings New Life

Since the last PWA newsletter just three months ago, the broad U.S. stock market, as measured by the S&P 500 index is up 26% (thru May 31st). As comforting as that is, an even better sign for recovery is that higher risk investments performed even better. Small cap stocks were up 35%, emerging market stocks up 53%, and for the first time in several quarters, high-yield (high-risk) bonds outperformed medium-term treasuries (low-risk) by more than 6%. After a period of 18 months where the risk was truly treated as a four-letter word, an appetite for that same risk has returned. We believe this is due to the end-of-the-financial-world trade being taken off the table. Banks have been able to raise money privately in the free market, rather than only being able to get it from the government. Some are even beginning to repay the government in full for their investment. While the longevity of each individual bank remains to be seen, it is now perceived that the financial system we rely on for security and economic growth is stable.

Markets At A Glance

Segment*	2008	Last 3 Months	YTD 2009	
US Large Cap Stocks	-36.8%	26.0%	3.2%	thru 5/31
US Small Cap Stocks	-36.1%	34.9%	6.6%	thru 5/31
Foreign Developed Stocks	-41.4%	35.4%	5.8%	thru 5/31
Foreign Emerging Market Stocks	-50.0%	53.2%	33.1%	thru 5/31
US Treasury Bills	1.8%	0.2%	0.3%	thru 5/31
US Med Term Treasuries	18.0%	-1.6%	-6.1%	thru 5/31
US Long Term Treasuries	33.8%	-6.7%	-20.2%	thru 5/31
US Aggregate Bond Index	5.2%	0.6%	-0.5%	thru 5/31
US Corporate Bonds	0.3%	2.8%	-1.6%	thru 5/31
US High Yield Bonds	-23.9%	5.7%	6.7%	thru 5/31
US REITs	-37.0%	39.3%	-8.8%	thru 5/31
Gold	3.0%	1.7%	11.9%	thru 5/31
Oil	-54.7%	37.8%	10.0%	thru 5/31
Aggregate Commodities	-36.7%	19.7%	7.8%	thru 5/31
US Home Prices	-18.6%	-7.0%	-7.0%	thru 3/31
GDP Growth	-6.2%	-1.5%	-1.5%	thru 3/31
Unemployment Rate**	7.2%	9.4%	9.4%	thru 5/31
Inflation (CPI) Y/Y	0.1%	0.8%	-0.7%	thru 5/31

*All asset class / commodity returns shown are returns by representative ETF
** Indicates ending value rather than change

Well, here's to a new bull market, right? Not so fast. You may remember in past newsletters we explained that part of the tumble in asset prices was due to real damage done to the economy and part was due to fear of both the unknown and a possible meltdown of the financial system. As 2009 has evolved, the uncertainty and the fear have gone away and that has led to a voracious rebound. But, the damaged economy still exists and it continues to worsen, albeit at a slower pace than before. Economists and reporters have begun to speak of "green shoots" in our economy, drawing the analogy to the first sprouts of life in an area that was devastated by disaster. Slightly better consumer confidence… a little movement in home sales in some areas… a decline in the rate of home price depreciation… a decline in the number of jobs being lost each month… all good signs that the our economy is not plunging into an abyss. But, none of them show that the worst is definitely behind us. Additionally, many of those green shoots may have been caused by the government keeping interest rates low by intervening in financial markets, printing money, and running a massive deficit. Eventually, the government will have to find a way to pay for all it is currently doing (read: higher taxes). With almost 1 in every 10 people out of work, house prices still falling, and higher taxes/less fiscal stimulus in the future, we can see it's going to be a long road back to U.S. prosperity.

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PWA's president, Tom Nardozzi, is a CERTIFIED FINANCIAL PLANNER™

In the financial markets, we're now seeing a struggle as fear of the end of the financial world abates and puts a floor under stocks, but continued economic turmoil and declining forecasts for corporate profits put a ceiling above them. In the bond market we see expectations of future inflation increasing long-term interest rates as the Fed & Treasury continue with extreme measures of monetary stimulus. But we also see those same worries of an extended recession pushing rates back down. In the commodity markets, we see prospects for the resumption of global growth through emerging markets pushing energy prices up, and the stalling of growth in developed markets pushing prices down. Back and forth like on a teeter-totter these forces battle each other and continue to create day-to-day volatility. But, that same volatility has become self-regulating as well. When it looks like conditions are improving and the stock market moves up, oil prices and interest rates jump pushing it back down. When pessimism sets in for the stock market, oil prices and interest rates come down too, thereby restoring hope for economic recovery. We believe this will lead to more stable markets over the medium term. We told clients in March that we believed the 10% per week moves down in the market were behind us thanks to the "game-changer" by the Fed and Treasury. After this recent run, it's likely that the 10% per week up moves are also behind us for a while.

Of course, for those with a well thought out financial plan and an asset allocation that keeps that plan and their goals in mind, the short-term movements of financial markets have little relevance. Think of them as background noise that PWA listens to and filters out for you so you can live life to the uninterrupted tune of your choice. Whatever that tune is, we hope it accompanies you through a wonderful summer.

The Pretirement Press is a PWA's quarterly newsletter to clients. If you have comments or suggestions for future newsletters please contact us at newsletter@perpetualwealthadvisors.com. If you're not a PWA client, but received this newsletter and would like to be added to our mailing list, please send an email to subscribe@perpetualwealthadvisors.com. As always, if you or someone you know is interested in PWA's comprehensive planning, asset management, decision support, or tax prep services, please contact us to set up a free consultation. It's a small amount of effort to start down the journey to perpetual wealth.