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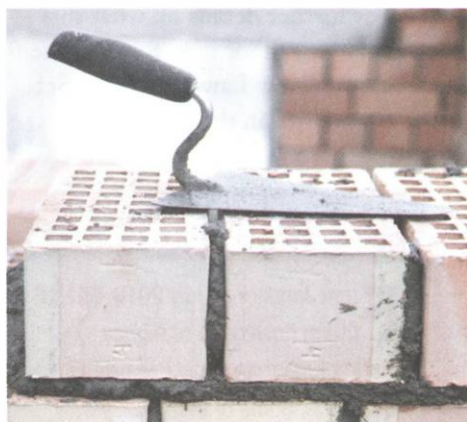
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CPA Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business AdvisorSM

What Financial Reform Means to You

December 2010



In July 2010, President Obama signed the Dodd–Frank Wall Street Reform and Consumer Protection Act into law. Although the law will mainly affect financial institutions, it also will have an impact on consumers, investors, and borrowers.

In general, the main purpose of the law is to reduce risk in the U.S. financial system. New regulatory agencies will be created, and others will be merged or eliminated. Ideally, this revised regulatory structure will help the U.S. economy avoid future financial crises such as that of 2008, which continues to cause turmoil for both the U.S. and global economies.

In addition, the creators of this legislation wanted to prevent the abuse of consumers by financial services companies. Therefore, several provisions of the new law are designed to provide consumer protection.

Powerful protector

Among other things, the law calls for the creation of a Consumer Financial Protection Bureau, which is scheduled to begin operating sometime in 2011. It will regulate banks, credit unions, mortgage brokers and servicers, foreclosure relief services, credit card issuers, and similar types of businesses. (Not all companies will be covered: auto dealers, for example, generally will be exempt from the Bureau's oversight.)

The new bureau will have broad powers. It will be able to write and enforce rules for financial services firms, covering areas such as deceptive lending practices. The bureau also will monitor and report on financial services, such as payday loans and check cashing shops, with the intent to minimize abuses. The new law specifically requires the bureau to conduct a study on reverse mortgages; other possibly controversial topics also are likely to come under scrutiny.

For some types of financial products and services, the drafters of the new law were not willing to wait for the Consumer Financial Protection Bureau to act. For example, the Dodd-Frank Act requires that all consumers who are denied credit or a loan, or have been charged a higher interest rate based on their credit record, are entitled to a free copy of their credit score in addition to a free credit report.

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CPA

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You can request a free credit report every 12 months at www.annualcreditreport.com, from each of the major credit reporting companies: Equifax, Experian, and TransUnion.

Trusted Advice

Federal Deposit Insurance

- ▶ The Federal Deposit Insurance Corporation (FDIC) insures deposits up to \$250,000 per depositor per bank. If that amount is insufficient, you can spread your accounts among multiple banks for more coverage.
- ▶ Another option is to add joint accounts at the same bank. If Jason and Jill Jones each have \$250,000 individual deposits at their local bank, they can open an additional \$500,000 joint account there and get full FDIC coverage.
- ▶ In addition, Jason and Jill can each have an IRA at the same bank, with FDIC coverage up to \$250,000 apiece.
- ▶ Besides all of these accounts, you also can get FDIC coverage for “trust accounts,” which are payable on death to specific beneficiaries. If Jason opens up a trust account with two children as beneficiaries, FDIC insurance for that account would go up to \$500,000.

Specific provisions

Other provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act include the following:

- ❖ Funding for the U.S. Department of Housing and Urban Development to manage a \$1 billion Emergency Homeowners Loan Program is provided. Borrowers who are at risk of foreclosure can receive up to 24 months of financial assistance.

To implement the program, state and nonprofit agencies will offer 0% interest loans of up to \$50,000. Loans will be made to borrowers who have had a substantial reduction in income because of job loss, income loss, or health problems. Borrowers must have had a good credit record prior to the income loss and be able to show a reasonable likelihood of resuming debt repayment within two years.

- ❖ Federal deposit insurance has been increased to \$250,000 per depositor per bank for the foreseeable future. The previous ceiling of \$100,000 was increased during the financial crisis. Under prior law, the \$100,000 limit was scheduled to return in 2014. Now the \$250,000 cap is “permanent,” at least until a new act of Congress sets another limit.

- ❖ Many managers of hedge funds and private equity funds will be required to register with the Securities and Exchange Commission (SEC), which hasn't previously been the case. They will have to disclose information to the SEC about their investment positions and the amount of leverage involved. Investors who participate in such funds may benefit from the increased information and greater fraud protection.
- ❖ The new law authorizes the SEC to conduct a six month study on the impact of changing the current suitability standard for broker-dealers to a fiduciary duty. For further details on what this could mean for investors, see the article “New Law May Help Set Standards” in this issue. ■

Did You Know?

From January to July 2010, \$515.6 billion flowed out of money market funds, primarily because of low yields. Some of that money may have moved to higher yielding bond funds, which attracted a net new cash flow of \$185.6 billion in that period.

Source: Investment Company Institute

New Law May Help Set Standards

As part of the Dodd–Frank Wall Street Reform and Consumer Protection Act, the Securities and Exchange Commission (SEC) is charged with looking into the responsibilities that certain financial firms have to their clients. Now, broker-dealers must observe a suitability standard. The SEC will look into whether a fiduciary duty is more appropriate.

Defining the terms

The term *broker-dealers* generally refers to a financial firm that engages in securities trades on behalf of clients and also for its own account. Securities brokerage firms (including the major Wall Street firms) and insurance companies are often broker-dealers. Firms that develop and sell consumers their own investment products, such as mutual funds, are broker-dealers.

Representatives of broker-dealers, including stock brokers and insurance agents, must meet a suitability standard when offering investment advice to clients. This means that the representatives must recommend investments that are suitable for a client, based upon the client's stated goals and individual circumstances. By this standard, for example, a representative probably should

not sell an aggressive growth stock mutual fund to an elderly widow who states that she wants capital preservation and steady investment income.

By comparison, registered investment advisory (RIA) firms and their representatives have a fiduciary duty to do what is best for each client. Some smaller, independent firms are RIAs. With a fiduciary duty, an investment advisor must put the client's interest first, rather than the interests of the advisor or his firm. The advisor must provide full disclosure on subjects such as investment risk and advisor's fees; he must reveal any possible conflicts of interest, such as recommending an investment from which the advisor stands to profit.

Impact on investors

The SEC study required by the new law may result in a recommendation that the fiduciary duty replace the

suitability standard, at least in some areas of the financial industry. If that causes broker-dealer representatives to provide more personalized recommendations, with greater disclosure and fewer conflicts of interest, so much the better.

Such an outcome is by no means guaranteed. Some broker-dealers have argued against this change in the past and may continue to do so. They contend that the more rigorous fiduciary duty would lead to a greater focus on affluent investors—who can afford to pay more for individualized service—and reduce the advice available to average investors.

Regardless of how this controversy is resolved, you should not get caught up in definitions. You can get good advice from broker-dealer representatives and from RIAs; it's also possible to get poor advice or even fraudulent behavior from people in either camp. Choose advisors



with care, perhaps after getting recommendations from people you trust. Pay attention to what an advisor is doing with your money and how much he's charging you. Change advisors if you become unhappy—and be especially skeptical of anyone who makes promises that sound too good to be true. ■

The Return of Estate Tax Planning

After a one-year repeal in 2010, the federal estate tax is scheduled to return for deaths occurring in 2011 and later years. If you expect to leave a sizable estate, you probably will want to plan for this tax. Otherwise, your beneficiaries might owe hundreds of thousands, or even millions, of dollars in estate tax. (See the November 2010 *CPA Client Bulletin* for suggestions about year-end estate tax planning in these uncertain times.)

Net worth

At your death, your executor will be responsible for rallying all of your assets and, thus, determining the size of your estate. Those assets could include your home, other real estate, stocks and other securities, bank accounts, retirement accounts, artworks, and so on. From this so-called "gross estate," your executor will subtract outstanding

debts and various final expenses (funeral costs, medical bills) to get a net value of your assets.

Although the future of estate tax legislation is uncertain, you probably can assume certain tax benefits will remain in place. Bequests to charity can be deducted from your estate for tax purposes. The same is true for any amount of assets left to a surviving spouse who is a U.S. citizen.

Example 1: Len Jordan dies with \$6 million of net assets. In his will, Len leaves \$1 million to various charities. He leaves the rest of his estate, totaling \$5 million in assets, to his wife, Pam. Therefore, Len has no taxable estate, and no estate tax is due.

Estate tax exemption

In addition to charitable and spousal estate tax breaks, you can assume that another exemption from federal

estate tax will exist. The amount of this additional exemption in 2011 is unknown, as of this writing. Estimates generally range from \$1 million to \$5 million. Under current law, unless Congress acts by year-end 2010, the federal estate tax exemption in 2011 will be \$1 million. (That estate tax exemption is reduced by the amount of any lifetime gifts that use the gift tax exemption, now set at \$1 million.) Estate assets from \$1 million to \$1.25 million will be taxed at 41%; the tax rate increases to 43% for assets from \$1.25 million to \$1.5 million, 45% for assets between \$1.5 million and \$2 million, and so on until amounts over \$3 million are taxed at 55%. (A 5% surtax will apply to certain amounts over \$10 million.)

Example 2: In the previous example, Len Jordan left \$5 million to his wife, Pam. Assume Pam dies

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in 2011 with an estate of \$6 million and leaves \$2 million to charity. The other \$4 million, which is subject to estate tax, is left to their son Greg.

Assume that current law remains in effect, with a \$1 million estate tax exemption scheduled for 2011 and tax rates starting at 41%. Also assume that Pam did not use any of her lifetime gift tax exemption. The first \$1 million of Greg's inheritance will not be taxed because of the estate tax exemption. Pam's estate will owe estate tax on the remaining \$3 million at rates ranging from 41% to 55%. Altogether, Pam's estate will owe \$1,495,000 in federal estate tax. Instead of inheriting \$4 million, Greg will inherit \$2,505,000. (Greg may inherit even less, if state estate tax also is due.)

In these examples, Len "wasted" his federal estate tax exemption by

leaving everything to Pam at his death. Consequently, Pam died with a large estate that was heavily taxed.

Example 3: With some estate tax planning, Len might have left \$1 million to their son Greg and \$1 million less to his widow, Pam. With a \$1 million exemption, no estate tax would have been due at Len's death. Then Pam would have died with a \$3 million taxable estate, not \$4 million. This simple step could have saved \$550,000 in federal estate tax, which would have gone to Greg instead of going to the IRS; Pam would have had an estate smaller by \$1 million at her death, and her estate would have avoided paying 55% tax on that last \$1 million.

Trust tactics

The previous examples are simplified to explain some estate tax concepts.



When planning for estate tax, many professionals suggest that clients use trusts. Properly structured trusts can help reduce future estate tax and provide trust beneficiaries with creditor protection and safeguards against wealth depletion. ■

TAX CALENDAR

DECEMBER 2010

December 15

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

Corporations. Deposit the fourth installment of estimated income tax for 2010.

JANUARY 2011

January 18

Individuals. Make a payment of your estimated tax for 2010 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2010 estimated tax. However, you don't have to make this payment if you file your 2010 return and pay any tax due by January 31, 2011.

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

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2010. Payments that are covered include (1) compensation for workers who are not considered employees; (2) dividends and other corporate

distributions; (3) interest; (4) rent; (5) royalties; (6) profit-sharing distributions; (7) retirement plan distributions; (8) original issue discount; (9) prizes and awards; (10) medical and health care payments; (11) debt cancellations (treated as payment to debtor); (12) payments of Indian gaming profits to tribal members; and (13) cash payments over \$10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2010.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2010 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2010.

For all taxes, deposit any undeposited tax. If the total is less than \$2,500 and not a shortfall, you can pay it with the return. If you deposited the tax for the year in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2010. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

CPA Client Bulletin

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Citation and Resource Guide

What Financial Reform Means to You

- The full text of the Dodd–Frank Wall Street Reform and Consumer Protection Act can be found at http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

New Law May Help Set Standards

- For a look at how an SEC director views advisors' fiduciary duty, go to www.sec.gov/news/speech/spch022706lar.htm.

The Return of Estate Tax Planning

- The IRS answers common estate tax questions at www.irs.gov/businesses/small/article/0,,id=108143,00.html.

Practice Development Tip

Request IRS Form 8606

In December, you probably will schedule tax planning meetings with clients. When you make appointments, remind clients to bring in statements showing IRA balances as well as the latest copy of IRS Form 8606, "Nondeductible IRAs," that they filed with a federal income tax return. This form shows nondeductible contributions made to traditional IRAs. Such information may be vital for year-end tax planning.

The data from Form 8606 can show the tax that clients will owe on distributions from traditional IRAs. Suppose you have a client, Joe Biggs, age 60. He wants to take \$10,000 from his traditional IRA to take his family on a holiday vacation. In Joe's 28% tax bracket, he expects to net \$7,200 from the distribution.

However, by going over Joe's Form 8606, you discover that he has \$100,000 in his traditional IRA, including \$25,000 from nondeductible contributions. Therefore, Joe's IRA distributions will be 75% taxable, and he will have a 25% tax-free return of after tax dollars.

You might explain to Joe that if he takes \$10,000 from his IRA, only \$7,500 will be taxable. In a 28% tax bracket, Joe will owe \$2,100 in tax. He'll net \$7,900 and be able to spend more on a family vacation.

The same information can be used to show the tax obligation from a Roth IRA conversion. In this example, Joe can convert his entire \$100,000 traditional IRA to a Roth IRA and report only \$75,000 in taxable income.

Form 8606 can help clients plan for partial Roth IRA conversions, too. Suppose Joe wants to pay no more than about \$10,000 in income tax on a Roth IRA conversion. You might calculate that Joe could convert \$48,000 of his traditional IRA; if 75% of the conversion is taxable, Joe would report \$36,000 (75% of \$48,000) of taxable income on the conversion. In Joe's 28% tax bracket, he would owe \$10,080 in tax on \$36,000 of conversion income.

As 2010 draws to a close, many clients may be eager to make Roth IRA conversions, yet anxious about paying the resulting income tax. Clients who have nondeductible contributions in their traditional IRAs will be relieved to learn their conversion will be only partly taxed and will appreciate your help in making decisions about Roth IRA conversions.

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