

the Competitive

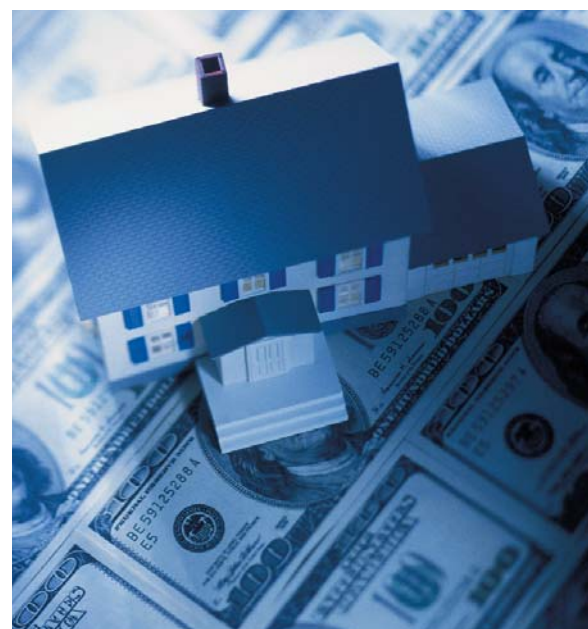
Edge

Sub-Prime: What's Happening?

Global financial markets are experiencing tremendous declines in value over the last few quarters, with losses estimated to exceed trillions of dollars. The uncertainty in stock markets, caused by concerns regarding banks' and financial institutions' solvency, is contributing to a global economic slowdown. The resilient, \$50+ trillion world economy may be in trouble and it all started with a relatively small percentage of home loans in the United States. The current crisis took root about six years ago when interest rates were at historic lows and mortgage lenders in the United States were providing quick and easy mortgages to almost all who applied. Between 2002 and 2006, millions of Americans bought real estate and millions of new mortgages were underwritten. Home values increased to record levels in many metro areas across the United States.

The First Signs of Trouble

With a few exceptions, all was going well until early 2006 when interest rate increases by the Federal Reserve Bank (FRB) began to take hold, home building inventories peaked, talk of a housing price bubble increased, and the boom in housing started showing signs of trouble. Many borrowers began having trouble paying their monthly loan payment and started to sell – flooding the market with homes they could no longer afford. Falling housing



demands, coupled with an increasing supply, created a glut of homes on the market and home prices fell – and are still falling. What started the flood of homes on the market were interest rate resets from loans approved years earlier during the mortgage underwriting boom of 2004 to 2006. Included in these millions of mortgages were a significant portion of loans provided to “sub-prime” borrowers – buyers with lower credit ratings. To approve loans to these “questionable” borrowers, mortgage lenders steered these customers into adjustable rate mortgages (ARMs) in which the initial interest rate is very

(Continued on page 2)

Inside This Issue

- 1 Sub-Prime: What's Happening?
- 3 Congress Enacts Military and Farm Tax Relief
- 4 FAQ: Should I Borrow From My 401(k)?
- 5 Reporting Rules for Small Business/Self-Employeds
- 5 Tax Relief at the Gas Pump
- 6 2009 Inflation Adjustments for Health Savings



DOEREN MAYHEW
Certified Public Accountants and Consultants

(Sub-Prime – Continued from page 1)

low, a “teaser rate,” and it then re-adjusts to a higher level after one or more years. The advantage to these “teaser” loans was that the reduced introductory interest rate kept monthly mortgage payments low and allowed millions of “sub-prime” borrowers the financial ability to purchase a home. However, the disadvantage, and what has led to the current crisis in the financial industry, is that once the low rate readjusted upward years later, millions of borrowers could no longer afford their homes. Here’s the math. A sub-prime borrower buys a home in April of 2005 with a \$150,000 three-year ARM mortgage. In April of 2008, the loan’s teaser rate of 5 percent resets to 8 percent and the monthly payment – overnight – increases \$296 or 37 percent. The homeowner cannot afford the new payment and decides to sell.

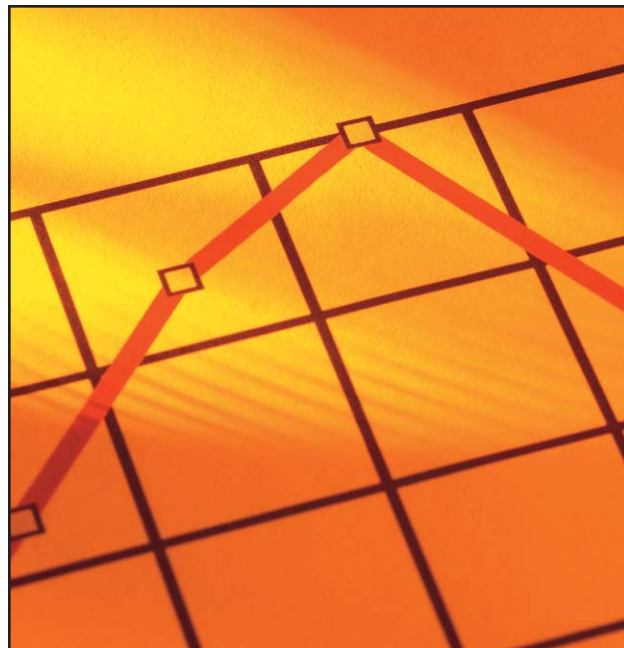
Unfortunately, so many other people are in the same boat that too many houses are on the market, and prices are driven down. The homeowner is left with a house worth less than what is owed on it and no means to make the monthly payment, so they walk away and allow foreclosure to occur. This is happening all over the country and foreclosures are at record levels in many metro markets. The higher monthly payment, coupled with an already depressed housing market and slowing economy, is creating an avalanche of foreclosures and is driving home prices down even further.

More Questions Than Answers

In earlier times, the local bank, credit union, or savings and loan would have underwritten and serviced their mortgage loans and suffered the consequences of poor approval decisions, but not in today’s global economy. Individual mortgages are now grouped together with mortgages from all over the country to form other types of financial instruments. These new assets contain thousands of

individual mortgages with a bundled loan value in the hundreds of millions of dollars or more. These assets are then bought and sold by huge global banks and investment groups, and they become integrated into global financial portfolios. However, the sub-prime crisis in the United States has led to a tidal wave of concern in the financial community. The true value of these mortgage-backed assets cannot be established since the underlying financial instruments are very complicated. The asset holder has no ability to quantify the underlying risk since so many unknown factors exist: What are the values of the collateral homes in a falling housing market? How many borrowers in the asset are at risk for default and how is this changing? What is this asset really worth? The result has been that international investors are selling these mortgage-related assets, and their values have fallen dramatically, leading to billions in losses.

This has created another major problem – the “Credit Crunch.” Billions of dollars worth of mortgage-backed bonds and securities are held by financial institutions around the world, and this is the problem. The value of these assets are unknown and now large banks are nervous about loaning money to other banks because they don’t know or trust each other’s financial solvency. Because there is so much uncertainty and lenders are tightening their purse strings, the FRB has stepped in to stabilize with aggressive monetary policies. Interest rates have been cut significantly to ease the pain of rate resets for ARM borrowers and the FRB has loaned billions of dollars to financial



institutions to ease the tightening of credit among banks. However, these actions have only slowed the tightening of credit in the U.S. economy and have had little impact on the collapse in the housing sector.

Down the Road

There may be light at the end of this tunnel, though. The huge wave of sub-prime resets will pass by the end of 2008, easing the downward pressure on the housing sector and mortgage-backed assets. The U.S. Congress is implementing programs to help homeowners avoid foreclosure.

Expansionary monetary policy by the FRB will begin having a significant impact on the economy, leading to stronger economic growth in the later part of 2008. Banks and financial institutions have recognized the asset and credit problems and are correcting their investment portfolios.

In the end, the financial losses incurred from easy mortgage loans to sub-prime borrowers over the last six years will impact the U.S. and global economies for years to come.

A special “thank you” to the author, Charles Chesbrough, Senior Economist at CSM Worldwide, for granting Doeren Mayhew permission to reprint the above article. Charles can be contacted at charleschesbrough@csmauto.com.

Congress Enacts Military and Farm Tax Relief; More Tax Bills Pending

Military families, farmers, and ranchers are just some of the recipients of tax breaks in two new federal laws: the Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) and the Food, Conservation, and Energy Act of 2008. Congress authorized more than \$3 billion in tax breaks in these two laws. Meanwhile, billions more in other tax breaks are pending in Congress – so it is shaping up to be a big year for tax legislation. As always, Doeren Mayhew will keep you posted of important tax developments. Please contact our office at (248) 244-3000 with any questions you may have.

Military Tax Relief

The military tax relief act includes roughly \$1.2 billion in tax incentives, most of which are targeted to servicemen and women on active duty, reservists who are called to active duty, and military families. Following are some of the highlights:

- Permanent extension of election to treat combat pay as earned income for the earned income credit
- Penalty-free withdrawals from 401(k)s and other retirement arrangements for individuals called to active duty
- Special rules for unused amounts in flexible spending arrangements (FSAs)
- Enhanced contributions of military death gratuities to tax-favored accounts
- State veterans bonuses and other payments treated as non-taxable gifts

The military tax relief act pays for these and other tax incentives by imposing new requirements on very



wealthy individuals who renounce their U.S. citizenship for tax purposes. The new law also treats foreign subsidiaries of U.S. companies as American employers for purposes of Social Security and Medicare taxes, increases the failure to file a tax return penalty, and extends a special mental health parity excise tax.

Military Families and Employers

Two incentives in the military tax relief act are especially important to military families and employers. The first one deals with the economic stimulus payments (also known as tax rebates) currently being issued by the IRS. The second incentive helps employers that have employees called up to active duty.

When Congress authorized economic stimulus payments earlier this year, it restricted them to recipients with valid Social Security numbers. The new law makes an exception for military families. As long as one spouse is a member of the U.S. Armed Forces and has a valid Social Security number, the IRS can issue an economic stimulus payment to the couple.

Many employers voluntarily pay the difference between a reservist's military pay and his or her regular pay when the individual is called to active duty. This is known as "differential pay." The new law gives small employers (generally employers with fewer than 50 employees) a temporary tax credit (20 percent of the differential pay with a \$4,000 cap). Additionally, the new law treats differential pay as wages rather than benefits.

Farm Bill

The tax incentives in the farm act are just one part of a huge (\$300 billion) new law. Among the highlights are:

- Enhanced charitable contributions of real property for conservation purposes
- New forestry conservation bonds
- Tax credit for safely securing pesticides and fertilizers

(Continued on page 5)

FAQ: Should I Borrow From My 401(k)?

The flagging state of the economy has left many individuals and families to cope with rising gas prices and food costs, struggle with their mortgage and rent payments, and manage credit card debt and other common monthly bills. Whether individuals are contemplating how to pay off their credit card or obtain a mortgage amid the “credit crunch” and “economic downturn,” many people may be considering alternative sources of financing to reach their goals, including the tapping of a retirement account.

You can generally withdraw funds from your 401(k) three ways: through regular distributions, hardship withdrawals, or plan loans. Many employers have adopted 401(k) plan provisions that allow employees to borrow money from their retirement account. Although borrowing from your 401(k) may be an option, there are several important considerations you should take into account before tapping your retirement fund.

The Basics of Borrowing From Your 401(k) Plan

The amount that you can borrow from a 401(k) plan is limited to 50 percent of the value of your vested benefit or \$50,000, whichever amount is less. However, you can take a loan up to \$10,000 even if it is more than one-half of the present value of your vested accrued benefit. Interest on a 401(k) plan loan is not deductible. Despite withdrawing funds from your 401(k) through a plan loan, you will remain vested in your account, subject to your obligation to repay the loan.

If certain requirements are not met, a loan from your 401(k) plan will be treated as a premature distribution for tax purposes,

subjecting you to current income tax at ordinary rates plus a 10 percent early withdrawal penalty on the amount distributed. You must repay a loan from your 401(k) within five years, subject to only one exception for a loan used to make a first-time home purchase (a principal residence, not a vacation or secondary home). This “residence exception” allows for a loan term as long as 30 years.

Loan repayments must be made at least every quarter, and are generally automatically deducted from your paycheck. If you are unable to repay the loan and default, the IRS treats the outstanding loan balance as a premature distribution from your 401(k), subject to income tax and the 10 percent early withdrawal penalty. Additionally, most plan terms require that you repay the loan within 60 days if you leave or lose your job.

Drawbacks to Borrowing From Your 401(k)

Before you dip into your 401(k), you need to be aware of the many disadvantages to taking money from your retirement savings. First, and foremost, many plans contain provisions that prohibit you, and your employer, from making contributions to your 401(k) until you repay the loan or for up to 12 months after the distribution. This is a critical disadvantage to borrowing money from your 401(k) because you are not saving for retirement during the time you are repaying the loan, which may take up to five years, or for the year in which contributions are prohibited. This not only means that you are not saving for retirement for a substantial period, you are also not earning a return on the money you could have contributed albeit for

the suspension.

It is imperative that you consider the effects of suspended contributions and the lost earnings and tax-free compounding you could have earned on the money you borrowed from your 401(k). And, as previously discussed, if you default and are unable to pay the loan balance, the outstanding amount is treated by the IRS as a premature distribution and subject to income tax at your ordinary tax rate as well as a 10 percent early withdrawal penalty. Additionally, the maximum contribution you will be allowed to make in the year following the suspension will be reduced by the amount contributed in the prior year.

Another point to consider: the money you borrow will only earn the interest you pay on the loan. Typically, on a 401(k) plan loan, administrators use an interest rate of one to two percentage points above prime interest rates. While paying a lower interest rate to yourself may be more favorable than paying a higher interest rate to a bank, you aren't necessarily earning money, especially considering that the interest you pay on the loan could be significantly lower than the potential earnings you could be making if the money remained in your account.

Potential Double Taxation

In fact, the interest you pay on the loan is money taken from your paycheck, after-taxes. While it is not an additional cost you'd be paying to a bank, but paying yourself, it is money you may essentially be paying tax on twice. That is because the money you pay yourself interest with is taxed in your paycheck currently, then later when it is distributed to you from the plan in retirement as ordinary income.

(Congress Enacts Military and Farm Tax Relief – Continued from page 3)

- Enhanced like-kind exchanges of water rights in the form of mutual ditch, reservoir irrigation stock
- Tax credit for cellulosic biofuels

Congress voted to pay for these and other tax incentives in the farm bill by limiting the amount of farming losses that a taxpayer receiving certain subsidies may use to offset non-farming business income. The farm bill also conditionally reduces the ethanol tax credit.

Extenders and More Tax Bills

If you took the higher education tuition deduction, state and local sales tax deduction, or one of many other popular tax breaks in the past, you may be surprised that some have expired or will soon expire.

Just before Memorial Day, the House voted to extend a host of temporary tax breaks, including the:

- State and local sales tax deduction
- Higher education tuition deduction
- Research tax credit
- Teachers' classroom expense deduction

- New Markets Tax Credit
- Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property

Similar legislation has also been proposed – but not yet voted on – in the Senate. We're also watching for a possible tax break for first-time homebuyers, extended energy tax breaks, and scholarships for veterans, which could be paid for by a surtax on wealthy individuals. The House has approved these measures but their fate is uncertain in the Senate.

IRS Reminds Small Business/Self-Employed of Income Reporting Rules

The IRS has issued guidance to assist small business and self-employed (SB/SE) taxpayers “to better understand their reporting obligations.” In other words, small businesses and those self-employed are being warned that they better start reporting income properly. The IRS indicated that underreporting of business income by small businesses and others is a major source of the tax gap.

The guidance focuses on business income, gross receipts, and cost of goods sold. The IRS stressed that all earned income is taxable, whether in the form of cash, credit, property, or services. Business income can also include canceled debt, damages, and kickbacks.

Businesses that make or buy goods to sell may deduct the cost of goods sold from their gross receipts, the IRS explained. The cost of goods sold is determined by adding beginning inventory to purchases, labor costs, material and supplies,

and other costs, and subtracting this total from ending year inventory.

Gross income equals net receipts minus cost of goods sold. The IRS stated that gross income must be determined before deducting business expenses.

Record-Keeping

The IRS strongly advises that small businesses should use a formal set of books and records and separate bank accounts for business and personal funds. The IRS provides the SB/SE One-Stop Resource, a web-based tool on the reporting and filing obligations of business, as well as a Small Business Workshop.

The IRS noted that good financial records can help a business seeking a loan or other capital. It also reminded small businesses and those self-employed that inadequate record keeping can cut both ways, contributing to over-reporting of taxable income and unintentional under-reporting.

Tax Relief at the Gas Pump

The IRS has announced that the optional mileage allowance for owned or leased autos (including vans, pickups, or panel trucks) will increase 8¢ from 50.5¢ to 58.5¢ per mile for business travel from July 1, 2008, to December 31, 2008, to better reflect the real cost of operating an auto in this period of rapidly rising gas prices. The rate for using a car to get medical care or in connection with a move that qualifies for the moving expense will also increase 8¢ for the last half of 2008 from 19¢ to 27¢ per mile.

2009 Inflation Adjustments for Health Savings Accounts

The IRS has announced the annual inflation-adjusted rise to the limits on deductible contributions to a health savings account (HSA). The base limit on contributions themselves will rise to \$3,000 for 2009, up from a limit of \$2,900 for 2008. This limit applies to an individual with self-only coverage under a high-deductible health plan (HDHP).

The annual limit for deductible contributions for an individual with family coverage under a HDHP will rise to \$5,950 for 2009, up from \$5,800 for 2008. The deduction limits for self-only and family coverage are adjusted for inflation.

Individuals who are 55 and older may also make a catch-up contribution of \$1,000, up from \$900 in 2008. This

increase is mandated by statute. The catch-up amount will remain at \$1,000 after 2009.

HDHPs coupled with HSAs are reported to be an affordable solution for employers to manage health care costs. Distributions from an HSA that are used for qualified medical expenses are tax-free, making HSAs extremely taxpayer-friendly. Premiums for HDHPs are lower than for comprehensive health insurance, and employees enrolled in an HDHP arguably have more control over their health care dollars.

Other HDHP Requirements

An HDHP must have a deductible of a stated minimum for both individual and family coverage. The plan also

must limit out-of-pocket expenses paid by the individual or family members for covered benefits.

These limits are also adjusted for inflation. For 2009, an HDHP must have an annual deductible of at least \$1,150 for a plan providing individual coverage, and \$2,300 for family coverage. These amounts increased from \$1,100 and \$2,200, respectively, for 2008.

The HDHP must cap out-of-pocket expenses (including deductibles, co-payments, and other amounts, but not premiums) at \$5,800 for a plan providing self-only coverage, and at \$11,600 for family coverage. These amounts increased from \$5,600 and \$11,200, respectively, for 2008.



DOEREN MAYHEW
Certified Public Accountants and Consultants

755 West Big Beaver Road
Suite 2300
Troy, Michigan 48084
www.doeren.com

248.244.3000

Doeren Mayhew is a certified public accounting and consulting firm, providing unsurpassed business expertise critical to middle-market, closely held companies and non-profit institutions since 1932.

- Accounting and Audit
- Tax
- International Tax and Consulting
- Corporate Finance and Strategic Services
- Operational Improvement and Restructuring Services
- Litigation Support and Forensic Services
- Payroll Services
- Risk Management Services
- Financial Services
- Information Technology Services

Doeren Mayhew is the only Michigan-based CPA firm ever to attain the "Best of the Best" rating from *Inside Public Accounting* as one of America's 25 best accounting and consulting firms — an honor we have received 13 consecutive years.