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2008 TAX PLANNING INFORMATION




Dear Clients and Friends:

Congress has been busy this year. First, it passed the Economic Stimulus Act of 2008 providing one-time tax rebates for individuals and various tax incentives for businesses. The economic stimulus law was followed by the Heroes Earnings Assistance and Relief Tax Act of 2008 benefiting military personnel and their families. Next, Congress enacted a massive new housing law—the Housing and Economic Recovery Act of 2008—that includes tax breaks for homeowners and one significant tax crackdown. Finally, the Emergency Economic Stabilization Act of 2008 extends several key tax provisions.

These new laws are likely to have an impact on year-end tax planning. In addition, legislation passed years ago—including the massive Economic and Growth Tax Relief Reconciliation Act of 2001 (EGTRRA)—must still be taken into account. Also, a continuous stream of new cases, rulings and regulations could affect your tax situation this year. As a result, it is important to carefully review the current tax implications.

Keeping all this in mind, we have prepared the following 2008 Year-End Tax-Planning Letter for our individual and business clients. Throughout the letter, we have highlighted several “insights” to help illuminate year-end planning techniques.


For convenience, the letter has been divided into the following three sections:

-  Individual Tax Planning
-  Business Tax Planning
-  Financial Tax Planning

Be aware that the year-end planning ideas discussed within this letter are general in nature and are intended only as an overview. We suggest that you review your situation with an experienced tax professional before you take any action.


INDIVIDUAL TAX PLANNING

Charitable Donations


 **INFORMATION:** As a general rule, you may deduct the full amount of monetary donations made to qualified charitable contributions. If you donate appreciated property held for more than one year, you can generally deduct the current fair-market value of the property.

But Congress has toughened the rules in recent years. For instance, under special substantiation requirements for cash or cash-equivalent gifts, no deduction is allowed unless you maintain a record of the contribution, such as a bank statement, receipt or written communication from the charity. The written communication must show the charity's name, the date of the contribution and the amount of the donation.

Furthermore, deductions for charitable gifts of clothing and household goods are generally limited to items in "good condition." **Exception:** If you obtain an appraisal of more than \$500 for a single item, the amount may be deducted regardless of condition.

 **INSIGHT:** If you charge a donation by credit card or post it online before January 1, 2009, you can deduct the full amount on your 2008 return—even if you don't actually pay the charity until 2009.


Alternative Minimum Tax

 **INFORMATION:** The ultimate fate of the alternative minimum tax (AMT) remains uncertain. Undoubtedly, this year's national election will be instrumental in determining its future. However, until further notice, taxpayers must continue to operate under current law.


Basic rules: The AMT is a special calculation involving "tax preference" items, technical adjustments and an exemption amount based on your filing status. (The exemption amounts are phased out for high-income taxpayers.) In effect, if the resulting AMT liability exceeds your regular income tax liability, you must pay the higher of the two. The AMT rate is 26% for the first \$175,000 of AMT income, 28% on amounts above \$175,000.

Congress has patched the AMT in recent years by passing several annual increases in the exemption amounts. The "rescue" legislation enacted in October includes another fix. The exemption amounts for 2000–2008 are shown below.


Filing status	2000	2001–2002	2003–2005	2006	2007	2008
Joint filers	\$45,000	\$49,000	\$58,000	\$62,550	\$66,250	\$69,950
Unmarried filers	\$33,750	\$35,750	\$40,250	\$42,500	\$44,350	\$46,200

 **INSIGHT:** If warranted, you may want to shift tax preference items to 2009 to avoid, reduce or eliminate AMT liability this year. Conversely, if you are in a high regular income tax bracket, you might accelerate income into 2008 if it will be taxed at the 26% or 28% AMT rate.

Kiddie Tax


 **INFORMATION:** Under the “kiddie tax,” unearned income of a child who has not reached a specified age is taxed at the top marginal tax rate of the child’s parents to the extent it exceeds an annual threshold. The threshold for 2008 is \$1,800 (up from \$1,700 for 2007).

New rules: Beginning in 2008, the specified age limit is increased from under age 18 to under age 19 (age 24 for children who are full-time students). The higher age limits apply if the child does not have earned income equal to half of his or her annual support. As a result, in 2008 the kiddie tax will affect more families with high school and college students.

 **INSIGHT:** If the kiddie tax will apply to your child, attempt to minimize the child’s unearned income for 2008. For instance, you might have the child shift some investments into government obligations where taxable income is deferred. Another option is to use investments in tax-free municipal bonds or municipal bond funds. Naturally, consider all the relevant economic factors.


It is also important to consider other tax implications for children, such as the 0% tax rate for long-term capital gain (more on this later).

Education Expenses


 **INFORMATION:** The tax law provides several tax incentives for pursuing higher education, but there are some limitations. Here is a brief rundown on four potential tax breaks.

1. **Tax credits:** You may qualify for the Hope scholarship credit or Lifetime Learning credit in 2008. However, each credit is phased out for taxpayers, based on their adjusted gross income (AGI). For 2008, the phase-out range for joint filers is an AGI between \$96,000 and \$116,000 (\$48,000 and \$58,000 for single filers).
2. **Tuition deduction:** Under this tax law provision, joint filers can deduct up to \$4,000 of tuition and related expenses for an AGI of \$130,000 or less (\$65,000 for single filers). The maximum deduction is \$2,000 for an AGI up to \$160,000 (\$80,000 for single filers). The deduction was recently extended through 2009.


3. **Student loan interest:** The tax law allows taxpayers to deduct up to \$2,500 of annual interest paid on student loans. For 2008, the deduction is phased out for joint filers with an AGI between \$115,000 and \$145,000 (\$55,000 to \$70,000 for single filers).
4. **Coverdell Education Savings Accounts (ESAs):** You may contribute up to \$2,000 annually to a Coverdell ESA. Distributions are tax-free for funds used to pay for qualified education expenses. However, availability of this technique is phased out for joint filers with an AGI of \$190,000 to \$220,000 (\$95,000 and \$110,000 for single filers).

 **INSIGHT:** The tax benefits for Coverdell ESAs are not limited to higher education. For instance, you can make contributions to a Coverdell ESA that will enable a beneficiary to attend a private elementary or secondary school.

Estimated Tax Payments


 **INFORMATION:** If you do not pay a sufficient amount of tax during the year through quarterly installments or income tax withholding—or a combination of both methods—the IRS may assess an “estimated tax penalty.” However, you may be able to avoid the penalty under any one of these three “safe harbor” rules.


1. Your annual payments equal at least 90% of your current liability;
2. Your annual payments equal at least 100% of the prior year’s tax liability (110% if your AGI for the prior year exceeded \$150,000); or
3. You make installments on a current basis under an “annualized income” method. This method is available to certain taxpayers who receive or accrue most of their annual income in a short span (e.g., during the holiday season).


 **INSIGHT:** When it’s possible, adjust your withholding at year-end to meet one of these safe harbor rules. Usually, it is easiest to qualify under the rule based on 100% (or 110%) of the prior year’s tax liability.


If you make a payroll adjustment after clearing the Social Security wage base (\$102,000 for 2008), you can increase the withholding with little or no reduction in your actual take-home pay.


Other Tax Ideas

 You can deduct your annual unreimbursed medical expenses over 7.5% of your AGI. If you are near the 7.5% mark or already over it, schedule elective medical and dental visits—such as routine exams—before the end of the year.

 Similarly, miscellaneous expenses are deductible to the extent that the annual total exceeds 2% of your AGI. If possible, pay these expenses at year-end to maximize your deduction for 2008.


 Generally, you may claim a dependency exemption of \$3,500 in 2008 for a child under age 19 (or a full-time student under age 24) if you provide more than half of his or her annual support. It doesn't matter how much taxable income the child receives. **Note:** The tax benefits of personal exemptions are phased out for high-income taxpayers.

 When state law permits, you can consolidate outstanding personal debts into a home equity debt. Interest on personal debts is not deductible, but you may deduct mortgage interest paid on the first \$100,000 of home equity debt, no matter how the proceeds are used. **Caution:** The debt must be secured by your home, so use this technique carefully.

 Some taxpayers may be entitled to bigger economic stimulus rebates. The extra amount may be claimed as a credit on your 2008 return.


BUSINESS TAX PLANNING

Section 179 Deductions


 **INFORMATION:** Under Section 179 of the tax code, your business may elect to “expense” (i.e., currently deduct) the cost of qualified assets up to an annual limit. However, the Section 179 deduction cannot exceed your taxable income for the year. Furthermore, the deduction is reduced on a dollar-for-dollar basis for purchases over an annual threshold.

New rules: The new economic stimulus law increases the maximum Section 179 deduction to \$250,000 for 2008. (The inflation-indexed limit was originally scheduled to be \$128,000.) In addition, the phaseout threshold for the Section 179 deduction is increased from \$500,000 (inflation-indexed to \$510,000) to \$800,000. The limits for recent years are shown below.

Tax year	Maximum deduction	Phaseout threshold
2002	\$ 24,000	\$200,000
2003	\$100,000	\$400,000
2004	\$102,000	\$410,000
2005	\$105,000	\$420,000
2006	\$108,000	\$430,000
2007	\$125,000	\$500,000
2008	\$250,000	\$800,000


 **INSIGHT:** Due to the dramatic increase in Section 179 limits for 2008, your business has greater flexibility in deciding year-end purchases of qualified assets.

Depreciation Deductions


 **INFORMATION:** The new economic stimulus law creates another incentive to acquire business assets before year-end. Under the new law, a business may claim a 50% “bonus depreciation” deduction for qualified assets—property with a cost recovery period of 20 years or less and certain software, leasehold improvements and water utility property—placed in service before January 1, 2009 (January 1, 2010, for property with a cost recovery period of 10 years or longer and certain other property).

Best of all, your business is able to claim bonus depreciation deductions in conjunction with Section 179 deductions (see above) and regular depreciation deductions under the Modified Accelerated Cost Recovery System (MACRS).

Caution: If the cost of business assets (other than real estate) placed in service during the last quarter of the year—October 1 through December 31—exceeds 40% of the cost of assets placed in service during the entire year, regular depreciation deductions are generally reduced.

 **INSIGHT:** Postpone purchases to 2009 if you will trigger this tax trap for MACRS deductions. However, be aware that business assets expensed under Section 179 are exempt from the last-quarter calculation.


Business Vehicles

 **INFORMATION:** If you own or lease a vehicle used for business driving, you can claim deductions relating to business travel. Generally, you may use one of two methods:


1. **Actual expense method:** You can deduct actual costs of operating the vehicle—such as gas, oil, insurance, repairs, etc.—based on the percentage of business use. In addition, you may claim an annual depreciation allowance, subject to the limits for “luxury cars.”
2. **Standard mileage rate:** In lieu of deducting actual expenses, you may be able to claim a deduction based on a flat rate established by the IRS (plus business-related tolls and parking fees). The IRS initially set a rate of 50.5 cents per business mile for 2008. However, midway through the year it authorized an increase to 58.5 cents per business mile for the last six months of the year.

Nevertheless, you may still qualify for a bigger deduction by using the actual expense method, even after the mid-year increase. This is particularly true for new vehicles qualifying for bonus depreciation. Below are the maximum deductions for vehicles placed in service in 2008 (based on 100% business use).

Type of vehicle	2008	2009	2010	2011 and thereafter
Automobiles	\$10,960	\$4,800	\$2,850	\$1,775
Light trucks and vans	\$11,160	\$5,100	\$3,050	\$1,875


 **INSIGHT:** When it suits your needs, you may switch from the standard mileage rate to the actual expense method. This will require additional recordkeeping. **Note:** You generally cannot switch from using the actual expense method in a prior year to the standard mileage rate.

LIFO Accounting


 **INFORMATION:** Your company's inventory will have a major impact on its annual tax liability.

Reason: The cost of goods sold during the year is subtracted from your gross sales receipts to arrive at the net profit or loss from sales. The cost of goods sold depends on the method used to account for inventory.


There are two basic methods of inventory valuation: the first-in, first-out (FIFO) method and the last-in, first-out (LIFO) method. Under the FIFO method, the oldest goods in inventory are considered to be the goods sold first. With the LIFO method, the last goods acquired or produced are treated as being the first goods sold.

 **INSIGHT:** In this current economic environment, a firm using the FIFO method might want to switch to the LIFO method. When prices rise, the LIFO method results in a higher cost of goods sold. This, in turn, reduces the taxable profit for the year, so the company's income tax liability is lowered.


Bad Business Debts

 **INFORMATION:** Due to the economic slowdown this year, you may have had more difficulty securing payments from clients or customers. Subsequently, you may be forced to write off an unpaid debt as a business bad debt.


As a general rule, business bad debts may be deducted from income when they become worthless. To qualify as a business bad debt, a loan or advance must have been created or acquired in connection with your business or result in a loss to your business if it cannot be repaid.

 **INSIGHT:** Keep detailed records of collection efforts, including letters, phone calls, e-mails and collection agency activities. This documentation can help support deductions based on the worthlessness of the debts.

Employee Bonuses


 **INFORMATION:** Normally, employee bonuses are deducted in the year that they are paid and taxable in the year that they are received. For instance, you must pay out bonuses before January 1, 2009, to deduct the bonuses on your company's 2008 return. However, there is a special rule for accrual-basis companies: The bonuses are currently deductible if they are paid within 2½ months of the close of the tax year.


This special rule does not apply to bonuses paid to majority shareholders of a C corporation or certain owners of an S corporation or a personal service corporation.


 **INSIGHT:** Have an accrual-basis company fix bonus amounts before year-end. Therefore, the bonuses can be deducted on your 2008 return as long as they are paid by March 16, 2009. Keep detailed corporate minutes to support the deductions.

Note: Recent regulations on “deferred compensation plans,” including bonus plans, impose new requirements on employers. Consult with your Whalen & Company tax professional for details.

Other Tax Ideas


 Repairs made by your company before year-end are deductible on its 2008 return. However, capital improvements to the business premises must be capitalized. Try to implement separate plans for repairs and major renovations.

 Any loss claimed by an S corporation shareholder is limited to the basis in the stock plus outstanding debt. Thus, shareholders might make a capital contribution or lend money to the corporation before year-end to increase the basis for loss deduction purposes.

 Your company can deduct 100% of its business travel costs and 50% of its qualified entertainment and meal expenses. To increase deductions for 2008, you might move up trips and events initially planned for early in 2009. Note that you can deduct 100% of the cost of a holiday party for the entire staff.

FINANCIAL TAX PLANNING


Capital Gains and Losses

 **INFORMATION:** At the end of the year, you may use several time-tested techniques to maximize the tax benefit of capital gains and losses. However, this concept takes on added significance in 2008. Reminder: Consider all economic factors, not just taxes.


Basic rules: Capital gains and losses offset each other. However, any excess capital loss can also offset up to \$3,000 of high-taxed ordinary income in 2008. The remainder is carried over to next year. If a gain qualifies as long-term capital gain—you have owned the asset for more than a year—the maximum tax rate is 15%. Consider the following:

- ▶ If you have already realized capital gains in 2008, you might realize capital losses at year-end to offset those gains.
- ▶ If you already realized capital losses in 2008, you might realize capital gains at year-end to absorb those losses.
- ▶ The “wash sale rule” prevents you from deducting a loss from the sale of securities if you acquire substantially identical securities within 30 days. To avoid this result, you can:
 - (1) Wait at least 31 days to repurchase the securities.
 - (2) Acquire replacements first and wait at least 31 days before selling the original shares.
 - (3) Buy similar (but not identical) securities at any time.

New rules: For taxpayers in the regular 10% or 15% tax brackets, the maximum tax rate for net long-term capital gain was 5% in 2007. This 5% rate has been reduced to 0% for 2008. Even taxpayers in the higher tax brackets may benefit from the 0% rate on a portion of their long-term capital gain for the year.


 **INSIGHT:** When it otherwise makes sense, take advantage of the 0% rate. For instance, you might have your children in low tax brackets sell securities to realize long-term capital gain in 2008. Technically, this tax break extends through 2010, but it could be repealed in a future tax reform package.

Individual Retirement Accounts

 **INFORMATION:** There are two main types of IRAs designed for retirement savings: the traditional IRA and the Roth IRA.


1. **Traditional IRAs:** Contributions are tax-deductible unless you are an “active participant” in an employer-sponsored retirement plan *and* your AGI exceeds a certain level. For 2008, deductions are phased out for an AGI between \$85,000 and \$105,000 for joint filers (\$53,000 and \$63,000 for single filers). If your spouse is an active participant and you are not, the deduction is phased out for an AGI between \$159,000 and \$169,000.

The maximum IRA contribution for 2008 is \$5,000 (up from \$4,000 for 2007). Plus, if you are 50 years of age or older, you can make an extra “catch-up” contribution of \$1,000.

 **INSIGHT:** The deadline for 2008 IRA contributions is your tax return due date. Nevertheless, you can boost retirement savings by making contributions sooner. This provides more time for contributions to grow on a tax-deferred basis.


2. **Roth IRAs:** Contributions are not tax deductible, but withdrawals after five years may be tax-free. To qualify, distributions must be received after age 59½, upon death or disability or to pay first-time home-buyer expenses (up to a lifetime limit of \$10,000). The ability to contribute to a Roth IRA for 2008 is phased out for joint filers with an AGI between \$159,000 and \$169,000 (\$101,000 and \$116,000 for single filers).

The contribution limits for Roth IRAs are the same as for traditional IRAs. If you choose, you may allocate contributions to both types of IRAs, up to the total annual limit.

 **INSIGHT:** You may convert a traditional IRA to a Roth IRA if your AGI is \$100,000 or less. However, you are required to pay tax on the conversion. If a conversion meets your needs, try to keep your AGI for 2008 below \$100,000 by postponing taxable income to 2009.


Beginning in 2010, you will be able to convert to a Roth IRA regardless of your AGI level. For a conversion in 2010, the resulting tax may be paid over the following two years (2011 and 2012). Therefore, it could make sense to postpone a conversion.

Estate and Gift Tax


 **INFORMATION:** The effect of EGTRRA on estate tax planning is still being felt. For example, the effective estate-tax exemption is scheduled to increase to \$3.5 million for 2009 (it is \$2 million for 2008) before the estate tax is completely repealed in 2010. Furthermore, the top estate-tax rate of 55% has been gradually reduced to 45%. However, the estate tax will be revived in 2011 with a top 55% rate unless additional legislation is enacted.

The following is the tax law schedule for the rate reductions and exemption increases.


Year	Top estate-tax rate	Effective exemption amount
2002	50%	\$1 million
2003	49%	\$1 million
2004	48%	\$1.5 million
2005	47%	\$1.5 million
2006	46%	\$2 million
2007–2008	45%	\$2 million
2009	45%	\$3.5 million
2010	Repealed	Not applicable
2011	55%	\$1 million

 **INSIGHT:** To avoid a potentially large federal estate tax in the future, you may reduce the size of your taxable estate through a series of lifetime gifts. Under the annual gift-tax exclusion, you can give each recipient up to \$12,000 in 2008 (\$24,000 for joint gifts by a married couple) without paying any gift tax.


New Housing Law


 **INFORMATION:** The new housing law includes several favorable tax provisions, but also cracks down on a tax technique for certain vacation home owners. Here is a brief summary.

1. **Home buyer's tax credit:** A qualified first-time home buyer can claim a tax credit equal to the lesser of \$7,500 or 10% of the purchase price. The home must be purchased after April 8, 2008, and before July 1, 2009. However, this new tax credit is phased out if your AGI exceeds \$150,000 (\$75,000 for single filers). Also, the credit must be repaid on your tax returns over a 15-year period.
2. **Property tax deduction:** For 2008, a non-itemizer may deduct a \$1,000 property tax allowance (\$500 for single filers), in addition to claiming the standard deduction. But the allowance cannot exceed the amount of actual property taxes paid. Note: This deduction has now been extended through 2009 by the rescue legislation.
3. **Converted residences:** One popular tax strategy is to convert a vacation home into a principal residence to benefit from the home-sale exclusion in the future. Generally, the home-sale exclusion can shelter tax on up to \$500,000 of gain from the sale of a principal residence (\$250,000 for single filers). For gains realized after 2008, the gain attributable to nonqualified use of a principal residence after 2008 does not qualify for the home-sale exclusion. Using the home as a vacation home is a nonqualified use.

 **INSIGHT:** If you were planning to convert a vacation home into your principal residence, do so before January 1, 2009. As a result, none of the gain from a future sale of the home will be attributable to nonqualified use.

Other Tax Ideas

 Increase contributions to your 401(k) plan. If you have cleared the Social Security wage base for 2008, you can use the savings to boost contributions. The dollar limit for elective deferrals for 2008 is \$15,500 (\$20,500 if you are 50 years of age or older).

 From a tax perspective, it is generally beneficial to sell mutual fund shares before the fund declares dividends at year-end (the "ex-dividend date") and to buy shares after the date the fund declares dividends.

✎ Defer tax on investment income from certificates of deposit (CDs) and Treasury securities by acquiring investments that mature after 2008. Generally, the income from these investments is taxable in the year it is received.

✎ Consider investments in dividend-paying stocks. As with long-term capital gains, the maximum income tax rate on qualified dividends received in 2008 is only 15% (0% for taxpayers in the 10% and 15% regular income tax brackets).

✎ Usually, pre-age-59½ distributions from an IRA or 401(k) plan are subject to a 10% penalty tax. Under the Heroes Act, reservists may be exempt from the penalty in 2008.

CONCLUSION

This year-end tax-planning letter is intended only to serve as a general guideline. Of course, your personal circumstances may require in-depth examination. We would be glad to schedule a meeting with you to provide assistance with your tax-planning needs.

Sincerely,

Whalen & Company

Whalen & Company, CPAs and Consultants

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