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2008 Year-End Tax Planning for Individuals

Dear Client:

As 2008 draws to a close, there is still time to reduce your 2008 tax bill and plan ahead for 2009. This letter highlights several potential tax-saving opportunities for you to consider. I would be happy to meet with you to discuss specific strategies.

As a general reminder, there are several ways in which you can file an income tax return: married filing jointly, head of household, single, and married filing separately. A husband and wife may elect to file a single return reporting their combined income, computing the tax liability using the tax tables or rate schedules for "Married Persons Filing Jointly." If a married couple files separate returns, under certain situations they can amend and file jointly, but they cannot amend a jointly filed return and file separately.

A joint return may be filed even though one spouse has neither gross income nor deductions. If one spouse dies during the year, the surviving spouse may file a joint return for the year in which his or her spouse died. Married persons who do not elect to file a joint return may be entitled to use the lower head of household tax rates. Generally, in order to qualify as a head of household, you must not be a resident alien, you must satisfy certain marital status requirements, and you must maintain a household for a qualifying child or any other person who is your dependent, if you are entitled to a dependency deduction for the taxable year for such person.

Basic Numbers You Need To Know

Because many tax benefits are tied to or limited by adjusted gross income (AGI)—IRA deductions, for example—a key aspect of tax planning is to estimate both your 2008 and 2009 AGI. Also, when considering whether to accelerate or defer income or deductions, you should be aware of the impact this action may have on your AGI and your ability to maximize itemized deductions that are tied to AGI. Your 2007 tax return and your 2008 pay stubs and other income- and deduction-related materials are a good starting point for estimating your AGI.

Another important number is your "tax bracket," i.e., the rate at which your last dollar of income is taxed. The tax rates for 2008 are 10%, 15%, 25%, 28%, 31%, and 35%. Although tax brackets are indexed for inflation, if your income increases faster than the inflation adjustment,

you may be pushed into a higher bracket. If so, your potential benefit from any tax-saving opportunity is increased (as is the cost of overlooking that opportunity).

IRA, Retirement Savings Rules for 2008

Tax-saving opportunities continue for retirement planning due to the availability of Roth IRAs, changes that make regular IRAs more attractive, and other retirement savings incentives. As discussed herein, even more changes began in 2008.

Traditional IRAs: Individuals who are not active participants in an employer pension plan may make deductible contributions to an IRA. The annual deductible contribution limit for an IRA for 2008 is \$5,000. Individuals who are active participants in an employer pension plan also may make deductible contributions to an IRA, but their contributions are limited in amount depending on their AGI. For 2008, the AGI phase-out range for deductibility of IRA contributions is between \$53,000 and \$63,000 of modified AGI for single persons (including heads of households), and between \$85,000 and \$105,000 of modified AGI for married filing jointly. Above these ranges, no deduction is allowed.

In addition, an individual will not be considered an “active participant” in an employer plan simply because the individual's spouse is an active participant for part of a plan year. Thus, you may be able to take the full deduction for an IRA contribution regardless of whether your spouse is covered by a plan at work, subject to a phase-out if your joint modified AGI is \$159,000 to \$169,000 for 2008. Above this range, no deduction is allowed.

Spousal IRA: If an individual files joint return and has less compensation than his or her spouse, the IRA contribution is limited to lesser of \$5,000 for 2008 plus age 50 catchup contributions, or total compensation of both spouses reduced by spouse's IRA contributions (traditional and Roth).

Roth IRA: This type of IRA permits nondeductible contributions of up to \$5,000 a year. Earnings grow tax-free, and distributions are tax-free provided no distributions are made until more than five years after the first contribution and the individual has reached age 59 1/2. Distributions may be made earlier on account of the individual's disability or death. The maximum contribution is phased out for persons with AGI above certain amounts: \$159,000 to \$169,000 for joint filers, and \$101,000 to \$116,000 for single filers (including heads of households); and between \$0 and \$10,000 for married filing separately and who lived with the spouse during the year. For 2008, a \$1,000 “catch-up” contribution is allowed for taxpayers age 50 or older by the close of the taxable year, making the total limit \$6,000 for these individuals.

Roth IRA Conversion Rule: Funds in a traditional IRA (including Roth, SEP and SIMPLE), and new for 2008, §401 retirement plan, §403(b) tax-sheltered annuity or §457 government plan, may be rolled over into a Roth IRA. Such a rollover, however, is treated as a taxable event, and you will pay tax on the amount converted. No penalties will apply if all the requirements for such a transfer are satisfied.

A taxpayer's AGI (whether married filing jointly or single) is limited to \$100,000 to make such a conversion and the taxpayer must not be a married individual filing a separate return.

401(k) Contribution: The §401(k) elective deferral limit is \$15,500 for 2008. If your 401(k) plan has been amended to allow for catch-up contributions for 2008 and you will be 50 years old by December 31, 2008, you may contribute an additional \$5,000 to your 401(k) account, for a total maximum contribution of \$20,500 (\$15,500 in regular contributions plus \$5,000 in catch-up contributions).

SIMPLE Plan Contribution: The SIMPLE plan deferral limit is \$10,500 for 2008. If your SIMPLE plan has been amended to allow for catch-up contributions for 2008 and you will be 50 years old by December 31, 2008, you may contribute an additional \$2,500.

Catch-Up Contributions for Other Plans: If you will be 50 years old by December 31, 2008, you also may contribute an additional \$5,000 to your §403(b) plan, SEP or eligible §457 government plan.

Saver's Credit: A nonrefundable tax credit is available based on the qualified retirement savings contributions to an employer plan made by an eligible individual. For 2008, only taxpayers filing joint returns with AGI of \$53,000 or less, head of household returns with AGI of \$39,750 or less, or single returns (or separate returns filed by married taxpayers) with AGI of \$26,500 or less, are eligible for the credit. The amount of the credit is equal to the applicable percentage (10% to 50%, based on filing status and AGI) of qualified retirement savings contributions up to \$2,000.

Maximize Retirement Savings: In many cases, employers will require you to set your 2009 retirement contribution levels before January 2009. You may want to increase your contribution to lower your AGI in order to take advantage of some of the tax breaks described above. In addition, maximizing your contribution is generally a good tax-saving move.

Deferring Income to 2009

If you expect your AGI to be higher in 2008 than in 2009, or if you anticipate being in the same or a higher tax bracket in 2008, you may benefit by deferring income into 2009. Deferring income will be advantageous so long as the deferral does not bump your income to the next bracket. Deferring income could be disadvantageous if your deferred income is subject to § 409A, thus making the income includible in gross income and subject to additional tax. Some ways to defer income include:

Delay Billing: If you are self-employed, delay year-end billing to clients so that payments will not be received until 2009.

Interest and Dividends: Interest income earned on Treasury securities and bank certificates of deposit with maturities of one year or less is not includible in income until received. To defer interest income, consider buying short-term bonds or certificates that will not mature until next year. If you have control as to when dividends are paid, arrange to have them paid to you after the end of the year.

Accelerating Income into 2008

In limited circumstances, you may benefit by accelerating income into 2008. For example, you may anticipate being in a higher tax bracket in 2009, or perhaps you will need additional income in order to take advantage of an offsetting deduction or credit that will not be available to you in future tax years. Note however that accelerating income into 2008 will be disadvantageous if you expect to be in the same or lower tax bracket for 2009. In any event, before you decide to implement this strategy, we should “crunch the numbers.”

If accelerating income will be beneficial, here are some ways to accomplish this:

Accelerate Collection of Accounts Receivable: If you are self-employed and report income and expenses on a cash basis, issue bills and attempt collection before the end of 2008. Also see if some of your clients or customers might be willing to pay for January 2009 goods or services in advance. Any income received using these steps will shift income from 2009 to 2008.

Year-End Bonuses: If your employer generally pays year-end bonuses after the end of the current year, ask to have your bonus paid to you before the beginning of 2009.

Retirement Plan Distributions: If you are over age 59 1/2 and you participate in an employer retirement plan or have an IRA, consider making any taxable withdrawals before 2009.

You may also want to consider making a Roth IRA rollover distribution, as discussed above.

Deduction Planning

Individual Deductions: Deduction timing is also an important element of year-end tax planning. Deduction planning is complex, however, due to factors such as AGI levels and filing status. If you are a cash-method taxpayer, remember to keep the following in mind:

Deduction in Year Paid: An expense is only deductible in the year in which it is actually paid.

Payment by Check: Date checks before the end of the year and mail them before January 1, 2009.

Promise to Pay: A promise to pay or providing a note does not permit you to deduct the expense. But you can take a deduction if you pay with money borrowed from a third party. Hence, if you pay by credit card in 2008, you can take the deduction even though you won't pay your credit card bill until 2009.

AGI Limits: The AGI limits on itemized deductions affect deduction planning. Normally, overall itemized deductions are reduced by 3% of the AGI exceeding \$159,950 (\$79,975 if married filing separately). For 2008, the reduction is reduced by two-thirds of what it otherwise would be, thus allowing for more deductions than in 2007 (reduction was only reduced by one-third). Similarly, certain deductions may be claimed only if they exceed a percentage of AGI: 7.5% for medical expenses, 2% for miscellaneous itemized deductions, and 10% for casualty losses.

Standard Deduction Planning: Deduction planning is also affected by the standard deduction. For 2008 returns, the standard deduction is \$10,900 for married taxpayers filing jointly, \$5,450 for single taxpayers, \$8,000 for heads of households, and \$5,450 for married taxpayers filing separately. If your itemized deductions are relatively constant and are close to the standard deduction amount, you will obtain little or no benefit from itemizing your deductions each year. But simply taking the standard deduction each year means you lose the benefit of your itemized deductions. To maximize the benefits of both the standard deduction and itemized deductions, consider adjusting the timing of your deductible expenses so that they are higher in one year and lower in the following year. You can do this by paying in 2008, deductible expenses, such as mortgage interest due in January 2009.

Medical Expenses: Medical expenses, including amounts paid as health insurance premiums, are deductible only to the extent that they exceed 7.5% of AGI. Consider bunching medical expenses into years when your AGI is lower.

State Taxes: If you anticipate a state income tax liability for 2008 and plan to make an estimated payment, consider making the payment before the end of 2008. Note that in 2008, you can elect to deduct as an itemized deduction state and local sales taxes instead of state and local income taxes. New for 2008, taxpayers who do not itemize their deductions can deduct up to \$1,000 if filing jointly or up to \$500 for single taxpayers for property taxes. This benefit is in the form of an additional standard deduction.

Charitable Contributions: Consider making your charitable contributions at the end of the year. This will give you use of the money during the year and simultaneously permit you to claim a deduction for that year. You can use a credit card to charge donations in 2008 even though you will not pay the bill until 2009. A mere pledge to make a donation is not deductible, however, unless it is paid by the end of the year. Note, however, for claimed donations of cars, boats and airplanes of more than \$500, the amount available as a deduction will significantly depend on what the charity does with the donated property, not just the fair market value of the donated property. If the organization sells the property without any significant intervening use or material improvement to the property, the amount of the charitable contribution deduction cannot exceed the gross proceeds received from the sale.

To avoid capital gains, you may want to consider giving appreciated property to charity. Regarding charitable contribution please remember the following rules: (1) no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better; (2) the IRS may deny a deduction for any item with minimal monetary value; and (3) the restrictions in (1) and (2) do not apply to the contribution of any single clothing or household item for which a deduction of \$500 or more is claimed if the taxpayer includes a qualified appraisal with his or her return. Charitable contributions of money, regardless of the amount, will be denied a deduction, unless the donor maintains a cancelled check, bank record, or receipt from the donee organization showing the name of the donee organization, and the date and amount of the contribution.

The ability to distribute to charity up to \$100,000 from a traditional or Roth IRA maintained for an individual whose has reached age 70½ continues into 2008. Ordinarily, such distributions

would be taxable to the individual, who would not be able to offset the income fully because of the percentage limitations on charitable contribution deductions.

Business Deductions

Self-Employed Health Insurance Premiums: Self-employed individuals are allowed to claim 100% of the amount paid during the taxable year for insurance that constitutes medical care for themselves, their spouses and dependents as an above-the-line deduction, without regard to the 7.5% of AGI floor.

Equipment Purchases: If you are in business and purchase equipment, you may make a “Section 179 Election,” which allows you to expense (i.e., currently deduct) otherwise depreciable business property. For 2008, thanks to Congressional legislation, you may elect to expense up to \$250,000 of equipment costs (with a phase-out for purchases in excess of \$800,000) if the asset was placed in service during 2008. In 2009, these dollar amounts are reduced to \$133,000 and \$530,000, so 2008 is the year to put property into your business to take advantage of the increased dollar amounts.

In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2008. In general, under the “half-year convention,” you may deduct six months worth of depreciation for equipment that is placed in service on or before the last day of the tax year. (If more than 40% of the cost of all personal property placed in service occurs during the last quarter of the year, however, a “mid-quarter convention” applies, which lowers your depreciation deduction.) A popular strategy in recent years is to purchase a vehicle (usually an SUV) for business purposes that exceeds the depreciation limits set by statute (i.e., a vehicle rated over 6,000 pounds). Doing so would not subject the purchase to the statutory dollar limit, \$2,960 for 2008; \$3,160 in the case of vans and trucks (If the vehicle qualifies for the “50% bonus depreciation” in effect in 2008, the dollar amounts are increased by \$8,000). Therefore, the vehicle would qualify for the full equipment expensing dollar amount. However, for SUVs (rated between 6,000 and 14,000 pounds gross vehicle weight) the expensing amount is limited to \$25,000.

NOL Carryback Period: If your business suffers net operating losses in 2008, you may apply those losses against taxable income going back two tax years. Thus, for example, the loss could be used to reduce taxable income—and thus generate tax refunds—for tax years as far back as 2006. Certain “eligible losses” can be carried back three years; farming losses and qualified disaster losses (for losses arising in taxable years beginning after 2007 in connection with disasters declared after December 31, 2007) can be carried back five years.

Bonus Depreciation: Taxpayers meeting certain criteria can claim a 50% bonus depreciation allowance for property placed in service after 2007 and before 2009, thanks again to Congressional legislation. The original use of the property must begin with the taxpayer after December 31, 2007, and before January 1, 2009. Also, the property must be acquired between such dates. Bonus depreciation is also allowed for machinery and equipment used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials placed in service after August 31, 2008.

Education and Child Tax Benefits

Child Tax Credit: A tax credit of \$1,000 per qualifying child under the age of 17 is available on this year's return. The credit is phased out at a rate of \$50 for each \$1,000 (or fraction of \$1,000) of modified AGI exceeding the following amounts: \$110,000 for married filing jointly; \$55,000 for married filing separately; and \$75,000 for all other taxpayers. A portion of the credit may be refundable.

Credit for Adoption Expenses: For 2008, the adoption credit limitation is \$11,650 of aggregate expenditures for each child, except that the credit for an adoption of a child with special needs is deemed to be \$11,650 regardless of the amount of expenses. The credit ratably phases out for taxpayers whose income is between \$174,730 and \$214,730.

HOPE Credit and Lifetime Learning Credit: The maximum HOPE credit for 2008 is \$1,800 (100% on the first \$1,200, plus 50% of the next \$1,200) for qualified tuition and fees paid on behalf of a student (i.e., the taxpayer, the taxpayer's spouse, or a dependent) who is enrolled on at least a half-time basis. The credit is available for only the first two years of the student's post-secondary education.

The Lifetime Learning credit maximum in 2008 is \$2,000 (20% of qualified tuition and fees up to \$10,000). A student need not be enrolled on at least a half-time basis so long as he or she is taking post-secondary classes to acquire or improve job skills. As with the HOPE credit, eligible students include the taxpayer, the taxpayer's spouse, or a dependent.

For 2008, both the HOPE credit and the Lifetime Learning credit are phased out at modified AGI levels between \$96,000 and \$116,000 for joint filers, and between \$48,000 and \$58,000 for single taxpayers.

Coverdell Education Savings Account: For 2008, the aggregate annual contribution limit to a Coverdell education savings account is \$2,000 per designated beneficiary of the account. This limit is phased out for individual contributors with modified AGI between \$95,000 and \$110,000 and joint filers with modified AGI between \$190,000 and \$220,000. The contributions to the account are nondeductible but the earnings grow tax-free.

Student Loan Interest: You may be eligible for an above-the-line deduction for student loan interest paid on any "qualified education loan." The maximum deduction is \$2,500. The deduction for 2008 is phased out at a modified AGI level between \$115,000 and \$145,000 for joint filers and between \$55,000 and \$70,000 for individual taxpayers.

Rules are in effect to coordinate education provisions, such as the qualified higher education expense deduction, the Hope and Lifetime Learning credits, Coverdell education savings accounts, and qualified tuition plans, to prevent double benefits.

Kiddie Tax: Beginning in 2008, the kiddie tax applies to: (1) children under 18; (2) 18-year old children who have unearned income in excess of the threshold amount, do not file a joint return and who have earned income, if any, that does not exceed one-half of the amount of the child's

support; and (3) children between the ages of 19 and 23 and if, in addition to the above rules, they are full-time students. For 2008, the kiddie tax threshold amount is \$1,800.

Energy Incentives

Alternative Motor Vehicle Credit: For 2008, a credit is available for purchases of motor vehicles powered by certain alternative fuels. The dollar amount of the credit depends on fuel savings and weight of the vehicle. The most popular vehicles subject to the credit are hybrids. However, when a particular manufacturer sells in the United States its 60,000th of the particular hybrid, a phaseout period kicks in. The phaseout will reduce the credit from fully available to nothing being available. The phaseout begins in the second calendar quarter following the calendar quarter where the manufacturer sold its 60,000th hybrid vehicle following December 31, 2005. Credits are also available for lean-burn technology vehicles (subject to the same phaseout), qualified fuel cell motor vehicles, qualified alternative fuel motor vehicles, and new for 2008, qualified plug-in electric-drive motor vehicles. If you have an interest in purchasing a hybrid vehicle before the end of 2008, please contact me and I can calculate the allowable credit. The amount of the credit could affect your decision on which vehicle to purchase.

Residential Energy Efficient Property Credit: Tax incentives are available to taxpayers who install certain energy efficient property, such as photovoltaic, solar water heating or fuel cell property. In 2008, a credit is available for the expenditures incurred for such property up to a specific dollar limitation. However, after 2008, the cap is removed for solar electric property, so 2009 may be a better time to purchase and install such equipment. The property purchased cannot be used to heat swimming pools or hot tubs. If you have made improvements to your home or plan to by the end of 2008, please contact me to discuss the amount of the credit you may qualify for.

Nonbusiness Energy Property Credit. The nonbusiness energy property credit expired after 2007. Recent legislation extended it for 2009 only; it does not retroactively apply the credit to 2008. Thus, if you plan on purchasing qualifying energy saving property it would be wise to delay such purchases until 2009 in order to qualify for the credit. Qualifying property includes windows (including skylights), exterior doors, insulation, advanced main air circulating fans, natural gas, propane, or oil furnace or hot water boilers, and other energy efficient building property that meets certain energy standards.

Business Credits

Small Employer Pension Plan Startup Cost Credit: For 2008, certain small business employers that did not have a pension plan for the preceding three years may claim a nonrefundable income tax credit for expenses of establishing and administering a new retirement plan for employees. The credit applies to 50% of the first \$1,000 in qualified administrative and retirement-education expenses for each of the first three plan years.

Employer-Provided Child Care Credit: For 2008, employers may claim a credit of up to \$150,000 for supporting employee child care or child care resource and referral services. The credit is allowed for a percentage of "qualified child care expenditures" including for property to

be used as part of a qualified child care facility, for operating costs of a qualified child care facility and for resource and referral expenditures.

Differential Wage Credit: If your business is an “eligible small business,” as an employer you may take a credit against the your income tax liability for a taxable year in an amount equal to 20% of the sum of the eligible differential wage payments for each of your qualified employees for the taxable year. The credit is for wages paid to a military person called to active duty to keep them at their current salary when they receive military pay. Effective with respect to amounts paid after June 17, 2008.

Investment Planning

The following rules apply for most capital assets in 2008:

- Capital gains on property held one year or less are taxed at an individual's ordinary income tax rate.
- Capital gains on property held for more than one year are taxed at a maximum rate of 15% (0% if an individual is in the 10% or 15% marginal tax bracket-reduced from 5% in 2007).

Timing of Sales: You may want to time the sale of assets so as to have offsetting capital losses and gains. Capital losses may be fully deducted against capital gains and also may offset up to \$3,000 of ordinary income (\$1,500 for married filing separately). In general, when you take losses, you must first match your long-term losses against your long-term gains, and short-term losses against short-term gains. If there are any remaining losses, you may use them to offset any remaining long-term or short-term gains, or up to \$3,000 (or \$1,500) of ordinary income. When and whether to recognize such losses should be analyzed in light of the changes in the capital gains rates applicable to your specific investments.

Dividends: Qualifying dividends received in 2008 are subject to rates similar to the capital gains rates. Therefore, qualifying dividends are taxed at a maximum rate of 15%. Qualifying dividends includes dividends received from domestic and certain foreign corporations.

Selling Your Home: A crucial planning device is in play for the end of 2008 if you plan on selling your principal residence that you once rented out or used as a vacation property. Beginning in 2009, the time you spent renting out your residence or using it as a vacation property will not be eligible for the generous exclusion from income on the gain from selling one's principal residence. There are some exceptions to this rule, and if you plan on selling your residence after 2008 that you are renting or using as a vacation property, we'll need to talk about the tax ramifications of this new law.

Social Security: Depending on the recipient's modified AGI and the amount of Social Security benefits, a percentage — up to 85% — of Social Security benefits may be taxed. To reduce that percentage, it may be beneficial to defer receipt of other retirement income. One way to do so is to elect to receive a lump sum distribution from a retirement plan and to rollover that distribution into an IRA. Alternatively, it may be beneficial to accelerate income so as to reduce the percentage of your Social Security taxed in 2009 and later years.

Other Tax Planning Opportunities

We also can discuss the potential benefits to you or your family members of other planning options available for 2008, including §529 qualified tuition programs.

Alternative Minimum Tax

Thanks to another close to year-end legislation, in 2008, the alternative minimum tax exemption amounts will be high enough to spare millions of taxpayers from the AMT effect. The exemption amounts are: (1) \$69,950 for married individuals filing jointly and for surviving spouses; (2) \$46,200 for unmarried individuals other than surviving spouses; and (3) \$34,975 for married individuals filing a separate return. Also, for 2008, nonrefundable personal credits can offset an individual's regular and alternative minimum tax.

The new legislation also gives taxpayers with ISO minimum tax liability some relief. The rules are complex, so if you sold ISOs we should discuss the new rules.

Some of the standard year-end planning ideas will not reduce tax liability if you are subject to the alternative minimum tax (AMT) because different rules apply. Because of the complexity of the AMT, it would be wise for us to analyze your AMT exposure.

If you have any questions, please do not hesitate to call. I would be happy to meet with you at your convenience to discuss the strategies outlined above. There is still time to implement these strategies to minimize your 2008 tax liability.

Very truly yours,

Bruce A. Rukkila, CPA, PC