CLIENT REPORT:

2008 Year-End Tax Planning for Individuals

Dear Client:

The end of 2008 is happening upon us faster than we think. With the year drawing to a close, now is an ideal time to review your tax situation and evaluate strategies that may help minimize your tax bill. Once December 31 passes, your 2008 tax bill is essentially set. Taking certain steps before then, however, can make a difference.

As is the case year after year, favorable changes to the tax laws made in 2008 are also accompanied by unfavorable modifications. This year end, of course, our unprecedented financial crisis looms large. This crisis generates tax loss situations that we may not have faced in recent years, as well as a more urgent need to maximize current income that involves taking steps to minimize tax payments whenever possible.

TRADITIONAL TAX STRATEGIES

Year-end tax planning tips typically fall into two general groups: (1) the traditional strategies that have proven themselves useful year after year, and (2) new opportunities and pitfalls that have arisen from recent changes to the tax laws.

Tried and true tax planning techniques can help virtually every taxpayer save money; some, of course, more than others. How much you can save depends on your individual circumstances, but examination of the following general areas is worth a look --in addition to considering the tax impact of any special circumstances in which you might find yourself this year.

Income shifting

One of the most fundamental year-end tax planning techniques involves accelerating deductible expenses in 2008 and deferring income, if economically feasible, into 2009. By delaying taxable income you defer taxes. Delaying taxable income may also prevent you from losing lucrative tax breaks that can be reduced or eliminated altogether as your income level rises and propels you into a higher tax bracket.

With only a few months left until the end of the year, you can probably anticipate with reasonable certainty what income and deductions you will be reporting on your 2008 tax return. You may also be able to predict with relative accuracy what your income and expenses for the first few months of 2009 will include. The ability to gauge your income and expenses for 2008 and into 2009 provides a golden opportunity to shift income or expenses into one year or the other depending on what will save you the most overall taxes.

Shifting income, however, is not always a matter of simply delaying receipt of funds. Tax rules may require you to recognize certain types of income when you have earned the right to receive it, even if you arrange for its delayed payment. This office can help you recognize and navigate the differences.

Deduction management

Essential year-end tax planning requires determining whether you will take the standard deduction or whether you will itemize your deductions. Consider "bunching" deductible expenses into one or the other year depending upon whether the standard deduction may be taken in one year or whether the adjusted gross income limits for medical (7.5 percent) or miscellaneous itemized deductions (2 percent) may be more easily met.

Even if you know you will itemize deductions, accelerating or deferring them is often a question of determining your probable tax bracket for year end and the next year to maximize their after tax value. Sometimes planning is as simple as paying your state estimated tax or real estate taxes in one year or the other; at other times, it's a question of making certain you gather the right proof and follow the proper steps in time to be entitled to a deduction in one year or the other. Again, this office can help.

Portfolio timing

The end of the year is the right time to examine your investments (winners and losers over the course of the year) to take the steps necessary to minimize your capital gains income and maximize the benefit of any capital losses. Especially this year, when the stock market took its roller-coaster ride, gathering your portfolio's records for the entire year can make a difference in not only what you might buy or sell in November and December but what estimated tax you will need to pay (or not pay) for the fourth quarter of 2008.

Long-term capital losses can be used to fully offset long-term capital gains. Losses taken in excess of gains can also be used to offset up to $3,000 in ordinary income (or $1,500 for a married couple filing separately). The strategy for short-term gains and losses follows a similar game plan, although coordinating the two sometimes takes special care. Unlike excess business losses that can be carried back two years to net an immediate refund in many cases, an individual's net capital losses unfortunately can only be carried forward.

In calculating gains or loss for purposes of balancing your gains and losses at year end, remember that, for tax purposes, it's not how much your stocks have gone down for the year but rather have much gain or loss you've realized since purchasing them. For example, you still may owe capital gains tax on stock acquired in 2001 at $15/share even though it may have dropped $20 in 2008 from a high of $65 to $45 when you sold it. You still have capital gain of $30/share on the sale.

Retirement planning

Year-end planning for 2008 also involves maximizing annual contributions to your retirement plan accounts, since one year's limit cannot be added to the next year's if not taken in time. While contributions to IRAs may be applied retroactively if made before the filing deadline, an individual's elective deferral contribution made as an employee to a qualified plan must be made before the end of the calendar year.

Maximizing contributions to your retirement plan (or plans) before year end also allows you to reduce your adjusted gross income in direct proportion to those contributions. This in turn can give you the benefit of increasing the deductibility of medical and other deductions subject to adjusted gross income floors.

As many 401(k) plan account owners have realized in 2008, managing a tax-deferred retirement account is not a "set it and forget it" proposition. Although sheltered from tax, a 401(k) or other defined contribution plan also requires careful management of the performance of those investments and re-allocation of assets whenever appropriate. Unfortunately, losses on any 401(k) plan are not tax deductible; nor can they offset capital gains in non-tax sheltered accounts.

Gift-giving

Slow and steady estate planning can yield dramatic results. Nowhere is that more apparent than devising an annual gift giving plan to family members. Before year-end 2008, you can transfer up to $12,000 per person, per year, without paying gift tax on the amounts transferred. Married couples can gift $24,000 per person by "splitting" their gifts. In 2009, the annual exclusion rises to $13,000 ($26,000 for couples). This strategy not only avoids the possibility of paying a hefty estate tax later, but it removes earnings from those gifts from your taxable income bracket into that of the lower-bracket gift recipient.

NEW OPPORTUNITIES

Tax law changes constantly, and therefore so must individual tax planning. Tax year 2008 is no exception. While fundamental techniques should not be overlooked, attention to tax legislation is equally important for most taxpayers. In 2008, Congress passed a host of provisions to encourage consumers to jumpstart the economy by having more money in their pockets to spend.

In addition to the Economic Stimulus checks that were mailed out -for the most part- before this past September, tax legislation in 2008 renewed or enhanced many benefits for individual taxpayers, some only for 2008 and others for both 2008 and 2009. Maximizing these tax benefits between 2008 and 2009, therefore, requires care in respecting a variety of effective dates.

AMT patch. The Emergency Economic Stabilization Act of 2008 (EESA) included among its many provisions a so-called alternative minimum tax (AMT) "patch." For the 2008 tax year, the AMT exemption amounts are raised to once again insulate most middle-income taxpayers from the reach of the AMT. The patch is only for 2008. Hopes are high that in 2009 Congress finally will face up to the need to find a permanent solution to the AMT and pass AMT reform rather than yet another patch.

Income for forgiveness of mortgage indebtedness. Those principal-residence homeowners who have part of their mortgage debt forgiven as part of a workout or foreclosure have been spared having to pay income tax on that forgiven income. The Mortgage Indebtedness Relief Act of 2007 first applied this tax-free treatment to debt forgiveness taking place from 2007 through 2009. The Emergency Economic Stabilization Act of 2008 extended it through 2012.

State and local sales tax deduction. Despite being one of the more popular tax breaks, the deduction for state and local sales taxes is not permanent and had been set to expire at the end of 2007. Under this deduction, taxpayers who itemize deductions the option of claiming either state and local income taxes or state and local general sales taxes. The Emergency Economic Stabilization Act of 2008 extended this deduction for 2008 and 2009.

Tuition and fees deduction. Taxpayers may continue to deduct qualifying tuition and fees paid in 2008 that are required for the student's enrollment or attendance at a post-secondary school. The tuition and fees deduction is an above-the-line write-off that, depending on adjusted gross income, can reduce taxable income by as much as $4,000. They are frequently more valuable than taking a Hope or Lifetime learning education credit. Since this deduction also has been extended for 2009, deciding in which tax year an upcoming tuition payment will be made can help maximize your overall education deductions and credits.

Classroom deduction. Full-time teachers, instructors, counselors, and other educators can deduct up to $250 worth of books, supplies, software, and other qualifying materials that they provide out of pocket expenses. The deduction had been set to expire at the end of 2007, but Congress now has extended it for 2008 and 2009. Educators should remember that this deduction is based on the calendar year rather than the school year.

Tax-free IRAs charitable contributions. The EESA extends through December 31, 2009, the opportunity for certain taxpayers age 70 1/2 or older to make tax-free distributions from IRAs for charitable purposes. This contribution can include any required minimum distribution that the taxpayer would be otherwise required to take.

Residential energy property. The high cost of energy is encouraging many people to make energy efficient improvements to their homes. If you are contemplating installing energy-efficient doors and windows, water heaters or other items in 2008, you may want to wait until 2009.

Several years ago, Congress created a residential tax credit for installing energy efficient doors and windows, water heaters and similar items. The nonrefundable lifetime credit could reach as high as $500. However, the credit expired at the end of 2007. Surprisingly, the EESA reinstates the credit but not for 2008. The new law reinstates the credit for 2009 through 2016. The EESA also expands the credit to include certain stoves that use renewable plant-derived fuel along with other enhancements; so while the credit is not available for 2008, the expanded credit for 2009 may be worth waiting for.

Another incentive is available in 2008 for certain energy efficient improvements. Solar electric property, small wind energy property and some heat pump property may qualify for the residential alternative energy tax credit. Additionally, you can use the residential alternative energy credit against AMT liability in 2008.

Biking to work. Another new tax break that doesn't begin until 2009 is a new employer- provided transportation fringe benefit. In addition to transit passes and van pooling, employers starting in 2009 can offer their employees up to $20/month as a tax-free benefit if they commute to work by bicycle. To inaugurate this benefit starting in January, however, employers must incorporate it into their written fringe benefit plan, a process that should start soon.

Vacation Home Conversions

Gain from the sale of a principal residence that is allocable to periods of "nonqualified use" can no longer be excluded from the taxpayer's gain realized on its sale. A technique that has been used by many vacation home owners is to eventually convert that second home into a principal residence before its sale and claim a full $250,000 principal residence exclusion ($500,000 for joint filers) on the gain. Due to a loophole closing provision in the 2008 Housing Assistance Tax Act, any conversion made after December 31, 2008, cannot shelter the portion of that gain allocable to post-2008 appreciation.

GIVE OUR OFFICE A CALL

With the complexity of the tax law, understanding what tax planning provisions to incorporate into your year-end tax planning strategy can be a daunting task. While this letter hopefully gives you a heads up on several strategies that you might like to utilize before year end, there are many more techniques that can be used depending upon a client's individual circumstances. For a more detailed plan that can be customized to your particular circumstances, please don't hesitate to give this office a call.

Sincerely yours,

Reproduced with permission from CCH's Client Letter, published and copyrighted by CCH Incorporated, 2700 Lake Cook Road, Riverwoods, IL 60015.