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Re: 2008 Year-end Tax Planning in an Uncertain Economy

Dear Client:

Year-end tax planning has taken on a new sense of urgency for many people. The downturn in the economy has everyone asking what they can do to recover from setbacks such as job and investment losses. Tax planning is always fluid and it is even more so in this time of economic uncertainty. At the same time, it's important to keep in mind that 2009 is likely to bring even more changes with a new Administration and Congress in Washington.

Before we take a look at traditional year-end tax planning, let's examine some of the developments that have made 2008 unlike any other year, along with some possible strategies.

Stock losses. Many people have sustained large losses in their investment and retirement portfolios from the crisis in the financial markets. Not only have many stocks declined in value in recent months; others have become worthless. In today's market, you are likely to have in your investment portfolio holdings that are currently priced below your purchase price. Now might be a good time to consider selling those stocks or mutual funds to generate losses to offset capital gains and then up to \$3,000 of your ordinary income. Capital losses inside a retirement account cannot be offset against non-retirement gains or other non-retirement income. You should of course always examine your portfolio first from an investment strategy standpoint, and then also consider the tax possibilities.

Alternatively, you may want to keep a loss security in your investment portfolio for various reasons. You may be able to sell the stock to recognize the loss and then reacquire it to continue your investment. However, to use the loss on your 2008 tax return, you must wait 31 days after the sale to repurchase the security. Another strategy is to sell now and then reinvest the proceeds immediately in shares of a company in the same industry that are likely to perform similarly to the stock you just sold. In either case, your loss qualifies for full capital loss treatment and can offset capital gains (including any flow-through capital gains from mutual funds – if any this year), with any excess used to offset up to \$3,000 of ordinary income. Of course if you already have large carryover losses you may not need to generate losses to use. If you have any net losses exceeding the \$3,000 allowable offset, those losses will carryover to future years.

Worthless stock also generates an immediate deduction. The rules for "worthless" stocks are very strict. Your definition of worthless may be very different from the IRS' definition. Stocks and securities must be totally worthless for a taxpayer to take a loss deduction. A mere diminution in

value, no matter how great, will not trigger a loss deduction. If you have stocks that are virtually worthless (penny stocks) but the company is still operating, one way to generate the loss is to sell the stock for little or nothing. Your broker can accommodate this need for you.

Do you want Tax-Free Capital Gains? If you are fortunate enough to have capital gains for 2008 (whether from the stock market or from other sources such as property sales) certain taxpayers may be eligible for tax-free rates on this gain under special provisions applicable to the year 2008. There are a complicated set of rules related to income limitations and the “mix” of your sources of income. Basically, if you are in the 10% or 15% tax bracket your gain on capital gains could be zero. The important issue here is that if you qualify and if you have gains yet to harvest (your stocks for instance might have gone down in value from last year, but they still might be worth more than your original cost) you might consider having us do a projection to see if you can qualify for the zero tax provisions. If so, and if you otherwise would not be able to use this provision, you might be able to sell your “gain” stock, pay no tax, and then repurchase the stock with a higher tax basis for future sales, particularly if you will be in a non-qualifying bracket in 2009. Be careful, however, of any effect on the taxability of your Social Security income or your itemized deduction limitations. Be sure to contact us soon if you need our assistance with this.

Retirement savings. According to the Congressional Budget Office, nearly \$2 trillion in retirement savings has been lost in the last 15 fifteen months. In response, Congress may – before the end of 2008 – temporarily suspend the required minimum distribution (RMD) rules for IRAs and qualified retirement plans (but nothing has been announced yet). You cannot keep funds in a retirement plan indefinitely. By April 1 of the calendar year following the year in which you reach age 70 1/2 , even if you have not retired, the remaining balance in a traditional IRA must be distributed to you in full or you must begin to receive RMDs from the account. RMDs from a qualified (non-IRA) plan are not required until April 1 of the calendar year following the later of the year in which you reach age 70 1/2 or the year in which you retire, unless you are a 5% or greater shareholder in the company with the retirement plan.

Because of the recent decline in the financial market, some retirees are being forced to withdraw assets that are currently undervalued. Suspending the RMD rules would help them but would not help individuals who must take RMDs to meet their everyday living expenses. Consequently, Congress may also allow individuals to take early distributions from IRAs and other arrangements penalty-free (but still subject to income tax). Although there is some leeway for “hardship” distributions, current rules are designed to discourage early distributions. Keep in mind, however, that you are using funds today that you originally set aside for retirement. If you have not already taken your RMD for 2008 and would not if not required to, continue to watch your newspaper or call us to see if any changes in the RMD rules are enacted.

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.

As many 401(k) plan and IRA 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 retirement account also requires careful management of the performance of those investments and

re-allocation of assets whenever appropriate. Unfortunately, losses within a retirement plan are not tax deductible (except to the extent you have smaller taxable income as it is withdrawn in the future); nor can they offset capital gains in non-tax sheltered accounts.

One of the potential trouble spots we've encountered this past year is partnership investments in IRA accounts. You are allowed to have partnership investments in IRA accounts, but they potentially cause at least two problems. The first is that you might incur unrelated business taxable income (UBTI). If your partnership has investment interest expense or other UBTI, this can cause an income tax on your IRA account even though it is theoretically tax exempt. Additionally, it is sometimes difficult to obtain year-end values to be used in calculating the RMD. You should discuss this issue with us more thoroughly if this might affect you.

Mortgage meltdown. The mortgage meltdown has surprised many homeowners with unanticipated tax consequences. When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives part or all of the unpaid mortgage debt, the Tax Code traditionally considered the cancelled debt to be taxable income to the homeowner. In 2007, Congress gave homeowners some relief. The Mortgage Forgiveness Debt Relief Act of 2007 and subsequent legislation excludes from taxation discharges of up to \$2 million of indebtedness secured by a principal residence and is incurred in the acquisition, construction or substantial improvement of the principal residence. This special relief is available for tax years beginning January 1, 2007, and ending December 31, 2012. This treatment also covers mortgage workouts under which the terms of the mortgage are changed to result in a lower monthly payment.

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. However, this year you must be extra careful particularly if you are in the higher tax brackets and have income above \$250,000. While there is no law yet, the new administration has announced plans that may raise the tax rates for individuals in the higher brackets (by restoring the older, higher rates). If that comes to pass and you are in that situation, you may wish to accelerate income into 2008 rather than delay it until 2009. This may also affect your timing of deductions and when to pay them.

Gift and estate taxes 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.

The estate tax exemption equivalent rises to \$3.5 million in 2009 for decedent's dying in that year. If you have proper planning and an appropriate trust set up, a couple can shield up to \$7 million from estate taxes. Be sure to discuss these issues with us to obtain a better understanding of the rules and to stay up to date because changes may occur in these rules.

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 have 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. This deduction is frequently more valuable than taking an 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 law now 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. If you have a distribution yet to withdraw for 2008, and if you were going to also make a charitable contribution before year end, this provision could save you money by directly transferring the distribution to your favorite charity. You don't get the charitable deduction, but neither do you have to include the distribution in income. This contribution can include any required minimum distribution that the taxpayer would be otherwise required to take. There are income limitations on the ability to use this provision, so if this is something you wish to consider you should have us calculate the potential benefit to you of considering this option.

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, insulation materials, skylights 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.

Vacation Home/Second 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 recommended by us and 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. So, it still might be beneficial, but perhaps not as much as before.

Property tax deduction for non-itemizers. The Housing Assistance Tax Act of 2008 gives non-itemizers a limited deduction for state and local real property taxes for 2008, up to a maximum of \$1,000 (\$500 for single individuals). The EESA extends the same relief to 2009.

California Tax Amnesty. Much like a program in prior years, California is offering taxpayers who have unpaid tax liabilities for the years 2003-2006 to come forward voluntarily between February 1 and March 27, 2009. If so, there will be penalty forgiveness. If not done, the penalties will be higher afterward.

Gifts into Trust Have you established, at any time in the past, an irrevocable trust (such as a life insurance trust or other trust for the benefit of your children or grandchildren)? We have found this past year that several clients had started these kinds of trusts and never told us about them. If you have established one of these, be sure to provide us a copy of the trust agreement and a schedule of all of the gifts you have ever made into the trust. You could have some gift and income tax reporting requirements that may not yet have been fulfilled.

Business-Related Information

Loss Deductions. Net operating losses will be something that many more businesses unfortunately will need to become familiar with during the present economic downturn. A trade or business has a net operating loss (NOL) when its allowable deductions exceed its gross income for the tax year. Generally, an NOL can be carried back 2 years and carried forward 20 years--the carryover period (businesses in specially designated disaster zones may be entitled to a 5 year carryback).

The first year of the carryover period is the year after the NOL arises; thus, it becomes important to determine the correct year in which gross income is recognized and deductions are taken. The carryback period is especially valuable since the carryback can immediately reduce any taxable income for those prior two years, entitling the business to an immediate cash tax refund upon filing an amended return.

Research Tax Credit and Energy Deduction

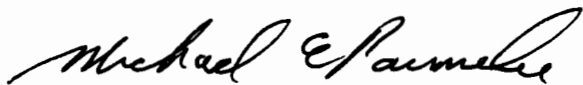
The new tax law revised research tax credit rules, and an "alternative simplified credit" has not only been extended but raised to a level at which smaller businesses have a greater tax incentive to spend money on research. Also good for both the environment and a lower bottom line tax, the new law has extended the energy deduction for energy efficient commercial buildings through 2013. Planning to take full advantage of these changes should start now.

Bonus depreciation. The Economic Stimulus Act of 2008 provided 50 percent bonus depreciation of the adjusted basis of qualifying property. This accelerates an additional 50 percent of depreciation that would be allowed on business property into the first year in which it is acquired. However, the property generally must be purchased and placed in service during calendar year 2008 to qualify. In 2009, the tax law reverts to its regular depreciation allowances.

Enhanced expensing. Most small businesses are eligible for the Code Section 179 deduction, a generous and lucrative tax break that enables businesses (especially those that are capital intensive) to immediately deduct equipment purchases that otherwise would have to be depreciated over a number of years. There are limits to this deduction, however. Looking at the tax law as it now exists, the limits for 2008 are far more generous than for 2009. There are also enhanced deductions for certain charitable contributions of food, books and computer equipment.

We've covered a lot of information. While the economy may have you thinking about your losses right now, remember that "If you count *all* your assets, you always show a profit." (Robert Quillen). Please contact our office so we can discuss these and many other year-end tax planning techniques.

Sincerely yours,
Harvey & Parmelee LLP

A handwritten signature in cursive script that reads "Michael E. Parmelee".

Michael E. Parmelee, Partner