TAX NEWS

Winter 2008 **Tax Client Newsletter**

It's been hard to get this letter out to you this year because it seems like on an hourly basis, everything changes. The roller coaster ride that we have been through watching Congress and the Administration try to address the economic woes is like nothing any of us have seen in our professional careers. One indication of this volatility is the fact that the stock market this Fall has moved up and down in value by wider margins in the last 50 trading days than it had in the previous 25 years. These moves are approaching a trillion dollars in value on a daily basis.

The tax law is so closely linked with the volatile shifts in politics and the economy that few of us know with certainty what will happen next. What I can do is give you an overview of the recent changes that might affect you and some idea of what the next round of stimulus measures and tax changes might be. If you have any questions concerning any of the information outlined below, please contact my office to schedule an appointment.

Bailout Bill Has 100 Tax Provisions

On October 3, 2008, President Bush signed into law H.R. 1424 (P.L. 110-343), the so-called "Bailout Bill." The new law contains not only the $700 billion financial industry rescue plan but also several important and far-reaching tax bills that were moving through Congress at the same time. The tax titles include the yearly extension of expiring tax provisions (the tax "extenders" bill), a temporary adjustment in income thresholds for the alternative minimum tax (the AMT "patch"), tax relief for Midwestern disaster areas hit by storms and floods, and, finally, numerous energy tax incentives.

The bailout bill provided the perfect opportunity for Congress to combine bank rescue with these tax bills. Both the energy bill and the extenders bill were being blocked by election year politicking, filibuster and veto threats. With Congress set to adjourn before the elections, it appeared that we were going to face yet another year of uncertainty, particularly with regard to the alternative minimum tax and the expiration of popular tax credits. Because of the urgency of the bailout plan and the backing of the Bush Administration and both Presidential candidates, these huge tax bills slipped through Congress at the last minute--with close to 100 Act sections and something for everyone! A description of the major provisions affecting your taxes is given below.

More Congressional Action Pending

But Congress is not finished yet. It is considering yet another economic stimulus bill, including a bailout for the U.S. car companies that might get passed in an historic second lame-duck session in December. Car companies are presenting a business plan to Congress which includes job cuts, closed factories, reductions in executive pay, and a commitment to fuel-efficient cars. They hope these concessions will land them $25 billion in emergency loans.

A second stimulus package already has been drafted by Senate taxwriters and is expected to serve as the basis for another round of tax incentives to jump-start the economy. Two key business provisions include an extension of bonus depreciation for 2009 which allows a taxpayer to depreciate 50 percent of the cost of an asset in the year it was acquired and an extension for one year of the rule which allows small businesses to immediately deduct up to $250,000 for property acquired and placed into service in 2009. This bill also contains relief to individuals and pension plans affected by the recent financial crisis, the most visible of which is to put a moratorium on required distributions from retirement plans. If you are age 70 ½ or older, you will not be required to take distributions from your retirement savings for 2009 if this bill goes through. This allows your savings to stay put and helps you avoid a tax hit when the market is down.

TAX PROVISIONS OF THE BAILOUT BILL

Highlights of the tax provisions include:

--Tax-free mortgage debt forgiveness for homeowners.

--Restricted deductions for executive compensation of bailed out companies.

--Increased AMT exemption for individuals and AMT credit offsets.

--Extension of many expiring tax provisions, including the sales tax deduction, tuition deduction, IRA charitable transfers, and the R&D credit.

--Additional standard deduction for property taxes of nonitemizers.

--Five-year depreciation for farm property.

--Child tax credit changes.

--Alternative energy and efficient energy credits and deductions.

--Liberalized loss deductions for disaster victims.

Mortgage Forgiveness Not Taxable

Congress has extended the tax exclusion for forgiven mortgage debt through 2012. There is a $2 million limit ($1 million for married individuals filing separately) on this tax exclusion, and the loan must have been used to buy or improve your principal residence. Under previous law, forgiven debt would be considered taxable income by the IRS. While you may qualify for this immediate tax exclusion, you may have to pay more tax once you sell your home. The nontaxable portion, or cost basis, of your home will be reduced by the excluded amount, possibly resulting in more gain on the eventual resale.

So-Called Alternative Minimum Tax Patch

You may be in the lucky group that avoids the higher alternative minimum tax this year. Congress has fixed the AMT problem for another year by increasing the exemption amounts to $46,200 for individuals and $69,950 for joint returns. Other adjustments to the AMT calculation could keep you out of the AMT system for another year.

Other Popular Individual Tax Breaks.

Many of these provisions were set to expire in 2008 and have been extended retroactively for 2008 and forward for several more years.

Deduction for State and local sales taxes. You may still elect to deduct State and local sales taxes instead of State and local income taxes for two years, through December 31, 2009. IRS publishes tables for each state based on income level and average sales and use taxes imposed by each state. Contact me if you are interested in finding out the average state and local sales and use taxes for your area.

Deduction of qualified tuition and related expenses. Even if you do not itemize your deductions you will be able to take a tuition deduction for college expenses for two more years.

Deduction for certain expenses of elementary and secondary school teachers. Elementary and secondary school educators may deduct the cost of books, supplies, computer equipment and other equipment and other materials used in the classroom for two more years, through 2009. You do not have to itemize your deductions to get this benefit.

Additional standard deduction for real property taxes for nonitemizers. You can get up to a $500 additional standard deduction for State and local real property taxes for an additional year. If you are married, the additional deduction limit is $1000.

Tax-free distributions from IRAs for charitable purposes. For two more years through 2009, you will be able to take tax-free distributions from your IRA accounts if you donate the money to charity. The limit on this tax exclusion is $100,000 a year.

Higher refundable child tax credit. Beginning in 2009, a higher refundable child tax credit will be available to qualified taxpayers because the earned income threshold for getting the refund will be reduced from $12,050 to $8,500.

Extension of Business Tax Provisions/ Disaster Relief

Numerous business relief provisions have been extended by Congress, but not for long. As in the past, Congress seems only to be able to deal with the tax code for two years at a time. Large corporations got a renewal of their research and development credit, which expires almost every year. As a small business owner, you can breath easier for a couple more years due to the following extensions for hard-hit areas and special industries:

• Bigger depreciation deductions for improvements to restaurants and to retail spaces.

• Quicker write-offs for investments in farming business machinery and equipment.

• Relaxed rules for deducting disaster losses and an increase in the deduction limit from $100 per casualty to $500, for taxable years beginning after December 31, 2008, and before January 1, 2012.

• More favorable treatment of charitable contributions for S Corporation shareholders.

• Extended work opportunity tax credit for employees who lived in the Hurricane Katrina disaster area and have been employed in the core disaster area.

• Extended credit for rehabilitating depreciable buildings in the Gulf Opportunity Zone.

• Temporary tax relief for areas damaged by 2008 Midwestern severe storms, tornados, and flooding, including faster write-offs for purchases of business property and employment credits. The Midwest Disaster area includes areas hit by severe storms, tornados, or flooding in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

• Immediate deductions for debris removal and repair of damaged business property in disaster areas.

• Faster depreciation for business property on Indian reservations.

Energy Tax Incentives

Congress's rush to adopt an energy plan has led to a confusing patchwork of energy tax incentives available for you if you drive hybrid vehicles or make energy efficient improvements to your home. There are so many different provisions, that the best thing to do is to consult with me before you make any significant improvements to your home, before you purchase any major appliances, and before you purchase a hybrid vehicle. Here's a list of some of the possible credits and deductions:

● Up to $2000 Credit for residential energy efficient property such as solar heaters or wind energy systems.

● $3000 Credit for new plug-in electric drive motor vehicles.

● An alternative fuel vehicle property credit for the cost of installing alternative fuel dispensing systems at a taxpayer's home or business.

● 10% Credit for energy efficiency improvements for existing homes.

● Energy efficient commercial buildings deduction.

● New energy efficient home credit for contractors who build new energy efficient houses purchased by individuals as their principal residence.

Ride Your Bike to Work

The energy portion of the bailout bill also allows tax-free employer reimbursements of up to $20 per month for employees who ride their bike to work. Previously, tax-free transportation fringe benefits included only commuter highway vehicles, transit passes, and certain parking expenses. The new rule is effective for taxable years beginning after December 31, 2008.

Higher Unemployment Taxes for Employers

If you are an employer, you have been paying an increased federal unemployment tax (FUTA) tax rate (6.2%), which was set to expire after 2008. The normal FUTA rate is 6%, but there has been a 0.2% surcharge on this rate for many years. One of the revenue raisers in the bank bailout bill is an extension of the 0.2% FUTA surtax through 2009. The rate now is set to go back down to 6% in calendar year 2010. One note: Employers who pay state unemployment taxes get a credit against a portion of their federal unemployment tax.

Mental Health Benefits Must Be on Equal Footing

Believe it or not, the bailout legislation (H.R. 1424) originally was a very limited bill requiring employers to offer mental health benefits in a similar fashion to regular medical coverage. This provision stayed in the bill as the bank provisions and numerous tax changes were added. The new law prevents group health plans from imposing stricter rules on mental health benefits than those for other medical benefits, such as lifetime or annual dollar limits that are not applied to medical and surgical benefits.

Highlights of the Upcoming 2009 Rate and Rule Changes

Many tax provisions are indexed for inflation on an annual basis based on the consumer price index (CPI). Tax rates, the standard deduction, the personal exemption and deductible contributions to some retirement plans all are increased for 2009. For example, the tax rate for single individuals changes from 15% to 25% at $33,950 worth of income, while for married couples, it goes up to 25% with $67,900 in income. Adjusting the tax brackets for inflation lowers your tax liability by taxing more of your income at a lower rate. If you do not itemize your deductions, the new standard deduction amount for married taxpayers filing jointly is moving from $10,900 to $11,400. For single taxpayers it is increased to $5700 from $5450 in 2008. Elderly and blind taxpayers get an additional standard deduction of $1050 in 2008 and $1,100 in 2009. Your personal exemption amount will increase from $3,500 in 2008 to $3,650 in 2009.

The cap on the amount of your wages subject to payroll taxes also is increased for 2009. For 2009, the 6.20% employee Social Security tax will be imposed on the first $106,800 of your wages (as compared to the first $102,000 in 2008), making your maximum social security contribution $6,621.60. The 1.45% in Medicare taxes you pay is computed on your total wages, with no limit.

Phaseout of Itemized Deductions and the Personal Exemption

If you bump up against certain income thresholds, your itemized deductions and personal exemptions start disappearing. The reduction does not apply to deductions for medical expenses, investment interest, nonbusiness casualty and theft losses, and gambling losses. Luckily, these thresholds are increased each year for inflation. For 2009, the applicable amount is $166,800 for married couples. For 2008, it's $159,950. The reduction itself is phased out by 2010. For 2008 and 2009, you will lose only 1/3 of the amount under the full reduction computation which was effective last year. Unless the new Congress changes the law, you should get your full itemized deductions back in 2010.

For 2008, the personal exemption also phases out at income levels of $239,950 (joint return or surviving spouse), $199,950 (head of household), $159,950 (single) and $119,975 (married filing separately). For 2009, these figures are $250,200, $208,500, $166,800 and $125,100 for these same filing categories. The reduction is phased out in 2008 and 2009 and expires in 2010.

Business standard mileage rate

If you use a passenger car, including a van or pickup truck for business purposes, the standard mileage rate you can use to compute your deductions changed in the middle of 2008. For the first half of 2008, the rate was 50.5 cents per mile. Recognizing the high cost of gasoline, IRS increased the rate for the second half of 2008 to 58.5 cents per business mile. The 2009 rates drop down to 55 cents per mile.

If you had to move this year because of a job change, you can deduct your actual expenses for traveling to your new home at the rate of 19 cents per mile for the first six months of 2008 and 27 cents per mile for the last six months of the year. The 2009 moving and medical mileage rate is 24 cents per mile. The mileage rate for charitable use of your vehicle is set at 14 cents per mile next year.

Mortgage Insurance Deduction Extended

If you are still paying PMI (private mortgage insurance) on your home, you may continue to deduct those payments as mortgage interest through 2010. The deduction is only allowed for debt on your principal residence.

Good News and Bad News on Exclusion of Gain on Your Home

If only you could sell, you would be able to exclude from your income up to $250,000 if you are single or $500,000 if you are married of the capital gains on the sale of your home. You must use the home as your principal residence for at least 2 of the 5 years before the sale to qualify for this tax break.

The catch is for those of you with rental property. To prevent taxpayers from turning rental property into a principal residence for a couple of years just to take advantage of the tax-free income, Congress changed the rules for sales after 2008. Now, the increase in value of the property which occurred during previous periods of rental use will not be eligible for the tax exclusion.

Beginning in 2008, a surviving spouse can get the full $500,000 exclusion from profits on the sale of a home if the sale occurs within two years after the first spouse's death as long as both taxpayers qualified before the death and as long as the spouse remains unmarried.

Paying the Babysitter

If you have a nanny or a cleaning service, the new annual threshold amount for having to report and pay employment taxes is $1,600 for 2008 and $1,700 for 2009. If your yearly payments to any one domestic employee exceed these amounts, you have to report withheld income and social security taxes on your individual tax return and you will need an employer identification number (EIN). This dollar amount applies separately to each employee so you do not have to combine all payments when calculating whether or not you owe employment taxes.

Rules Change for Claiming a Dependent Child in Divorce

In a move that is sure to lessen the friction between divorced spouses, IRS has said that it will automatically treat a child as a dependent of both parents whether or not the custodial parent consents. This treatment only applies if the parents are divorced, legally separated under a court order, or live apart at all times during the last 6 months of the calendar year. The child must receive over one-half of his or her support during the calendar year from the parents and must be in the custody of one or both parents for more than half of the calendar year. Finally, the child must have a family connection to the parents or must be a member of the parent's household.

Before this rule change, IRS got in the middle of custody disputes by requiring proof that one parent had released the exemption to the other parent before the noncustodial parent could take advantage of certain employer-provided fringe benefits or take the medical deduction for their children. This must have been too much for IRS to police, so IRS has gone back to allowing both parents to claim these tax benefits for their children.

Dependency claims even when there is no custody issue continue to be one of the most scrutinized areas by the IRS and can result in a very unfavorable adjustment to your tax bill. If you want to claim someone as a dependent who is not your natural or adopted child and who is over the age of 18, you should be prepared to prove that you supported this person with credible, written documentation that proves they lived in your home and that you paid a substantial amount of their support.

Paying Tax on Your Children's Income—the Kiddie Tax

If your child has unearned income (interest, trust payments, or just about anything other than earnings at a job), your child will have to pay the so-called "kiddie tax" at your highest marginal tax rate. The threshold amount for the kiddie tax has been increased to $1800 in 2008 and $1900 in 2009.

Giving Made Easier

If you want to give more away, you will be exempt from gift tax if your annual gift to any one individual is over $12,000 in 2008. This amount increases to $13,000 for 2009.

Act Quickly to Get Home-Buying Credit

If you buy a home after April 8, 2008 and before July 1, 2009, you may be entitled to a refundable tax credit up to $7,500. Of course, like other provisions, the credit is phased out for taxpayers at higher income levels. To qualify for this credit, you must not have owned a principal residence within three years before the new purchase.

Business Owners Beware. Credit Card Transactions Reported to IRS in 2011

This provision does not appear to be getting much press, but banks and online payment networks will have to report a merchant's credit and debit card sales to IRS beginning in 2011. The merchant's name, address, and taxpayer identification number will be included on these information returns. Online third-party network transactions, such as those done with PayPal, also must be reported. The stated objective of this rule is to improve tax compliance by merchants.

Hardship Distributions from Retirement Plans

If your money is locked away in an ever-decreasing 401(k) or IRA account and you need it to stay afloat, relief may be on the way. Heavy penalties, including regular income tax as well as a 10% additional penalty usually apply to early distributions from these plans. However, there are special loan provisions and hardship withdrawal rules you may be able to take advantage of in these tough economic times which will lessen the penalty. You also can withdraw certain amounts for an immediate and heavy financial need. You can withdraw from IRAs for extraordinary medical expenses, medical insurance premiums if you are unemployed, and college tuition expenses. First-time homebuyers may withdraw $10,000 from IRAs to put down on a house. If you have had to take money from your retirement plan or if you will need to do so in the immediate future, contact me to find out if you may qualify for a hardship exemption.

Another important note. One of President-Elect Barak Obama's tax proposals is to allow a withdrawal from a retirement plan of up to $10,000 in 2008 penalty-free. This provision may be enacted early in the Obama Administration with retroactive effect!

Other Possible Tax Changes Early in Obama Administration

As the transition to a new President progresses, more information is coming out on what to expect early on the tax side in Barak Obama's presidency. He may let some 2001 and 2003 tax breaks expire at the end of 2010, as they are currently scheduled to do. But it is beginning to look less likely that he will take any immediate action to raise taxes, even on higher income individuals earning more than $200,000 per year. At one point, Obama floated the idea of raising the capital gains and dividend tax rate on high-income filers from 15% to 20%.

You can expect some "middle-class" tax cuts to be included with any new economic stimulus package. Obama's campaign platform included an exemption of $50,000 for all seniors, a 50% credit for child care expenses for low-income families, a working families credit of up to $1000, a universal mortgage credit of 10% for non-itemizers, a $4000 tax credit for tuition, and an increased savers' credit. At one point, Obama advocated a $1000 Emergency Energy Rebate for families paid for with a Windfall Profits Tax on oil prices exceeding $80 per barrel. Oil prices are below that right now, but expected to rise again in the not-too-distant future.

You can be sure that I, as your tax professional, will be working hard to keep up with all of the potential changes and to make sure you will be able to take full advantage of any available tax relief.

IMPORTANT NEWS ON OUR PROFESSIONAL RELATIONSHIP

Congress Ends Discrepancy Between Our Reporting Standards

Congress has come to its senses and passed a law rolling back the different tax return reporting standards for you, as the taxpayer, and me, as your tax preparer. In 2007, in an effort to make tax preparers police their clients, Congress raised the penalty threshold for tax preparers to a higher standard than is required for taxpayers. Since that time, my colleagues and I have been struggling with the potential conflict of interest. Specifically, the 2007 change said I would have to disclose certain positions on your return even if you were not required to. The profession has been up in arms ever since and our professional associations have worked hard to have the law changed. Congress has now backed off its position and has set "substantial authority" as the standard for both of us in reporting tax positions. The change is retroactive to May 25, 2007, which completely reverses the earlier change.

I want to assure you that my main objective is to give you the very best advice and to prepare your returns in the most favorable and professional manner. I will continue to resist any attempts by the government to interfere with this privileged relationship.

Conclusion:

The Bailout Bill represents the single biggest piece of tax legislation in years. As always, your individual focus should be on how the law changes affect you and how the tax law changes benefit you. Whether it is a concern you might have over the new legislation or general issues concerning your individual tax situation, your particular tax needs are in the forefront of our thoughts. As your Tax Professional, I look forward to speaking with you regarding any personal concerns or questions you might have. Please make an appointment to see me soon.

Thank you for reviewing the Winter 2008 Tax Client Newsletter, and I appreciate the opportunity and privilege of serving as your tax professional.

Sincerely,

Joshua W Harmening CPA CFE