The Kiplinger Tax Letter

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SPECIAL

YEAR-END TAX PLANNING

Dear Client: Washington, Oct. 31, 2008

HIGHLIGHTS

Retirement Plans	Help for seniors
Minimum Tax	Potential problems
Energy	Tax credits renewed
Withholding	Avoiding penalties
Investments	Tax saving strategies
Depreciation	Extra break expiring

If you make the right moves now...
You can save a bundle on your taxes.
Before year-end, there are many tax issues to review. And with the changes that Congress passed this year, there are more chances to save and traps to avoid.

The key to year-end planning is simple:
Look at the overall impact on two tax years
as you weigh your options...2008 and 2009. The goal is to cut your tax bill over both years, not just one. Keep that in mind as you decide whether it is better for you to accelerate deductions from 2009 into 2008 or defer receiving income until 2009. If you expect to be in a higher bracket in 2009, consider accelerating income and delaying taking deductions. This is especially true if you're a high-incomer and Obama wins the election. He wants to raise the top rate to 39.6% for married couples with incomes over $250,000 and singles over $200,000. Congress will almost certainly agree to this change and make it effective for all of '09.

You can game the standard deduction. If your 2008 itemized deductions won't quite hit the standard deduction amount, you can delay taking some of them so you can itemize in 2009. If your itemizations are just over the standard deduction for this year, accelerate some others to '08 and take the standard deduction in '09. In 2008, the standard deduction for marrieds is $10,900 plus $1,050 for each spouse who is age 65 or older. Singles get $5,450...$6,800 if 65 or older. Household heads get $8,000 plus $1,350 if they're 65. Next year's figures will be $250 to $450 higher.

Don't forget to factor in the extra standard deduction for real estate taxes. In '08 and '09, marrieds can add up to $1,000 of property taxes paid. Singles, $500.

Try shifting itemized deductions between years: State and local income tax. Mail your Jan. '09 estimate in late Dec. and deduct the payment this year, not in '09.

Interest. Making the Jan. 2009 mortgage payment on your residence before the end of this year allows you to deduct the interest portion in 2008.

Medicals. Consider getting and paying for elective procedures in 2008 if you are close to or have exceeded the 7½%-of-adjusted-gross-income threshold.

Gifts to charity. Donations planned for '09 can be accelerated to this year, but you must hand over money or mail checks by Dec. 31 for gifts to count for 2008.

Note that high-incomers lose some itemizations. If your AGI tops $159,950, your deductions are trimmed by 1% of the excess but not more than 80% of the total. However, the cutback doesn't affect medicals, casualty losses or investment interest.

Remember the option to take state and local sales tax in lieu of income tax. This is a no-brainer if you itemize and your state has no income tax. You can deduct the actual tax paid or an amount in IRS tables. Car buyers can add sales tax paid to the table amount, up to the same rate as the state's general sales tax rate. Thus, it can pay to buy a vehicle before Dec. 31 if doing so makes your sales tax payments exceed your income tax bill. Given the economy, you may get a pretty good deal, too.

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RETIREMENT PLANS

You may get relief on required year-end distributions from IRAs and plans. Treasury is considering waiving the mandatory payout requirement for '08. It is concerned that, to make these payouts, retirees would have to sell securities in their retirement accounts at a large loss, which would further deplete their assets. If Treasury decides it doesn't have the authority to waive the age-70½ payout rule, Congress will consider OKing this in its lame-duck session. The chances are 50-50.

But you may want to decline the offer. If Sen. Obama wins the election, rates on high-incomers will go up, as we noted earlier. So delaying payments till '09 may increase your tax bill. Also, if you have taxes withheld on these payouts, you may owe estimated tax underpayment penalties if you skip the '08 withdrawal.

If you are 70½ or older and don't need the money in your IRA to live on...
Do a direct payout from the IRA to charity. Congress restored this break for 2008 and 2009. You won't owe tax on the money. Nor will you have extra income that could cost you itemized deductions or personal exemptions, or trigger more tax on your Social Security benefits. You and your spouse can give up to $100,000 each from your separate IRAs annually. But you don't get a deduction for the donation.

And note the rules on substantiating your gift. You'll need to have a receipt on hand before filing your tax return. That may pose a problem for the organization receiving the payout, because the check comes straight from the IRA administrators. Donors should ensure that charities know whose account the donation comes from. You can solve the problem by personally delivering a check made out to the charity.

MINIMUM TAX

The AMT can throw a monkey wrench into your year-end tax planning. If you owe it, you cannot use many of the strategies we suggested earlier: For example, paying your Jan. '09 state tax estimate in '08. Or buying a car in Dec. to deduct the sales tax. Also, home equity loan interest isn't deductible for the AMT unless you used the proceeds to buy, build or renovate your principal residence. And if you exercised an incentive stock option in 2008, the discount you received is subject to the minimum tax unless you sell the acquired shares by Dec. 31.

The minimum tax is a lot like a flat tax, with only a few deductions. It has just two tax rates: 26% on the first $175,000 of AMT income, then 28%. Many write-offs are not allowed...personal exemptions, the standard deduction, state and local income taxes, sales taxes and real estate taxes. Taking large gains can trigger it. You pay the AMT to the extent that it exceeds your regular tax bill.

ENERGY

Making energy saving home improvements? You may want to wait until '09. Although Congress reinstated a tax credit for energy efficient improvements and expanded the credit to apply to biomass fuel stoves, it doesn't kick in until 2009. So delaying the installation of energy-efficient skylights, windows and outer doors until next year will enable you to claim the 10% credit on those improvements. Ditto for high-energy water heaters, central air conditioners and biomass stoves. Note that the total credit cannot exceed $500. No more than $150 can be claimed for furnaces and water heaters, $200 for windows and $300 for biomass stoves.

It may also pay to hold off installing solar water heating equipment. In 2008, the tax credit for 30% of the cost of such systems is capped at $2,000. But next year the $2,000 ceiling is repealed. Keep in mind, however, that the credit is not available for any equipment that's used to heat swimming pools or hot tubs.

WITH-HOLDING

If you're facing an underpayment penalty, jack up your withholding in Nov. and Dec. Taking more out of your paycheck or retirement plan payouts is an easy way to avoid a penalty. You needn't pay in all the tax you expect to owe. As long as you prepay 90% of this year's tax bill, there's no penalty. Alternatively, you can escape the penalty by prepaying 100% of your 2007 tax liability (110% if your AGI for 2007 topped $150,000) even if your 2008 tax far exceeds your payins.

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INVEST-MENTS

Has your portfolio taken a hit? There may be opportunities to save taxes. If you were considering dumping some losers, take your lumps in 2008. Capital losses can offset all your gains and as much as $3,000 of other income. Any excess losses carry over to 2009. But be sure not to sell solely for tax reasons.

The wash-sale rule bears watching: It denies a deduction for a loss if you purchase the identical securities up to 30 days before or after the sale. The loss that's disallowed is added to the tax basis of the replacement security. You can also trigger this rule by selling close to the date that mutual fund dividends are reinvested, or if your IRA quickly buys back stock you sold at a loss. However, you're OK if you sell one mutual fund and buy another with similar investment goals.

The wash-sale rule also can affect bond "swaps." When selling bonds at a loss and reacquiring other bonds sold by the same issuer, the wash-sale rule won't apply if you buy replacements with different maturity dates or interest rates.

Donate appreciated stock the correct way: If you have owned the shares for over a year, you can deduct the full value without paying tax on the appreciation. That's a win-win situation. But don't donate any stock that has fallen in value. If you do, you are precluded from deducting the loss on your income tax return. In that case, selling the stock first and donating the proceeds is a better tax saver.

Be particularly wary of buying a mutual fund this time of year. If the fund pays a dividend in 2008 after you buy it, you owe tax on the distribution this year. But you aren't better off financially because the share price of the fund will decline by a corresponding amount. In effect, you are prepaying your tax bill. To avoid this, buy into the fund after the record date for the dividend. Despite the market's drop, some funds will still make large payouts because they had to sell appreciated assets to meet redemptions. Your fund can tell you how much of a dividend you can expect.

Don't miss the new 0% tax rate on long-term capital gains and dividends: If you are in the 10% or 15% brackets this year, profit from the sale of assets owned for over a year plus dividends are tax free until they push you into the 25% bracket. In 2008, the 25% tax bracket begins at $65,100 of taxable income on joint returns and $32,550 for single filers. Once your taxable income exceeds these thresholds, the remainder of your dividends and long-term capital gains is taxed at 15%.

This special relief is in effect for three years: 2008, 2009 and 2010.

Some gains are taxed at higher rates: Collectibles. Profits on sales of art, antiques, gems, stamps, coins and bullion have a maximum rate of 28%.

Recapture of depreciation on real estate. It's taxed as much as 25%.

Short-term capital gains. Ordinary income rates of up to 35% apply.

Taking short-term capital gains can boost your margin interest deduction, which is limited to the amount of your net investment income. Any short-term gains that you have count as investment income. But your long-term gains are not treated as investment income unless you forgo claiming the 15% maximum rate on them.

As you conduct your year-end review of your investment portfolio...

Watch the holding period for dividends: You can't use the 15% top rate unless you have owned the shares for at least 60 days before and after the date that the stock goes ex-dividend. So if you buy a stock just before it pays a dividend and sell it soon thereafter, the dividend is taxed to you as ordinary income. Any loss can still be used to offset your other capital gains or up to $3,000 of other income.

Tax-favored dividends will not help you deduct more margin interest, as a general rule. You have to elect to forfeit the 15% maximum tax rate on them before you can count them as investment income to boost your interest deduction.

Many source documents are available in the online edition of The Kiplinger Tax Letter

DEPRECIATION

Companies that want the benefit of 50% bonus depreciation must act soon. Assets must be placed in service by Dec. 31 to be eligible for the write-off, which allows half of the asset's cost to be deducted up front. The balance of the cost is recovered via regular depreciation. New assets with useful lives of 20 years or less get the break, such as machines, equipment, land improvements and farm buildings.

Firms wanting the higher cap on expensing assets may have to act fast, too. Businesses can expense up to $250,000 of assets placed in use in the 2008 tax year. Next year, the limit will fall to $133,000. Fiscal year firms have a little more time: The higher limit applies to assets put in use in the 2008/2009 year. For example, firms on a July to June year get the higher limit on assets in use before July 2009.

Buying a new heavy SUV by Dec. 31 can generate a slew of tax breaks. Look at the write-offs if your business buys a new $50,000 SUV with a loaded weight of more than 6,000 pounds and places it into service before the end of this year: The firm can expense $25,000, the maximum for vehicles. And it can claim $12,500, half the remaining $25,000 cost, as bonus depreciation. Plus regular depreciation is 20% of the $12,500 balance of the cost. The total first-year write-off is $40,000, assuming 100% business use. Used heavy SUVs don't receive bonus depreciation.

Farmers may want to hold off buying equipment until 2009. After this year, new farm machinery and equipment can be written off over six years instead of eight. This doesn't cover grain bins, cotton gin assets or land improvements such as fences.

Buying too many assets in the last quarter may actually hike your tax bill. If more than 40% of your asset purchases for this year are made during that period, regular depreciation on all assets put in use in 2008 is figured on a quarterly basis. So assets that are purchased near the end of the year get 1½ months of depreciation instead of six months' worth. Those bought in the first quarter get 10½ months. This rule doesn't apply to buildings...depreciation depends on the month put in use.

BUSINESS TAXES

Professionals can delay their year-end billings to collect less in 2008. Or speed them up if they expect to be in a higher tax bracket next year. And they can juggle income by shifting their expenses from one year to another. However, the Service will balk if there's too much distortion of annual earnings.

Consider delaying year-end bonuses so they aren't taxed until 2009.

But there are some traps: This plan will not work for a majority owner if the bonus amount is fixed during 2008 and the business has enough cash on hand to pay the bonus. IRS treats the owner as being in constructive receipt of the money.

Deductions for accrual method firms are limited. They get no '08 write-off for bonuses that are deferred to '09 by owners of 50% or more of regular corporations or by the owners of any stake in an S firm, personal service company or partnership.

And weigh taking some dividends in lieu of salary. Although corporations cannot deduct dividend payments, if the firm is in the 15% bracket and the owner is in a high bracket, the owner's tax savings due to the 15% top rate on dividends can exceed the additional tax that's paid by the corporation. But this is no benefit to owners of personal service corporations. Those businesses pay a flat 35% tax.

We'll have more year-end planning tips for you in upcoming Letters.
And we'll keep an eye on Congress and IRS for any late developments.

Yours very truly,

The Kiplinger Editors

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THE KIPLINGER WASHINGTON EDITORS

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