

**ANNUAL TAX TOME – DECEMBER 2008**  
**BROUGHT TO YOU BY:**  
**KATHLEEN M ZAFFORE PC CPAs**

We all know about the \$700B gorilla in the room – or is it \$1.4T (at last reckoning)? And we all are developing a new vocabulary that includes such things as “toxic assets,” “mark-to-market,” “liquidity crisis” and “junket.” Are we exhausted yet? What we all need is some GOOD NEWS. Because the handwriting has been on the wall for some time (in spite of all the people in high places that have stated that they were blind sided by this economic catastrophe---puh-leeze!), Congress, the Bush Administration AND our buddies at the Internal Revenue Service have been diligently attempting to stave off disaster by passing a plethora of tax law since last December. Normally, I would not call a plethora of new tax law “good news,” but because “Depression Economic Theory” calls for lower taxes, money give-aways, public works projects etc etc -- there is actually a lot of tax-payer-friendly tweaks – and a couple of not so nice ones. And I do not expect the Obama Administration to change anything soon...other than to add more goodies to the pile for most if not all of us. ***So, welcome to the longest tax tome ever. I guarantee that there is something for just about everyone. I will hit only the highlights here or risk boring the socks off of you. If you would like to discuss your situation with us, just let us know.***

***If you hang in there to the end of the letter, shoot me an email, and we will enter you in our Annual Gift Card Award Contest – just be sure to use it soon.....***

***And remember ... (at risk of sounding like Pollyanna) ... in times of great challenge, there is great opportunity.***

We have had **FOUR MAJOR** pieces of tax legislation this year (and several minor ones) – unprecedented! There is still a little time to take advantage of the changes implemented in 2008.

1. **MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007.** Yes, you read that correctly, a mortgage relief act signed into law in 2007. Somehow Congress and Executive Branch already knew that mortgages were in foreclosure. For that matter, most of us knew it, too.
  - **DISCHARGE OF MORTGAGE DEBT – NOT TAXABLE.** Under our federal income tax rules, if you have borrowed money and then, for whatever reason, the debt is forgiven (discharged), you must include the forgiven amount on your tax return as income. There are a couple of huge exceptions – bankruptcy and insolvency. If you are in legal bankruptcy, you do not have to include discharged debt as income. Insolvency is a bit trickier. If you can prove that your debts exceeded your assets when the debt was forgiven, you are deemed insolvent and once again, you do not have to include the forgiven debt as income. Generally speaking, if you have your mortgage forgiven, you are in deep financial trouble, right? It shouldn't be difficult to prove insolvency. But the government stepped in because so many people were in trouble and clarification seemed necessary. So – with this tax legislation, if your home mortgage debt discharge occurs in 2007- 2012, you may exclude up to \$2 million of debt discharge income from taxable income. It must be principal residence debt that was incurred to acquire, construct or improve that property and it must be secured by that property. Home equity loans that were NOT used to acquire, construct or improve do NOT qualify for this tax relief, nor do second homes. But – remember, you can always fall back on the old trusty insolvency argument if the new law does not help in

your situation. If you do use this new law, you must reduce the basis of your property by the amount excluded (but not below zero – thank heavens ☺) .

- ***SURVIVING SPOUSES GET A BREAK ON SALE OF RESIDENCE.*** As you probably know, you can have a federal-income-tax-free home sale gain of up to \$250,000 if you are unmarried, or up to \$500,000 if you file jointly with your spouse. However, if you are an unmarried surviving spouse, you file a joint return only in the year of your spouse's death. After that, you are not allowed to file jointly. Therefore, if you waited to sell the family house, under old law, you were limited to the single \$250,000 gain. How unfair was that? [Of course, in the "correction" (read that "crashing") of the real estate market, maybe it is now a moot point.] With the new law, effective for sales after 12/31/07, an unmarried surviving spouse may utilize the \$500,000 exclusion if the home sale occurs within 24 months after the spouse's death and all the other requirements for the exclusion were met immediately before that spouse's death. ***TRAP:*** Note that the two-year period starts on the deceased spouse's date of death and that means 24 months, NOT two tax years. Therefore, a home sale that occurs more than 24 months after the date of death, will not qualify for the larger \$500,000 exclusion.
  - ***MORTGAGE INSURANCE PREMIUM DEDUCTION – EXTENDED FOR 3 MORE YEARS.*** If you are paying mortgage insurance premiums AND your joint adjusted gross income is less than around \$110,000 (or \$55,000 single), you MAY be able to deduct mortgage insurance premiums through 2010 on your primary residence. More help for potentially troubled homeowners.
  - ***THE BAD NEWS.*** And then there are the tax increases.
    - ***Failure to file penalty for partnership returns.*** For up to 12 months, \$85 per month per partner. Ouch.
    - ***NEW Failure to file penalty for S corporations.*** For up to 12 months, \$85 per month per shareholder. This is NOW in effect. If you have not filed your S corporation return, you will pay penalties for the first time. Double ouch!
2. ***NOTICE 2008-1 – S CORPORATION HEALTH INSURANCE*** – Many of our S corporation clients jumped through hoops with us earlier in the year to take advantage of a health insurance deduction. You know who you are. Suffice to say here that the law now clearly states that:
- ***Health insurance premiums for shareholder-employees and dependents must be either paid by the company or reimbursed to the shareholder-employee.*** It does NOT have to be a group health plan. Be careful, though. You may need to offer insurance to all of your employees – talk to us.
  - ***The shareholder covered by the premium must not be eligible for a subsidized health insurance plan through his/her spouse's employment.*** That is virtually all health plans offered by larger employers. Again, please check with us. Many rules.
  - ***Health insurance premiums MUST BE INCLUDED in taxable wages but are not considered social security or medicare wages.*** Therefore, the premiums are deductible at a company level for Schedule K-1. The

shareholder-employee must include the premiums in taxable wages, but then may deduct the premiums on page one of the personal 1040 tax return. Trust me, I did not write this law. If I had, it would have been much simpler – I am still trying to figure out what is accomplished by this nonsense. But, it is the law. So we have to do it this way. Or challenge the law. Volunteers?

- **S CORP SHAREHOLDERS – PLEASE CONTACT YOUR PAYROLL ADMINISTRATORS NOW (WE ASKED YOU TO DO THIS MONTHS AGO) TO MAKE SURE THAT YOUR HEALTH INSURANCE IS BEING HANDLED CORRECTLY TO AVOID COSTLY PROBLEMS AFTER THE YEAR CLOSURES. IF WE DO YOUR QUARTERLY REPORTS, WE WILL BE TALKING WITH YOU ABOUT HEALTH INSURANCE PREMIUMS SOON.**

3. **ECONOMIC STIMULUS ACT OF 2008** – Passed February 7, 2008, this is the one with the “rebate.” I won’t go into much detail here except to say that **IF you did not get a rebate based on filing your 2007 tax return (or if you filed after October 15), you are STILL ELIGIBLE to receive the rebate based on your 2008 return.** Once again, there are income limitations. URBAN LEGEND: you must pay tax on the rebate income....FALSE. Nor do you have to pay it back if your income is actually too high to be truly eligible, since it is ultimately based on your 2008 income. How confusing can something be? The important thing to note here is the rebate is not taxable. And if you didn’t get it, you may get it in 2009. Or not.

**The Economic Stimulus Act of 2008 had a couple of other goodies for businesses:**

- **Bigger Section 179** deductions for qualifying assets placed in service in tax years beginning in 2008. With the Section 179 deduction, small and medium-sized businesses can instantly depreciate most or all of the cost of qualifying new and used assets in the year they are placed in service. For tax years beginning in 2008, the maximum Section 179 deduction is generally increased to \$250,000 (up from \$128,000 before the new law). For 2009–2010, the maximum deduction returns to \$125,000 with inflation adjustments. If your business purchases more than \$800K of qualified assets in 2008, the Section 179 election begins to phase out. **TRAP:** If you are a shareholder of several pass-through entities (partnerships, S corps, LLCs), you are individually limited to \$250K of Section 179 deduction on your tax return. But you take a hit to your basis for the Section 179 in each company even though you might not have been able to deduct it – major problem. If you think you may be in this predicament, call us right away.
- **50% Bonus Depreciation is back.** We have a return of the 50% first-year bonus depreciation break for NEW (not used) qualifying assets that are purchased and placed in service during 2008, including NEW AUTOS used for business. In addition, 50% first-year bonus depreciation can be claimed for certain assets placed in service by 12/31/09. FOR CARS AND LIGHT TRUCKS...maximum depreciation for first year will probably be \$11,160...but with the potential bail out of Detroit...maybe we will all get massive deductions for buying American made cars, eh? Worked for 6,000+ pound SUVs. In fact, it worked too well. Stay tuned.
- **Certain Leasehold Improvement Costs Qualify for the 50% depreciation!!** Must be improvement to an interior portion of the building; must be nonresidential real property; must be made pursuant to a lease; must be placed in service

MORE THAN 3 YEARS after the date the building was FIRST placed in service. This is great news if you moved into new quarters and upgraded this year.

#### 4. **AMERICAN HOUSING RESCUE AND FORECLOSURE PREVENTION ACT OF 2008**

So, way back on July 30, 2008, a foreclosure prevention act became law and nobody heard a thing about it. Why? It was incredibly complicated and included aid for cities and undergirding for Fannie Mae and Freddie Mac – all very controversial. Here is what the average taxpayer got out of it – both GOOD AND BAD (REALLY BAD):

- a. **TEMPORARY TAX “CREDIT” FOR “FIRST TIME” HOME OWNERS** The maximum credit equals the lesser of: (1) 10% of the purchase price of a principal residence or (2) \$7,500 (or \$3,750 for those using married filing separate status). You may use the credit to offset your entire federal tax liability and if there is excess, you get the money. However, you are only eligible if you have not owned a principal residence in the U.S. during the three-year period that ends on the purchase date. Somehow that makes you a “first time” homeowner. Go figure.

The credit is generally available for principal residence purchases after 4/8/08 and before 7/1/09. If you are building your own home, the purchase date is considered to be move in date. However, if you purchase a residence from a relative, you will be ineligible for the credit. Just when we thought there might be a break for the middle class...ie selling one of your rental properties to your young adult kid. No can do for this credit.

If you make a qualified home purchase in 2009 (before the 7/1/09 deadline), you can choose to treat the transaction as if it happened in 2008 and get your credit sooner by claiming it on your 2008 Form 1040.

***This credit is aimed at those with moderate to lower incomes.*** The phase-out range for unmarried taxpayers and married taxpayers filing separately is between AGI of \$75,000 and \$95,000. The phase-out range for married joint filers is between AGI of \$150,000 and \$170,000.

***Not Really a “Credit” because it must be repaid.*** So -- the new credit is really just a loan from the government. You must repay it (without interest) over 15 years starting with the second year after the year the credit is claimed on your Form 1040. Each year's repayment will be added to the tax liability on your Form 1040. ***TRAP: If you sell the home or stop using it as your principal residence before the credit has been repaid,*** the unpaid credit balance must be paid with your Form 1040 for that year.

**TEMPORARY PROPERTY TAX DEDUCTION FOR NON-ITEMIZERS** For 2008 and 2009, an unmarried taxpayer who doesn't itemize can add up to \$500 of state and local real property taxes to the normal standard deduction amount. The same \$500 allowance applies to a married person who files separately. Married joint filers can add up to \$1,000 to the standard deduction amount. However, if you actually pay less than \$500 or \$1,000 for your property tax, you may only add the actual amount – no freebies here. For EVERYONE – that means that if you pay property tax that is at least \$500/\$1,000, you will NOT have to file Schedule A if your deductions are less

than \$11,900 for a joint filer, \$5,950 for a single or separate filer, or \$8,500 for a head of household. Clear as mud? If you'd like more clarity (and think this applies to you or a loved one), shoot us an email. Could save you some brain damage during tax season.

- b. NOW THE BAD NEWS – NEW RULES FOR PROPERTIES CONVERTED INTO PRINCIPAL RESIDENCES.** In the good old days, 2008 and earlier, if you had a rental or vacation property and converted it to a principal residence, lived in it for two years then sold it, you were able to pocket the \$250K/\$500K gains without taxation (except to recapture some depreciation perhaps). Those days are officially gone as of 12/31/08. ***I don't know of any of our clients currently using or planning to use this tax strategy, but IF YOU ARE DOING THIS – CALL US ASAP.*** This new law will make a portion of your gain ineligible for the gain exclusion privilege.

Here is an example from Practitioner's Tax Action Bulletin that is helpful:

**Example:** Say you bought a vacation home in an exclusive area on 1/1/05. On 1/1/11, you convert the property into your principal residence. Then you and your spouse live there for all of 2011 and 2012. On 1/1/13, you sell the home for a \$450,000 gain. Your total ownership period is eight years (2005–2012). However, the two years of post-2008 use as a vacation home (2009–2010) count against you and result in a non-excludable gain of \$112,500 ( $\frac{2}{8} \times \$450,000$ ). You must report the \$112,500 as capital gain income on your 2013 Schedule D and pay the resulting federal income tax hit. If you file jointly, you can claim the \$500,000 gain exclusion which will shelter the remaining \$337,500 of gain ( $\$450,000 - \$112,500$ ). However, if you sold the residence under the same circumstances in 2008, your \$450,000 gain would be entirely federal-income-tax-free.

5. **EMERGENCY ECONOMIC STABILIZATION ACT OF 2008** This is the biggie, passed October 2, 2008 – history in the making. While most of us are painfully aware of the \$700 billion bail out bucket, we have heard almost nothing about the literally HUNDREDS of tax changes included in this Act that will effect virtually all of us and our businesses. While most of the changes are beneficial, some are not. Here are the highlights:

- ***Extension of many popular tax breaks that were scheduled to end including:***

***College Tuition Deductions***

***Optional Sales Tax Deduction***

***Teacher Expense Deduction***

***Charitable Donations of IRAs***

***Credits for Residential Energy-Saving Expenditures***

- ***Alternative Minimum Tax Credits*** – if you are sitting on a pile of AMT credits (generally because you exercised profitable incentive stock options), you may finally be able to cash in the credits. I am still working

on figuring out this section of the law, but suffice to say here that it looks like you will be able to collect 50% of unused AMT credits generated in pre-2005 years after filing your 2008 tax return. You can then collect the other half from pre-2005 years after you file your 2009 return. For AMT credits stockpiled after 2005, you can redeem them over two years, but you have to wait until they are more than three years old. Whew! This stuff is deep and wide and I'm sure we will understand the mechanics better after we have worked through a few returns.

- **More good news for incentive stock option victims** – the new law wipes out unpaid AMT liabilities outstanding as of 10/3/08 IF they were the result of exercising incentive stock options BEFORE 2008. Interest and penalties assessed by the IRS will also be abated. If you have paid interest and penalties, you can get them back over two years. Amazing. People quit jobs in 1999 and 2000 during the last irrationally exuberant period (dot coms) to avoid the enormous AMT gains coming their way on stock that was becoming more worthless by the moment – adding insult to injury. It took 8 long years to get this fixed. Don't get me started.
- **Go GREEN – Ride a Bike, Catch a Break** – Really. In 2009, employers will be allowed to give employees who ride bikes to work up to \$20/month TAX FREE. The employer gets a deduction, to boot. The money is designed to be a reimbursement for purchasing, improving, repairing or storing a bicycle used regularly to commute to work. Adds up to \$240 a year. Tell your employer! They may miss this one.
- **Alternative Minimum Tax** – PATCH – again. The exemption levels have been set for 2008 – **if your taxable income is lower than these limits, you are safe. Otherwise.....**
  - \$69,950 for married filing joint or a surviving spouse
  - \$46,200 for single and head of household
  - \$34,975 for married filing separately

#### **Good Stuff for Businesses:**

- **Extension of 15-year depreciation rule for leasehold improvements and restaurants (someone has a good lobbyist—restaurant buildings may now be eligible for 15 year depreciation) through 2009**
- **New 15-year depreciation rule for retail space improvements (with some notable exceptions that are structural)**
- **New 5-year depreciation for farming equipment**
- **Research credit is extended and increased to 14% for tax years ending after 2008**
- **Enhanced deduction for charitable food donations (for businesses, not individuals), up to two times basis!**

- **C Corp book donations to qualified schools – up to two times basis!**
- **C Corp computer donations and related technologies to “educational organizations and libraries” – up to two times basis!**
- **S Corp appreciated property donations – allows S corp shareholders to reduce basis in stock by the basis of the donated property rather than its fair market value**
- **Allows for higher percentage of depletion allowances for marginal oil and gas wells in 2009 (but not 2008)**
- **Freezes domestic production deduction at 6% for oil/gas related income (OK, this is not a good thing for small operators).**
- **New personal and business credits for plug-in electric vehicles. Up to \$7500 (depending on kwh) for cars and up to \$15,000 for heavy vehicles over 10,000 pounds. Will be phased out after 250,000 qualifying vehicles have been sold in the US. Shop early.**
- **Many more tax incentives in the Act to encourage expenditures for energy-efficient equipment as well as incentives for electricity generation and transmission industries, as well as energy improvements credits for homeowners.**
- **Also a number of disaster-relief tax changes for both individuals and businesses**

At this point, I am about worn out...I'm sure you are, too. But there are a couple more things to think about before the end of the year.

#### **ZERO PERCENT TAX RATE**

YES, VIRGINIA – THERE IS A **ZERO PERCENT TAX RATE FOR 2008 (and 2009-2010...maybe)!!!!** This is the truth. And if you are under Age 35, you probably don't know who Virginia is. But that is OK. Ask your mother. Here is the deal -- You need to have the right type of income. The 0% rate applies to most long-term capital gains (i.e., gain from selling something such as stock that you've held for more than a year) and qualified dividend income (generally dividends from U.S. corporations and certain eligible foreign corporations).

You also need to have the right amount of qualified income and the right mix of other income and deductions to maximize the savings from the 0% rate. Depending on your filing status, the 0% rate can apply to up to \$65,100 of taxable income this year—not adjusted gross income, but taxable income (that is after deductions and exemptions, so more attainable to more people). However, it could also apply to none of your income (even if you have long-term capital gains and/or qualified dividend income), if your other income and deductions don't net to a small enough number. As a result, qualifying for the favorable 0% rate is very fact specific and tricky.

Those most likely to benefit (ie low income) will already be close to the zero per cent rate – funny how that works. But if you are young and just getting started and have the good fortune to own appreciated stock that was perhaps gifted to you – the zero percent tax rate could work for you, allowing you to sell, pay no tax, and diversify your portfolio. Higher income taxpayers who have mostly capital gain or qualified dividend income with little other taxable income may also qualify. But there can be unintended consequences...like increasing income and thereby increasing taxable Social Security benefits = more tax.

And, of course, in this current market...we all know more about losses than gains. A zero percent bracket for capital gains does not take advantage of those zillions of dollars of losses. AND losses can actually generate alternative minimum tax. Good grief. Can this get more complicated? Do you ever get the impression that members of Congress do not live in the same world as you and I?

Just wanted you to know it is out there because you will hear it from someone. If you want more details about how to qualify, give us a call. We can have a good laugh together. Or maybe save you or your young adult child a little money.

### **CHARITABLE CONTRIBUTIONS**

Many many years ago, I was audited for charitable giving. It was an easy audit. All I had to do was bring in my cancelled checks. The auditor added them up. The total agreed with my tax return. No change. End of story.

Times have changed. It is much tougher to support your deductible giving. Here are a few of the rules:

- For any gift over \$250 at one time – GET A RECEIPT. Your cancelled check is NOT ENOUGH. Make sure the receipt says that you did not receive anything of value in consideration for the gift – like memberships or books etc. If you did get something of value, the receipt should indicate how much of your gift is deductible.
- If you give frequently, get an accounting at the end of the year on the stationery of the organization showing your gifts itemized and dated, and which ones are deductible and which ones are not.
- If you give cash – it is NOT DEDUCTIBLE unless you get a receipt as per above. So, the money that you pop into the Salvation Army kettle...it is NOT deductible. Write a check instead and pop it in. If you give cash at church, put it in an envelope with your name on the outside and request an receipt.
- If you buy something for charity, keep the receipt. If you volunteer and have out-of-pocket expenses, keep the receipts. If you incur expenses that exceed \$250, you must get a receipt from the charity – a note on organization stationery thanking you for your expenditure of \$x with your receipts stapled to it should suffice.
- If you give away something major, like a car or boat, the organization will tell you whether it will use the asset in its work or if it will sell the asset outright. If it sells the asset, your deduction is limited to what the asset sold for, NOT

the Kelley Blue Book. If the organization uses the asset in its mission, you may take a full fair market value deduction. This can be a huge difference, so shop around.

- If you are giving away more than \$500 of stuff to Goodwill during the year, document it! List it, photograph it, get a receipt. Be realistic about the thrift store value of the items. The site [www.itsdeductible.com](http://www.itsdeductible.com) is not a silver bullet and it is not sanctioned by the IRS. Stuff must be in good condition to be deductible, whatever that means. For any donation that exceeds \$500 at one time, you must tell the IRS how much you originally paid for the items. Here is the real kicker. **For all stuff you give away, it is only deductible if you have the original purchase receipt. Again, good grief. The government really does want us to be pack rats. Be aware that if you are audited you must be able to substantiate your deduction with receipts. Tip – an audit can cost a lot of money. Balance the cost of an audit with your potential tax savings as you are adding up the value of all those clothes, toys, and dishes in the “give away” box. Deductions are NOT dollar for dollar...but rather a percentage, ie your effective tax rate. So if you are gifting \$1000 of stuff, and your effective tax rate is 15%, your tax savings is \$150 [\$1000 x .15].**
- Volunteer mileage is deductible. Keep a log. If you are driving thousands of miles (ie you deliver Meals on Wheels), turn in the log to the organization and have them receipt it with a letter on organization stationery.
- Scripture says that God loves a cheerful giver. The IRS makes it hard to be cheerful. But give anyway—especially here at the end of the year. It is good for your soul. Even in these difficult economic times.

And with that, I will end this tome. Look on our web site (home page) for the article **A DOZEN THINGS TO DO NOW TO REDUCE YOUR 2008 TAXES** for a quick list of fixes. If you don't own a business or rental property, your options are limited. And truly, if you made it this far, let me know and we will enter your name in our Gift Card Award Contest, winner, picked out of a hat, to be announced on our Update Letter in January. Just include the secret phrase in your email : “Clear As Mud.”

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