

# CPA CLIENT TAXLETTER



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## Year-End Tax Planning for Individuals

Even after we know the results of the November elections, we won't know what tax legislation the new Congress will pass or whether the new president will sign it into law. Therefore, you may base some year-end moves on your best speculations about the future. You might, for example, realize long-term capital gains by year-end 2008 if you believe 2009 will see an increase in the current 15% maximum tax rate. However, any tax legislation passed in 2009 won't impact your 2008 tax return. Thus, regardless of election outcomes, astute tax planning now can pay off when you file your 2008 tax return. Winning tactics include:

- **Make your January mortgage payment.** You probably can pick up an extra month's worth of mortgage interest deductions for 2008 by paying your January obligation in December. Mail the check as early as possible to ensure that your mortgage lender includes the payment on Form 1098 for 2008. If the payment is included on this form, you won't have a discrepancy to explain to the IRS.
- **Pay your outstanding property taxes.** Again, you might gain extra deductions by paying your property tax bill in December, even if the taxes aren't due until early next year.

**Cautions to consider:** First, this strategy will work only if you normally send your property tax payments directly to the tax collector. If you generally include your property tax outlays with your mortgage payments, paying early won't make the taxes deductible for 2008 because of the turn-over delay. Second, paying property taxes

(as well as state and local income taxes) in December will be useless if you're subject to the alternative minimum tax (AMT) this year, so check first with our office.

- **Crunch your numbers for Schedule A.** For example, go over this year's miscellaneous itemized deductions, which include outlays such as tax preparation, unreimbursed employee business expenses, and investment expenses. If these miscellaneous items top 2% of your adjusted gross income (AGI), the excess is deductible.



**Example:** You expect your AGI for 2008 to be about \$100,000. If you've already spent at least \$2,000 (2% of \$100,000) on miscellaneous deductions, you've exceeded the floor amount. You can make payments on all the investment publications, investment software, etc. that you use and deduct them in full. On the other hand, suppose you have only \$700 in miscellaneous expenses this year, far below the 2% threshold. Wait until January to write your checks. Perhaps they'll help you get a deduction in 2009.

Similarly, itemized medical deductions are permitted only to the extent that they

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America Counts on CPAs

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exceed 7.5% of your AGI. Pay now for eyeglasses, checkups, etc. if you're over the 7.5% mark for the year—or defer until 2009 if you're not.

**AMT alert:** Miscellaneous itemized deductions won't help if you're subject to the AMT this year; furthermore, the threshold for medical deductions for the AMT is 10% of your AGI.

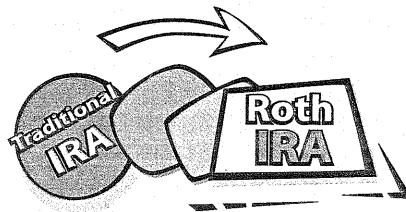
■ **Reverse course.** Year-end tax planning should take into account the 2008 standard deduction, which is \$5,450 for single taxpayers and \$10,900 on joint returns. Couples filing jointly should take the standard deduction if their itemized deductions are less than \$10,900 this year; single filers should do so if those deductions are below \$5,450.

If you'll be taking the standard deduction, reverse the previously described year-end strategy of accelerating deductible expenses into the current year. Instead, defer paying expenses such as state taxes, mortgage interest, and charitable donations until 2009. Next year, the total of your itemized deductions might be great enough to make itemizing worthwhile. Following this strategy in alternate years can keep you from wasting deductible expenses.

■ **Get ready for retirement.** If you have self-employment income this year and wish to make a tax deductible contribution to a Keogh plan for 2008, you must establish the plan before year-end. However, you can make the actual contribution at any time until the due date of your 2008 tax return, including an extension to October 15, 2009.

Instead of Keogh plans, some self-employed individuals might prefer so-called "solo 401(k)" plans, which may permit larger contributions, depending on the amount of self-employment income involved. Those contributions will reduce your taxable income for the

year. The year-end rules for a solo 401(k) plan are the same as for a Keogh plan. If you're interested in a solo 401(k), fill out an adoption agreement from a financial firm such as a bank, broker, or mutual fund company before December 31. You can make the actual contribution for 2008 up until next year's filing deadline, including an extension.



■ **Convert your IRA.** If you are interested in converting a traditional IRA to a Roth IRA, you should withdraw funds from the traditional IRA by the end of the year. Such a conversion will start the Roth IRA clock at January 1, 2008, even if the conversion is at year's end. As long as you're at least 59½ years old, all withdrawals from a Roth IRA will be tax free after 5 years; that is, after January 1, 2013. Thus, a year-end conversion eliminates one of those five years right away.

To qualify for a Roth IRA conversion, your income this year can be no more than \$100,000 on a single or a joint tax return. If you're uncertain about your income, go ahead and convert your traditional IRA anyway. If you end up over the limit, or if you change your mind for any reason, you have until October 15, 2009 to reverse the conversion with no penalty.

■ **Decide on distributions.** If you turned 70½ in 2008, you must take your first required minimum distributions from IRAs and other tax deferred retirement plans by April 1,

2009. The required amount of your first distribution is based on the amount in the account at year-end 2007. However, your second distribution must take place by December 31, 2009, based on the year-end 2008 amount. If you take two distributions next year, the added income may push you into a higher tax bracket.

The alternative is to take one distribution in 2008 and one in 2009. Check with our office to see if it makes sense to begin taking distributions in 2008.

If you're still working, you do not have to take distributions from an employer sponsored plan after age 70½, even though you must take money from your IRA. (The employer plan exception doesn't apply if you own at least 5% of your company, however.) Also, if you have converted your traditional IRA to a Roth IRA and paid the deferred income tax at the time of the conversion, no distributions are required.

■ **Check out this charitable strategy.** During the holiday season, you probably will make charitable donations. Generally, you're better off making those contributions with appreciated securities instead of cash.

Suppose, for example, you'd like to give \$2,000 to your favorite charity. Rather than write a check, you might give \$2,000 worth of stock that you bought more than a year ago for \$500. You'll get a full \$2,000 deduction while avoiding any capital gains tax. The charity can sell the shares and collect the \$2,000, also without owing any tax. However, if you donate assets held for a year or less, even if the assets have appreciated in value, your charitable deduction generally will be limited to your basis in the assets. To

implement this type of transaction, call the charity and get its brokerage account number. Then provide that account number to your broker, who will handle the transfer. Be sure to act well before year-end so that the donation can be completed in time for a 2008 deduction.

■ **Make multiple contributions easier.** Donating appreciated securities directly to charity, as described above, probably will work fine if you're making one \$2,000 donation, perhaps, or two \$1,000 donations. However, if you intend to make, for example, donations of \$500 each to 10 different charities, the paperwork involved can be substantial. You might be better off using a donor advised fund.

Many local community foundations sponsor donor advised funds, which most major financial firms also offer. You can make an upfront contribution (cash, securities, or other assets) to the donor advised fund. For the year of the contribution, you can take a deduction. Subsequently, you can specify "grants" from the fund to various charities. The result is that you can deduct now and deal with the paperwork later. Contributing to a donor advised fund may be an especially effective strategy if you have unusually

high taxable income this year. You can get an upfront write-off to offset the extra income and fulfill your charitable commitments over a period of years.

■ **Be charitable with your IRA . . . or maybe not.** In 2006 and 2007, people age 70½ and over could use their IRAs to make charitable gifts. Although this provision has expired, many observers expect Congress to extend the so-called IRA Charitable Rollover for 2008. Assuming that Congress extends this provision without substantial alteration from the 2006–2007 version, people age 70½ and over can make charitable distributions from their IRAs—up to \$100,000 this year. Donors will recognize no taxable income, but they won't be able to claim an income tax deduction for these donations.

Taxpayers over 70½ must take required distributions from IRAs. If the IRA Charitable Rollover is restored for this age group and you're a member of it, you can take a qualified charitable distribution from your IRA in an amount at least equal to your minimum distribution for 2008. That will allow you to satisfy the minimum distribution rules without picking up taxable income. In addition, this strategy lowers your AGI, which may help in other areas of your tax return.

**Be careful:** Make sure that such contributions are made directly from your IRA to a charity or charities. Don't mistakenly deposit any checks you receive because that money will count as income for you. Also make sure the charity knows the gift is from your IRA, so it can send you an acknowledgment of the donation.

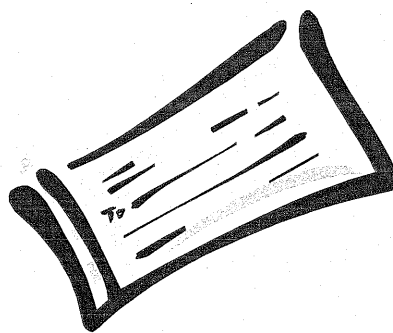
■ **Exploit your flex plan.** Do you participate in your employer's "cafeteria" or "flex" benefits plan? In such plans, you agree to reduce your taxable income so that certain outlays (such as uninsured medical expenses) can be paid with pretax rather than after-tax dollars.

These plans may expire at year-end, after which a new plan begins. Employers have the opportunity, but not an obligation, to extend the deadline to March 15, 2009. If your employer holds the deadline at December 31, 2008, you can't carry unspent dollars from 2008 into 2009. If you have a year-end deadline, review your account in December to determine if you have money available. If so, spend it by December 31—you might get a dental checkup or an eye exam. If you don't beat the deadline, you're just throwing away money.

## Year-End Tax Planning for Businesses

If you have a stake in a business or professional practice, you need to keep an eye on that entity's tax bill, too. Again, year-end moves can pay off.

■ **Accelerate expenses.** Write checks before year-end to pay for deductible items. You can claim 2008 deductions even though the checks might not be cashed or deposited until 2009. You might pay for office supplies, phone service, subscriptions, rent, insurance, or utilities. If you're short on cash, charge deductible business expenses on a credit card before year-end. These



purchases will create 2008 tax deductions even though you won't pay for them until 2009.

■ **Delay your invoices.** If your business or professional practice uses the cash method of accounting, don't be in any hurry to send out bills. Even if you perform income producing services in 2008, you won't have to recognize taxable income until you collect. If you receive payments in January or February, you'll have 2009 income from those payments.

■ **Buy business equipment.** If you have a business or professional practice, you probably can take advantage of the "expensing" election permitted under Section 179 of

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the tax code and claim a full first year write-off for equipment you buy. In 2008 you can expense up to \$250,000 worth of business property. The \$250,000 limit applies to taxpayers who purchase no more than \$800,000 worth of equipment per year. Above \$800,000, you lose the benefit of expensing, dollar for dollar.

In order to expense equipment in 2008, you must place it in service

this year, no matter when you pay for it. Thus, if you buy equipment in December 2008 but don't use it until January 2009, you can't qualify for a 2008 write-off, even if you pay for the equipment in December. On the other hand, if you place the equipment in service in December and your obligation to buy is solid, you can qualify for a 2008 write-off even if you don't pay until January.

- **Investigate your inventory.** Dispose of goods that have been damaged or have become obsolete. The products' current value may be deductible.
- **Write off worthless debts.** If you use the accrual method of accounting, you can deduct bad debts in the year they become uncollectible. Before year-end, make collection calls and send letters, then keep records to demonstrate that no payments were likely to result.

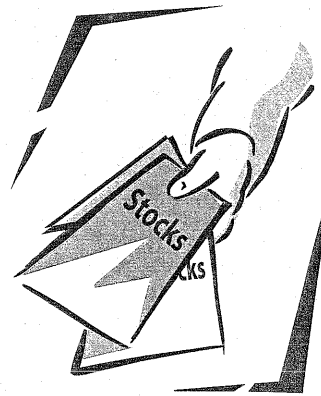
## Year-End Tax Planning for Investors

The tax code is replete with provisions relating to investments. Here are some tax saving tactics to consider before year-end:

- **Track your trades.** Start by going over all of your securities trades so far this year. Aim to conclude 2008 with a net capital loss of at least \$3,000.

Why should \$3,000 be your goal? Because a net capital loss up to \$3,000 can be deducted from your ordinary income. If you're in a 35% federal tax bracket, for example, a \$3,000 capital loss saves you \$1,050: 35% of \$3,000. Your total tax savings may be even greater when you count state and local income tax. Suppose you count all your trades so far in 2008 and discover you have a \$5,000 net capital gain. If you don't take any action, you'll owe \$750–\$1,750 to the IRS. The exact amount will depend on how your trades divide between long-term gains (taxed at 15%) and short-term gains (up to 35%).

- **Take your losses.** Starting with your \$5,000 year to date gain, you can sell securities by year-end, realizing \$8,000 worth of losses. Now you have a \$3,000 net loss



and a tax deduction rather than a tax obligation.

What if your net capital loss is greater than \$3,000? Any excess loss can be carried forward to future years, when it can offset future capital gains. If you have no gains to offset, loss carryforwards may be deducted, up to \$3,000 per year.

- **Factor in mutual funds.** When you calculate your 2008 gains and losses, be sure to include any capital gains distributions from mutual funds. Mutual funds are required to distribute any net trading profits to shareholders. If you hold the fund in a taxable account, such distributions

are taxable income, even if you choose to reinvest them in the fund.

The example above assumed you had \$5,000 worth of net capital gains for the year before making any year-end moves. If you also received \$2,000 worth of capital gains distributions from mutual funds, your net gain for the year increases to \$7,000. In that case, you'd need to realize \$10,000 worth of losses to end the year with a \$3,000 net capital loss, which you can deduct from your ordinary income.

- **Buy later, not sooner.** Avoid investing in mutual funds just before a scheduled year-end capital gains distribution. You'll get some of your own money back right away... and owe tax on that return of your capital.

**Example #1:** You invest \$25,000 in XYZ Mutual Fund (XYZ) on December 6, when the fund trades at \$20 per share. You acquire 1,250 shares: \$25,000 divided by \$20. XYZ makes a \$5 per share capital gains distribution on December 15, representing its 2008 net capital gains. You receive a \$6,250 distribution—\$5 per share on your 1,250

shares. If you hold the fund in a taxable account rather than in a tax deferred or tax free retirement plan, you'll owe tax on that \$6,250 distribution even though you didn't receive any cash in hand.

At the same time, the net asset value (and the trading price) of the fund drops from \$25 to \$20 after the fund makes its \$5 distribution. You'd be better off waiting until after the distribution to buy the fund because you'll probably be buying at a lower price and you'll avoid the tax liability. Check with the mutual fund you're considering before investing near year-end. Find out the fund's "record date" and buy on the next day ("ex-dividend date") or later because the fund's share price will drop after the distribution.

■ **Sell sooner, not later.** The timing of the ex-dividend date also can make a difference to fund sellers. That will be true if you'll be selling for a long-term capital gain and the distribution will include short-term capital gains as well as nonqualified dividends.

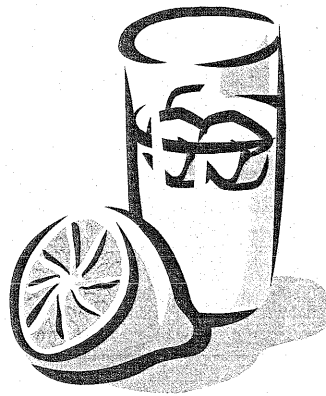
*Example #2:* You invested many years ago in ZYX Precious Metals Fund (ZYX). This fund has performed well over the years, and precious metals are above your target for asset allocation. You decide to sell shares to rebalance your portfolio. ZYX will make a year-end distribution that will include net long-term gains, net short-term gains, and dividends that do not qualify for the bargain 15% rate on stock dividends. The total distribution will be \$5 per share, of which \$3 will be short-term gains and nonqualified dividends. After the \$5 per share distribution, the price of ZYX will drop from \$25 to \$20 per share.

If you keep those shares until after you receive the distribution, you will pick up \$5 per share in taxable income, including \$3 per share taxed as short-term gains and nonqualified dividends, where the federal tax rate is as high as 35%. Instead, you could sell

before the distribution, when the fund is still trading at \$25. Assuming you've held all the shares for more than one year, all of your gain will qualify as long-term, with federal tax rates at 15% or lower.

■ **Boost your basis.** When you do your year-end tax planning, you might discover you have a large realized loss so far in 2008. In this situation, you may be able to take capital gains without incurring additional tax.

*Example #3:* You have \$10,000 worth of realized net capital losses so far this year. You can take \$7,000 worth of capital gains by year-end and offset that amount with your capital losses. You then can deduct the remaining \$3,000 net loss from your ordinary income. The proceeds from your year-end gains won't be taxed. If you wish, you can take gains and immediately reinvest in the same secu-



rity you sold. (The wash sale rules, described below, don't apply to gains.) This sale and repurchase raises your basis in that security. A higher basis, in turn, probably will reduce the tax you'll owe on a future sale.

■ **Make lemonade from a lemon.** If you invested in a business that failed in 2008, you can take a capital loss this year. To take the loss your holding in the failed venture must be absolutely worthless. However, it may be hard to show that a

business has no value at all. To address this problem, realize your capital loss by selling your interest in the business to an unrelated party for a nominal amount. For example, you might sell your interest in the failed company to a neighbor for \$1. As long as you make the sale by December 31, you can claim a capital loss for 2008.

■ **Swap shrewdly.** Exchange-traded funds (ETFs) can play a role in tax loss harvesting strategies. When you take a loss on a security, the wash sale rules prohibit buying back the same stock or fund within 30 days. Such a buyback would prevent you from claiming a capital loss on your tax return. You can wait 31 days and then buy back the same security that you sold. If you're out of the market for 31 days, though, you might miss out on a sharp upward move in the stock or fund you just sold.

One solution to this problem is to buy an ETF that correlates closely with the stock or fund that you sold.

*Example #4:* You take a loss on a bank stock that has been hurt by credit market concerns. You can immediately buy an ETF that tracks an index of bank stocks, such as the KBW Bank ETF. Buying a highly correlated ETF won't prevent you from reporting a capital loss on the bank stock you sold. Then if that bank stock runs up, chances are the bank ETF also will gain ground. After 31 days you can sell the ETF and go back into your original stock, if you wish, without forfeiting the capital loss you previously realized.

■ **Double up.** Another way to avoid a wash sale is to buy the same security at least 31 days before you sell it. You must initiate this strategy before the end of November if you plan on a tax loss in 2008.

*Example #5:* You own 100 shares of a mortgage real estate investment trust (REIT) that has tumbled in price as a result of real estate market weakness.

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You think this REIT is oversold and expect the price to rebound sharply, perhaps in the next few weeks. You could buy another 100 shares of the same mortgage REIT. Thirty-one (or more) days later, you can sell the 100 shares you originally owned. If the original 100 shares are still trading at a loss, you will have a valid capital loss. You'll also own 100 shares of that mortgage REIT from your double-up purchase, and you will not have been on the sidelines. As you can see, you must buy the duplicate lot in November. That will enable you to sell the original lot in late December and sustain a capital loss this year.

■ **Cash in on your kids.** If you're planning to sell appreciated securities, there may be a smarter move you can make. Give those securities to your children. Parents can give up to \$24,000 worth of assets this year to each child without triggering any gift tax. After you transfer the securities, the child can sell them before year-end. As long as the child is at least 24 years old (or at least 19 and no longer in school),

those gains may qualify for a 0% tax rate, available to low bracket taxpayers. If you wait until next year, you might be out of luck. Depending on the results of the 2008 election, the new Congress might abolish the 0% tax rate and raise the maximum tax on long-term gains from the current 15%.

■ **Tame the AMT.** Consider a taxpayer who is locked into the AMT for 2008. She invested \$25,000 in a speculative stock early this year, and that stock has shot up to \$80,000. She's afraid that this stock might give back all those gains so she'd like to sell. Ordinarily she'd owe tax at rates up to 35% on positions held for one year or less.

With the AMT, while your taxable income is higher, tax rates are lower: 26% (up to \$175,000 in AMT income) and 28%. Therefore, you can take those short-term gains by year-end and pay tax at the relatively low AMT rates.

■ **Defer and conquer.** In another scenario, the AMT might encourage you to defer long-term capital gains. When you take long-term capital

gains, your income increases, and at certain income levels the "AMT exemption" is phased out. At roughly between \$150,000 and \$400,000 on a joint return, you'll pay tax at a higher rate because you lose the AMT exemption. This loss can effectively raise your tax on long-term gains from 15% all the way up to 21%, in some circumstances.

It might be possible to take some gains in December and some next January. Spreading the gain over two tax years may eliminate or reduce the extra tax resulting from the AMT.

■ **...or act now.** On the other hand, taxpayers at certain income levels may find spreading taxable gains over two years to be a trap. You might be in the AMT exemption phaseout range both years, paying tax at a relatively high rate. Thus, you might actually pay tax at a lower rate if you take a large gain this year.

The bottom line is that there is no simple way to deal with the AMT. Check with our office before taking a substantial capital gain at year-end.

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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