ElliottDavis

Accountants and Business Advisors

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Dear Client:

Although the majority of taxpayers think of April 15th as their deadline for federal tax purposes over the course of any single year, looking at December 31st as a more important date makes much more sense for many taxpayers. You always can file an extension to avoid the April 15th deadline; but you can't move the end of your tax year.

Once December 31 passes, your taxable income, deductions, credits and tax liability for the year are all "set in concrete" with little if any opportunity to change the outcome. As a result, year-end tax planning should form an essential part of your financial strategy. Changes brought about during this year, and forecasts for 2009, make that advice even more compelling for year-end 2008.

Effective year-end tax planning for 2008 combines use of traditional techniques of acceleration and deferral of income/deductions with appropriate responses to a constantly changing tax landscape. Change in 2008 in particular has come in unique ways over the past several months:

- The impact that the current financial crisis has had on the value of our homes, debt management, investment portfolios and retirement savings is obvious; some tax-wise ways to manage this crisis on a personal level are available.
- Several tax breaks will end on December 31, 2008. Still others have been extended or enhanced by the recently-passed Emergency Economic Stabilization Act of 2008. Both situations require proactive responses to maximize tax benefits.
- New energy tax incentives are now available, thanks again to the Emergency Economic Stabilization Act of 2008. When combined with rising fuel prices, these incentives for "going green" are now worth serious investigation, by individuals and businesses alike.
- The prospect of major upheavals in our tax laws in 2009 makes the need to maximize tax savings in 2008 more urgent. The possibility of retroactive tax law changes by the next Administration to the start of 2009, as well as alternative minimum tax (AMT) reform and sun-setting of favorable tax rates under the "Bush tax cuts," are real.

Traditional Planning

Traditional year-end tax planning incorporates a standard set of considerations but is far from a one-size-fits-all process. Every plan must account for the particular needs and circumstances of each individual or business.

Income shifting. Individuals and businesses alike can benefit from the classic strategy of shifting taxable income and accelerating or deferring deductions between 2008 and 2009 by controlling the receipt of income and payment of expenses. Taxpayers expecting to be in the same or lower tax bracket in 2009 should consider deferring income until next year and accelerating deductible expenses in 2008. Alternatively, if a substantial increase in income is anticipated in 2009 (propelling the taxpayer into a higher tax bracket), income should be accelerated in 2008 and deductions deferred until next year. You should also consider the impacts that you project from changes proposed by the new Administration in Washington, which may impact your decisions.

Capital losses. Long-term capital losses can be used to fully offset long-term capital gains. Losses taken in excess of gains can also be used to offset up to $3,000 in ordinary income (or $1,500 for a married couple filing separately). Short-term losses can be used to offset short-term gains that are otherwise taxable at your ordinary income tax rate (which can reach as high as 35 percent). Unlike carrybacks for businesses, excess capital losses incurred by individuals may only be carried forward.

Stock losses. Many people have taken huge hits in their investment and retirement portfolios from the crisis in the financial markets. Not only have many stocks declined in value in recent months; others have become worthless. In today's market, you are likely to have in your investment portfolio holdings that are currently priced below your purchase price. Now might be a good time to sell those stocks or mutual funds to generate losses to offset capital gains and then up to $3,000 of your ordinary income.

Alternatively, you may want to keep a loss security in your investment portfolio. You may be able to sell the stock to recognize the loss and then reacquire it to continue your investment. However, to use the loss on your 2008 tax return, you must wait 30 days after the sale to repurchase the security. One strategy to avoid lost investment opportunities while fulfilling the 30-day rule is to purchase additional shares of the security now, especially if you anticipate that the stock price may rise during the next 30-day period. After you have held the newly acquired stock for 30 days, you can sell the original shares at a loss that will be recognized for tax purposes. Another strategy is to sell now and then reinvest the proceeds immediately in shares of a company in the same industry that are likely to perform similarly to the stock you just sold. In either case, your loss qualifies for full capital loss treatment and can offset capital gains, with any excess used to offset up to $3,000 of ordinary income.

Worthless stock also generates an immediate deduction. The rules for "worthless" stocks are very strict. Your definition of worthless may be very different from the IRS' definition. Stocks and securities must be totally worthless for a taxpayer to take a loss deduction. A mere diminution in value, no matter how great, will not trigger a loss deduction.

Casualty losses. Both individuals and businesses are also allowed deductions for casualty and theft losses; and capital losses. Deductions by individual taxpayers for those losses, however, are limited. Casualty losses generally are deductible only if deductions are itemized and then subject to both a $100 deductible per occurrence and a 10 percent adjusted gross income limitation. The Emergency Economic Stabilization Act of 2008, however, provides some further relief to victims of certain natural disasters during 2008.

Life events. A birth of a child, a marriage, divorce, death, new job, loss of a job, new home, foreclosed home, and other "major life changes" also typically have significant tax implications. Many of the applicable tax rules are tied to the calendar year in which they occur.

Mortgage meltdown. The collapse of the housing market has brought about higher default rates on subprime, adjustable rate and other mortgage loans made to higher-risk borrowers. At the same time, financial institutions holding mortgage-backed assets are saddled with trillions of dollars in bad debt.

The mortgage meltdown has surprised many homeowners with unanticipated tax consequences. When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives part or all of the unpaid mortgage debt, the Tax Code traditionally considered the cancelled debt to be taxable income to the homeowner. In 2007, Congress gave homeowners some relief.

The Mortgage Forgiveness Debt Relief Act of 2007 and subsequent legislation excludes from taxation discharges of up to $2 million of indebtedness secured by a principal residence and is incurred in the

acquisition, construction or substantial improvement of the principal residence. This special relief is available for tax years beginning January 1, 2007, and ending December 31, 2012.

This treatment also covers mortgage workouts. If a lender determines that foreclosure is not in its best interest, it may offer a mortgage workout under which the terms of the mortgage are changed to result in a lower monthly payment. This and other mortgage workouts technically would result in forgiveness of indebtedness income that would be taxable to the homeowner if it were not for the new law.

Employment. Year-end is the most common time of the year for employers to announce layoffs and job cuts. If you're uncertain about the future of your employment, you may want to liquidate some assets to have more cash on hand. You may also be able to borrow from a life insurance policy. Another way to save is to discontinue automatic contributions to retirement, investment and college savings accounts. These may be some painful steps to take but they will help shield you and your family against the financial pressures brought about by a job loss.

Gift-giving

Slow and steady estate planning can yield dramatic results. Nowhere is that more apparent than devising an annual gift giving plan to family members. Before year-end 2008, you can transfer up to $12,000 per person, per year, without paying gift tax on the amounts transferred. Married couples can gift $24,000 per person by "splitting" their gifts. In 2009, the annual exclusion rises to $13,000 ($26,000 for couples). This strategy not only avoids the possibility of paying a hefty estate tax later, but it removes earnings from those gifts from your taxable income bracket into that of the lower-bracket gift recipient.

Business Deductions

Deduction planning is an integral aspect of year-end business tax planning. There are many important deductions beyond the Code Sec. 162 deduction for ordinary and necessary business expenses that may benefit many small businesses by lowering their tax liability.

Bonus depreciation. The Economic Stimulus Act of 2008 provided 50 percent bonus depreciation of the adjusted basis of qualifying property (generally 20-year or less life for tax). This accelerates an additional 50 percent of depreciation that would be allowed on business property into the first year in which it is acquired. However, the property generally must be purchased and placed in service during calendar year 2008 to qualify. In 2009, the tax law reverts to its regular depreciation allowances.

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

The Economic Stimulus Act of 2008 almost doubled the amount of deductible Code Sec. 179 expensing for tax years beginning in 2008 to $250,000 and increased the threshold for reducing the deduction to $800,000. After 2008, the expensing limits revert to prior inflation-adjusted caps, anticipated for 2009 to be $133,000 for the deduction limit and $530,000 for the start of the phase-out. Of course, another economic stimulus package may be passed in 2009 to keep these amounts higher, but businesses likely to make purchases of qualifying property soon should consider at least maximizing amounts for 2008.

Domestic production deduction. The Code Sec. 199 deduction for qualifying domestic production activities benefits a broad array of businesses, including construction, engineering, architecture, and

farming. For 2008 and again for 2009, the deduction generally equals six percent of the lesser of (1) qualified production activities income for the tax year, or (2) taxable income that does not take the deduction into account for the tax year. However, the deduction cannot exceed 50 percent of W-2 wages allocable to domestic gross receipts. The deduction applies for both regular and alternative minimum tax (AMT) liability. Starting in 2010, the deduction jumps to nine percent. Maximizing this deduction over all three years of the 2008-2010 period first requires a run-through on various computations and allocations.

Compensation and bonus deductions. If your business operates a qualified retirement plan, consider maximizing 2008 contributions to qualified retirement plans since the contributions are tax deductible in the year that they are made to plan participants. For employees with 401(k) balances especially hard hit by the recent downturn in the markets, these contributions will take on an added luster this year.

Year-end bonuses also require care. Paying year-end bonuses in December or January can create a significant compensation-based business deduction. For example, businesses can deduct in 2008 a bonus paid in 2009, as long as the obligation is paid within two and one-half months of the close of 2008. Accrual businesses can take a deduction in 2008 for bonuses not actually paid to employees until 2009 as long as (1) the employee does not own more than 50 percent in value of the business's stock, (2) the bonus is properly accrued on the company's books before the end of 2008, and the bonus is paid within two and one-half months of 2009.

Research tax credit. For businesses, the EESA extends the research tax credit to amounts paid or incurred in 2008 and 2009. It also modifies the credit, increasing the alternative simplified credit, which promises to transform the research credit into a greater benefit for smaller businesses.

Business Loss Deductions

Business losses sustained during the tax year generally can be deducted. For pass through entities such as S corps, LLCs and partnerships, losses will be passed through and deducted on the owners' personal income tax returns. Loss deductions can be taken for:

- Bad debts;
- Casualty and theft losses;
- Capital losses;
- Losses on the sale of business assets; and
- Net operating losses.

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

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

Temporary Tax Breaks

Many tax breaks are "temporary." They are enacted for a one or two year period, with the next Congress left with the decision over whether to continue them longer. Congress in 2008 made a decision to let several provisions expire; but it also extended (and in some cases enhanced) many others. In any case, action in 2008 is necessary. For those tax breaks that end in 2008, action before year-end 2008 is essential; for those that apply to both 2008 and 2009, remember that you don't get double the amount in 2009 if you don't take the necessary action to qualify you in 2008.

Here is a partial list of those tax breaks especially relevant to 2008 year-end planning:

AMT patch. The Emergency Economic Stabilization Act of 2008 (EESA) included among its many provisions an alternative minimum tax (AMT) patch. For the 2008 tax year, the AMT exemption amounts are raised to once again insulate most middle-income taxpayers from the reach of the AMT. The patch is only for 2008. Hopes are high that in 2009 Congress finally will face up to the need to find a permanent solution to the AMT and pass AMT reform rather than yet another patch.

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

State and local sales tax deduction. The American Jobs Creation Act of 2004 and subsequent legislation allowed individuals to deduct state and local general sales taxes in lieu of state and local income taxes. This deduction expired at the end of 2007. The EESA makes the deduction retroactive for 2008 and extends it for two years through December 31, 2009.

Higher education tuition deduction. The EESA extends through December 31, 2009, the above-the-line higher education tuition deduction. The deduction allows eligible taxpayers to deduct the costs of qualified higher education expenses paid during the year for themselves, a spouse, or a dependent.

Tax-free IRAs charitable contributions. The EESA extends through December 31, 2009, the opportunity for certain taxpayers age 70 1/2 or over to make tax-free distributions from IRAs for charitable purposes. This contribution can include any required minimum distribution that the taxpayer would be otherwise required to take.

Energy Incentives

The Emergency Economic Stabilization Act extends a host of energy tax incentives, some targeted to consumers and others to producers and manufacturers. The new law also introduces many favorable changes in qualifying for these tax breaks. Many of the extensions go beyond the one or two year periods that Congress authorized for non-energy extenders. New solar and wind power industries will arise due to these powerful tax breaks.

Residential energy property. The energy incentive impacting most individuals is the credit for the purchase of residential energy property. A credit of up to $500 is available in 2009 for nonbusiness energy property that meets the requirements for qualified energy efficiency improvements or qualified residential energy property expenditures. Eligible improvements include insulation materials, exterior windows, including skylights and exterior doors. If you are planning any of these improvements soon, waiting to complete them until early 2009 makes sense because of this credits new effective date.

Commercial buildings. A deduction for energy efficient commercial buildings is extended through December 31, 2013. Congress also modified the energy efficient appliance credit for manufacturers of qualifying dishwashers, clothes washers, and refrigerators.

Biking to work. The EESA introduces a new employer- provided transportation fringe benefit. In addition to transit passes and van pooling, employers starting in 2009 can offer their employees up to $20/month as a tax-free benefit if they commute to work by bicycle.

Retirement Planning

Year-end planning for 2008 also involves maximizing annual contributions to your retirement plan accounts, since one year's limit cannot be added to the next year's if not taken in time. While contributions to IRAs may be applied retroactively if made before the filing deadline, an individual's elective deferral contribution made as an employee to a qualified plan must be made before the end of the calendar year.

Maximizing contributions to your retirement plan (or plans) before year end also allows you to reduce your adjusted gross income in direct proportion to those contributions. This in turn can give you the benefit of increasing the deductibility of medical and other deductions subject to adjusted gross income floors.

As many 401(k) plan account owners have realized in 2008, managing a tax-deferred retirement account is not a "set it and forget it" proposition. Although sheltered from tax, a 401(k) or other defined contribution plan also requires careful management of the performance of those investments and re-allocation of assets whenever appropriate. Unfortunately, losses on any 401(k) plan are not tax deductible; nor can they offset capital gains in non-tax sheltered accounts.

Vacation Home Conversions

Gain from the sale of a principal residence that is allocable to periods of "nonqualified use" can no longer be excluded from the taxpayer's gain realized on its sale. A technique that has been used by many vacation home owners is to eventually convert that second home into a principal residence before its sale and claim a full $250,000 principal residence exclusion ($500,000 for joint filers) on the gain. Due to a loophole closing provision in the 2008 Housing Assistance Tax Act, any conversion made after December 31, 2008, cannot shelter the portion of that gain allocable to post-2008 appreciation.

Give Our Office A Call

Because of the complexity of the tax law, understanding what planning provisions to incorporate into your year-end tax planning strategy can be a daunting task. While this letter hopefully gives you a heads-up on at least several tax opportunities on which you might follow through before year end, there are many more techniques that can be used depending upon your individual circumstances. For a more detailed plan that can be customized to your particular circumstances, please don't hesitate to give our office a call. Our contact information can be found at www.elliottdavis.com. An electronic version of this letter is also there that you may share with others.

Sincerely yours,

Elliott Davis, LLC