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2008 Tax Update

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Dear Client,

As with the last two years, I have decided to send a year-end tax update letter. In this letter, I comment on the tax law changes that are most likely to impact my clients. Included are the 2008 tax rebates that will be available for some taxpayers, a significant expansion of the alternative minimum tax credit relief, and a property tax deduction for people who don't itemize.

<u>2008 Tax Rebates:</u> Last summer certain taxpayers (single taxpayers making less than $75,000 and married taxpayers making less than $150,000) received a tax rebate as a result of last January's Economic Stimulus Bill. A common misconception regarding the rebates is that the rebate amount was based on a taxpayer's 2007 tax situation. It is actually based on 2008. Any amount received last summer was an "advance refund amount" based on their 2007 tax return. If the actual rebate calculated on their 2008 return is greater, they get the difference. If it's less, they don't have to repay the excess. Due to the scarcity of capital gains in 2008, I expect that some clients who did not qualify for the rebate based on their 2007 income, will qualify based on their 2008 income.

<u>15% Tax Rate on Qualified Dividend and Long-term Capital Gains:</u> Under the current law qualified dividends and long-term capital gains are taxed at a maximum rate of 15% through year 2010. For years 2008 through 2010, taxpayers in the 10% and 15% bracket have a 0% capital gains rate (down from 5% for 2007). This means that low-income taxpayers could have qualified dividends and long-term capital gains of up to $65,100 ($32,550 for single taxpayers) and pay no tax! Unfortunately, the "kiddie tax" rules (see next page) prevent parents from taking advantage of this break by transferring highly appreciated assets to their kids.

During the Presidential campaign, President-elect Obama pledged to raise the qualified dividend and capital gains rate to at least 20%. Recently Mr. Obama has backed off on this pledge stating that he may hold off on raising taxes for upper-income taxpayers due to the recession.

<u>Alternative Minimum Tax Credit Relief Expanded:</u> There is great news for taxpayers who have unused AMT credits (typically from a stock option exercise and hold) *that is more than three years old*. The taxpayer will be able to claim a refundable credit of 50% of the unused credit starting in 2008. Unlike last year, there is no longer an income phase-out to qualify for the credit.

<u>Limitation on Use of Tax-Free Sale of Primary Residences:</u> The Housing Act of 2008 removes one of the best tax loopholes allowed. Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale.

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Under the 2008 Act, for sales after December 31, 2008, with certain exceptions, the gain from the sale of a principal residence will no longer be excluded from gross income *for periods after December 31, 2008 that the home was not used as the principal residence* (the portion of the gain for the period when the home was a principal residence will still qualify for the exclusion). This new provision will impact taxpayers who convert their vacation home or rental property into a principal residence.

First-time Home Buyer Credit: Effective for principal residences purchased after April 8, 2008, and before July 1, 2009, Federal law now provides up to a $7,500 credit on your return if you are a "first-time home buyer" (i.e. you haven't owned a home in three years). The credit is really a loan as you will be charged $500 each year until you repay the $7,500 or you sell the house and repay the balance then. The amount allowed as a credit is phased out for taxpayers with "modified Adjusted Gross Income" above $150,000 ($75,000 for single taxpayers).

Property Tax Deduction for Non-Itemizers: For tax years 2008 and 2009, taxpayers who don't itemize their personal deductions are allowed an addition to the standard deduction for property taxes paid equal to the lesser of the amount paid or $1000 ($500 for single filers).

Mortgage Forgiveness: The worst real estate downturn since the Great Depression is resulting in millions of foreclosures in America. As hard as it may be to understand, foreclosed homeowners can end up with a large tax bill after losing a home. The Mortgage Forgiveness Debt Relief Act of 2007 provides an income exclusion for qualifying portions of the debt relief. I will not go further into the details of these complicated rules as fortunately I believe none of my tax clients are faced with a foreclosure.

IRA Charitable Contributions: Originally scheduled for 2006 and 2007 only, this provision has been extended through 2009. The provision allows an individual aged 70-1/2 or older to make a direct contribution (including the required minimum distribution) of IRA funds to a charity. Although you will not be able to claim a deduction for the contribution, you will not be taxed on the withdrawal of the money from your IRA.

"Kiddie Tax": Students are now subject to kiddie tax as long as they are under age 24. Children subject to "kiddie tax" are taxed at their parents' tax bracket to the extent their interest and dividend income exceeds $900 or total investment income exceeds $1800. The effect of the "kiddie tax" law change is to substantially eliminate the Federal tax benefit for a parent to establish a custodial account to take advantage of a child's lower bracket. The State of California has not conformed to the change. For CA tax purposes, "kiddie tax" only applies to children under age 14.

IRA (Regular & Roths) Contribution: The annual amount that can be contributed is as follows:

	2002-2004	2005	2006	2007	2008	2009
Taxpayers Under Age 50	$3000	$4000	$4000	$4000	$5000	$5000
Taxpayers Over Age 50	$3500	$4500	$5000	$5000	$6000	$6000

Roth IRA Conversions for 2010: Roth IRAs are very appealing because no tax is paid when qualified distributions are received. Contributions to Roths, though, are only allowed for taxpayers below a certain income limit. In addition, for taxpayers with modified adjusted gross income below $100,000, a regular IRA can be converted into a Roth IRA. Income is taxed to the extent that the amount converted is with pre-tax dollars. For instance if a $25,000 IRA with no tax-basis is converted to a Roth, the $25,000 must be recognized as ordinary income in the year of conversion.

Starting in 2010, the existing $100,000 income test for converting a traditional IRA to a Roth IRA will no longer apply. In addition, under the 2006 Tax Act, taxpayers who convert an IRA to a Roth IRA in 2010 can elect to defer the related income inclusion and recognize the income ratably over the two years, 2011 and 2012.

Credit for Energy-Efficient Improvements to a Personal Residence by a Homeowner:
This modest credit, which was available for 2006 and 2007, expired on December 31, 2007. It has been reinstated for 2009 only and is not available for 2008. One of the 2008 Tax Acts, however, did extend through 2016 the credit for solar, wind and other alternative energy expenditures by homeowners.

2009 CA Estimated Payments: In a bizarre attempt to address California's budget problems, the legislature has accelerated the required estimated payments for individuals and corporations. The first two 2009 payments are required to be at least 30%, and the second two payments to be 20% of the "required annual payment". Furthermore, individuals with 2008 Adjusted Gross Income in excess of $1 million will no longer be able to rely on the "110% of prior year tax" as a safe harbor to avoid underpayment penalties for 2009.

Gift Tax Annual Exclusion: A very effective estate planning tool for taxpayers with large estates is to annually gift a portion of their assets to their heirs. For year 2009 donors can gift up to $13,000 annually (up from $12,000 for 2008) to any one donee and not be subject to gift tax.

Please let me know if you have any questions regarding these tax law changes.

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