SmartMoney

# 2009 TAX GUIDE

# Foreword

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The stimulus package. The roller-coaster stock market. Your shrinking retirement. It's never fun dealing with your taxes, but this year it's positively painful. That's why we decided to put together this guide: to help you get through what may be the toughest tax season in our lifetime.

We're blessed at SmartMoney to have the perfect person to help you navigate this challenge. Bill Bischoff, the tax columnist for Smart-Money.com, has been a tax specialist and licensed CPA for 25 years. He writes about taxes for tax professionals, as well as for individuals, and has authored many books, including "Anti-Audit Warfare: How to Avoid or Beat an IRS Audit" and "175 Tax Reduction Strategies." So we've asked him to update his tax advice—not just for the rules, but for the times as well. We hope it helps.

# Introduction

BY BILL BISCHOFF

As you know, keeping up with tax changes has become a big challenge—in large part because they've been coming so fast and furious. Just in the last 15 months, we've had nine new laws that included significant tax changes. I expect more of the same as politicians continue to cast about for solutions to the current economic mess. One thing you don't want to do during tough times is pay more taxes than you need to. I hope you'll find this information helpful both in dealing with your 2008 income tax return and in planning ahead to lower your taxes and increase your cash flow for this year and beyond—without, of course, running afoul of the IRS.

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# I. BREAKING NEWS

## WHAT THE STIMULUS PLAN MEANS FOR YOUR TAX BILL (PART I)

PRESIDENT OBAMA'S American Recovery and Reinvestment Act of 2009 (the Stimulus Act) is a mind-blowing $787 billion package that includes some new and expanded tax credits and other taxpayer-friendly changes. Here are four important changes that will affect many individual taxpayers.

### 'MAKING WORK PAY' CREDIT

A FAIR MAJORITY of workers will be entitled to the temporary "Making Work Pay" credit for 2009 and 2010. This credit is equal to 6.2% of annual earned income and can amount to a maximum of $400 for an individual or $800 for a joint-filing married couple.

The credit is also refundable. That means it can be used to offset your entire federal-income tax bill, including any alternative minimum tax (AMT), and you get to collect any leftover credit amount in cash after your tax bill has been reduced to zero.

There are phase-out rules, however. The credit is reduced or completely eliminated over the following adjusted gross income (AGI) ranges:

- $75,000 to $95,000 for singles and married folks who file separately.
- $150,000 to $190,000 for joint-filing married couples.

The IRS has issued updated federal employment-tax withholding tables to allow employees to collect their credits in advance via reduced payroll tax withholding for the rest of 2009. So the cash will come through in the form of slightly higher paychecks. Frankly, you aren't going to notice a big difference (about 10 extra bucks a week). Self-employed folks can collect their credits in advance by reducing their quarterly estimated tax payments.

### $250 ECONOMIC RECOVERY PAYMENT FOR GOVERNMENT PROGRAM BENEFICIARIES

MAINLY GEARED TOWARD retirees, the one-time $250 Economic Recovery Payment will be doled out to the following government program recipients.

- Adults eligible for Social Security benefits and anyone eligible for Supplemental Social Security Income (SSI) except those who receive them while in a Medicaid institution.
- Adults eligible for Railroad Retirement benefits.
- Adults eligible for veteran's compensation or pension benefits.

To cash in, you must have been eligible for at least one of the programs listed above for at least a month during the three-month period that includes November and December of 2008 and January of 2009.

The IRS is figuring out how to get payments underway within the next four months.

**NOTE:** If you receive the $250 Economic Recovery Payment, it gets subtracted from any Making Work Pay credit that you would otherwise be entitled to collect.

### $250 REFUNDABLE CREDIT FOR GOVERNMENT RETIREES

THE STIMULUS ACT includes a comparable $250 free-money goodie for certain government retirees. This payment comes in the form of a one-time 2009 refundable tax credit of $250 for each eligible individual or $500 for a joint-filing married couple when both spouses are eligible.

You have to meet all three of the following requirements to be eligible.

1. During 2009, you receive retirement benefits for past service as an employee of the U.S. or other government entity based on earnings that were not subject to Social Security tax withholding at the time.
2. You're ineligible for the aforementioned $250 Economic Recovery Payment deal .
3. You report a Social Security number on your 2009 Form 1040.

**NOTE:** If you're eligible for this $250 credit, it gets subtracted from any Making Work Pay credit that you would otherwise be entitled to collect.

### EXTENDED FIRST-TIME HOMEBUYER CREDIT

THE STIMULUS ACT extends the first-time homebuyer credit deal for another five months, covering purchases through November of 2009. It also makes this refundable credit a bit more generous. But the biggest change is that the earlier requirement to pay back the credit over 15 years no longer exists for 2009 purchases.

For a qualified purchase of a principal residence between

January 1, 2009, and November 30, 2009, the maximum credit under the revamped rules equals the lesser of: (1) 10% of the purchase price or (2) $8,000 or (3) $4,000 if you use married filing separate status. These credit maximums are up from the $7,500 and $3,750 amounts that apply for 2008 purchases.

You're only eligible for the credit if you have not owned a principal residence in the U.S. during the three-year period that ends on the purchase date. If you're married, both you and your spouse must pass this test (whether or not you file jointly). For a newly-constructed home, the purchase date is deemed to be the date you move in.

The credit is phased out over the following AGI ranges:

- $75,000 to $95,000 for singles and married folks who file separately.
- $150,000 to $170,000 for married joint-filing couples.

### CREDIT MUST BE REPAID IN SOME CASES

EVEN UNDER THE liberalized new rules, you may have to repay the credit if you sell the home for a gain within three years of the purchase date or stop using it as your principal residence within that timeframe.

### CLAIMING CREDIT FOR 2009 PURCHASE ON YOUR 2008 RETURN

IF YOU BUY a home between January 1, 2009, and November 30, 2009, you can choose to treat the deal as if it occurred in 2008. Then you can claim the credit on your 2008 Form 1040 and get the benefit that much quicker. To do so, fill out Form 5405 (First-Time Homebuyer Credit), and check the box to show you want to claim the credit for 2008. Then file Form 5405 with your 2008 return. The 15-year repayment rule won't apply to you even though you're claiming the credit on your 2008 return. You're also eligible for the expanded 2009 credit maximum of $8,000 (or $4,000 if you use married filing separate status) even though you're claiming the credit on your 2008 return.

## THE STIMULUS PLAN AND YOUR TAX BILL (PART II)

THE MASSIVE $787 BILLION Stimulus Act includes quite a few taxpayer-friendly changes worth taking advantage of. I just covered four important ones for individuals. Now, I'll cover several more.

### ANOTHER ALTERNATIVE MINIMUM TAX PATCH

YET AGAIN, Congress applied a one-year patch on the alternative minimum tax, preventing millions of individuals from being forced to pay the dreaded tax for 2009. As in the past, this year's patch has two parts:

### EXPANDED EXEMPTIONS

YOU SUBTRACT THESE exemptions in calculating taxable income under the AMT rules, so bigger exemptions mean less chance of being hit with the AMT. The exemptions for 2009 are as follows:

- $70,950 for married joint-filing couples (up from $69,950 for 2008).
- $46,700 for unmarried individuals (up from $46,200).
- $35,475 for married individuals who file separately (up from $34,975).

### NONREFUNDABLE CREDITS

THE SECOND PART of the patch allows you to use any and all nonrefundable personal tax credits to reduce your 2009 AMT bill, as well as your regular tax bill. The most common nonrefundable credits are the child credit (up to $1,000 per kid) and the two higher-education credits that I write about below. There are others. For example, you can use the credit for buying a new hybrid or clean-burn diesel vehicle to lower your AMT bill. (This was not true for pre-2009 tax years.)

### MORE GENEROUS HIGHER EDUCATION TAX CREDIT

FOR 2009 AND 2010, the Stimulus Act makes taxpayer-friendly changes to the rules for the Hope Scholarship higher education tax credit—which has been temporarily renamed the American Opportunity credit. For simplicity's sake, I'll call the revamped credit the modified Hope credit.

The modified credit equals 100% of the first $2,000 of qualified post-secondary education expenses paid during the year, plus 25% of the next $2,000. So the maximum credit is now $2,500. (Under the old Hope credit rules, the maximum credit for 2009 would have been only $1,800.)

### QUALIFIED EXPENSES AND ELIGIBILITY RULES

THE MODIFIED HOPE credit now covers the cost of tuition, fees, and course materials (but not room and board) for the first four years of post-secondary education. The credit becomes unavailable after the student has logged in four years' worth of academic hours. (Under the old Hope credit rules, the credit was

only allowed for the first two years of post-secondary education, and course materials were not a qualified expense.)

#### PHASE-OUT RULE

WHILE THE MODIFIED Hope credit is still phased out (reduced or eliminated) above certain income levels, the phase-out ranges are considerably higher than before.

- The phase-out range for unmarried individuals is between adjusted gross income (AGI) of $80,000 and $90,000.
- The phase-out range for married joint filers is between AGI of $160,000 and $180,000.

(Under the old Hope credit rules, the phase-out ranges for 2009 would have been $50,000 to $60,000 and $100,000 to $120,000, respectively.)

#### PARTIALLY REFUNDABLE RULE

THE MODIFIED HOPE credit can be used to offset both your regular federal income tax bill and your AMT bill (if you have one). In addition, up to 40% of the credit is now refundable. That means if you still have some credit left after reducing your federal income tax bill to zero, you can collect 40% of the leftover amount in cash.

Another thing worth noting is that the new law doesn't change the rules for the Lifetime Learning higher education tax credit, which can be as high as $2,000. For 2009, the Lifetime credit is phased out between AGI of $50,000 and $60,000 for unmarried taxpayers and between AGI of $100,000 and $120,000 for married joint-filing couples.

#### FIRST $2,400 OF 2009 UNEMPLOYMENT COMPENSATION IS TAX-FREE

IN GENERAL, unemployment compensation benefits count as taxable income. The Stimulus Act grants a one-year federal income tax exemption for the first $2,400 of unemployment compensation received in 2009. Unemployment benefits above the $2,400 limit will still count as taxable income.

#### BIGGER TAX-FREE LIMIT FOR EMPLOYER-PROVIDED TRANSPORTATION FRINGE BENEFITS

FOR MARCH OF 2009 and through December of 2010, the new law increases the maximum federal-income-tax-free fringe benefit allowance for employer-provided transit passes and van pooling to $230 (up from $120). The $230 ceiling is an overall limit. It applies if you use just one of these benefits or both. You can also choose to receive up to $230 per month for one or both of these benefits on a tax-free basis under a salary reduction arrangement, if your employer offers this option.

## 5 NEW TAX BENEFITS FOR 2008

IT'S TIME TO THINK seriously about getting your 2008 Form 1040 underway—whether you choose to do it yourself or hire a pro.

No matter how you get your taxes done, there are a few key changes almost everyone should know about. Here's what to look for:

#### SECOND SHOT AT LAST YEAR'S STIMULUS PAYMENT

IN 2008, you had the chance to collect an economic stimulus rebate payment based on information reported on your 2007 Form 1040. The maximum rebate was $1,200 for a married joint-filing couple and $600 for others. Those with qualifying children could snag up to another $300 per child. However, there were a lot of eligibility rules, and many higher-income folks didn't receive anything due to phase-out rules.

For those who didn't receive any rebate (or who received less than the maximum), there's some good news: You're allowed a second bite at the rebate apple based on information reported on your 2008 Form 1040 (the one you are about to file). The same eligibility and phase-out rules still apply, but you may get a better answer this time. In fact, you can potentially collect the difference between the maximum rebate amounts listed above and what you received last year (if anything).

This second-chance rebate is called a "recovery rebate credit." You can calculate the credit using the worksheet on page 62 of the Form 1040 instruction package. Then, enter the amount on line 70 of your return. You'll get your money in the form of a bigger tax refund or a smaller amount owed to Uncle Sam.

Your odds of qualifying for a recovery rebate credit are pretty good if your 2007 income was high enough to cause you to be affected by the phase-out rule, but your 2008 income was lower. Sadly enough, that will be the case for many of us.

#### NEW PROPERTY TAX WRITE-OFF FOR NON-ITEMIZERS

IF YOU DON'T itemize deductions, you may qualify for a

brand-new write-off for state and local real property taxes. The new break comes in the form of an add-on to your normal standard deduction amount. The maximum add-on is $1,000 for married joint-filing couples or $500 for others. However, it can't exceed the amount of state and local real property taxes you actually paid during 2008. Check the box on line 39c of your Form 1040 and include the additional standard deduction amount on line 40.

### NEW SO-CALLED CREDIT FOR HOMEBUYERS

IF YOU BOUGHT or plan to buy a home between April 9, 2008, and December 31, 2008, you may qualify for a brand-new tax credit. However, you're only eligible if you haven't owned a principal residence in the U.S. during the three-year period leading up to the purchase date. (If you're married, your spouse must pass this test, too.) The maximum credit equals the lesser of: 10% of the home price, or $7,500 ($3,750 if you use married, filing separate status).

The good news is the credit offsets both your regular tax and any alternative minimum tax (AMT), and it's refundable. That means the government will fork over any leftover amount after the credit has been used to offset your entire federal income tax bill (including any AMT).

The bad news is you must repay the credit over 15 years (which is why I describe it as a "so-called credit" above). It's also phased out for higher-income folks. If you think you might qualify, fill out Form 5405 to find out for sure. Then enter the credit amount on line 69 of your Form 1040.

**NOTE:** See our earlier item about the much more generous first-time homebuyer credit rules for purchases between January 1, 2009 and November 30, 2009.

### NEW PERSONAL CASUALTY LOSS WRITE-OFF FOR NON-ITEMIZERS

FOR THOSE WHO don't itemize, the normal standard deduction amount can be increased by any disaster-related personal casualty loss you may have suffered in 2008. Only losses in federally-declared disaster areas are eligible for this brand-new break. Sadly enough, many folks will qualify for this bit of tax-saving assistance because there were quite a few weather-related disasters last year. To figure out the extra standard deduction amount, fill out Form 4864. Then check the box on line 39c of your Form 1040, and include the extra write-off on line 40.

### LIBERALIZED PERSONAL CASUALTY LOSS WRITE-OFF FOR ITEMIZERS

IF YOU ITEMIZE and suffer a personal casualty loss, the general rule says you can only claim a deduction to the extent the loss exceeds 10% of your adjusted gross income (AGI). However, under a brand-new rule, the normal 10%-of-AGI threshold is suspended for 2008 disaster-related losses in federally-declared disaster areas. To figure the deductible amount under this liberalized rule, fill out Form 4864. Then enter the deduction on line 20 of your Schedule A.

## 3 NEW TAX CHANGES TO KNOW BEFORE YOU FILE

WITH APRIL 15 LOOMING, here are a few more key changes to note as you get started on your 2008 Form 1040.

### MORE-GENEROUS IRA CONTRIBUTION RULES

IN PREVIOUS YEARS, your adjusted gross income (AGI) may have been too high to allow you to make deductible traditional IRA contributions or Roth IRA contributions. Things have changed for the better.

### TRADITIONAL IRAS

FOR 2008, you can contribute more to traditional IRAs than ever before, and you have a better chance of making a tax-saving deductible contribution.

For the 2008 tax year, you can contribute up to $5,000 to a traditional IRA, up from $4,000 for 2007. If you were age 50 or older on December 31, 2008, the contribution maximum is $6,000 (up from $5,000). If you're married, the same contribution limits apply to your spouse if he or she wants to fund a separate IRA. The deadline for contributions for the 2008 tax year is April 15. So you still have time.

Here are the other traditional IRA contribution ground rules.

- Once you turn 70½, you can no longer contribute to a traditional IRA. However, Roth IRAs are still fair game.
- You (or, if you're married, you and your spouse), must have had 2008 earned income from salary or self-employment that at least equals the amount you contribute to IRAs for 2008. Note: Any alimony payments you received also count as earned income.

For those who were covered by retirement plans in 2008, the AGI restrictions on deductible contributions are considerably looser than just a few years ago. In each of the cases below, these AGI restrictions only affect your ability to make deductible contributions to traditional IRAs. (You can make nondeductible contributions to traditional IRAs no matter how high your income.) Here's the breakdown.

- If you're unmarried, your eligibility to make a deductible 2008 contribution to a traditional IRA is phased out between AGI of $53,000 and $63,000.
- If you're married and both you and your spouse were covered by retirement plans in 2008, your right to make deductible 2008 contributions to traditional IRAs is phased out between joint AGI of $85,000 and $105,000.
- If you're married and only one spouse was covered by a retirement plan in 2008, the covered spouse's eligibility to make a deductible 2008 contribution to a traditional IRA is phased out between joint AGI of $85,000 and $105,000. The noncovered spouse's deductible contribution privilege is phased out between joint AGI of $159,000 and $169,000.

### ROTH IRAS

THE LARGER 2008 contribution limits for traditional IRAs (explained above) apply equally to Roth IRAs. After that, there are some important differences.

- If you've turned age 70½, you can no longer contribute to a traditional IRA, but you can still contribute to a Roth as long as you—or you and your spouse if you're married—had earned income at least equal to what you contribute.
- The privilege of making Roth contributions for the 2008 tax year is phased out between AGI of $101,000 and $116,000 for unmarried taxpayers. For joint filers, the range is between $159,000 and $169,000. These ranges are considerably higher than just a few years ago.
- Being covered by a retirement plan (or not) has no impact on your eligibility to make Roth contributions.

Overall, for 2008, you have a better chance of being able to make the maximum Roth IRA contribution than ever before. Not only that, the maximum contribution amount is also larger than ever. The deadline to make a Roth contribution for the 2008 tax year is April 15.

### NEW AND IMPROVED ALTERNATIVE MINIMUM TAX CREDIT

AS I EXPLAINED earlier, you may be able to recover AMT amounts paid in prior years, thanks to liberalized AMT credit rules. If you've paid big AMT amounts in the past, this could be the single most important change for the 2008 tax year. To collect your rightful AMT credit, just complete Form 8801 (Credit for Prior-Year Minimum Tax) and attach it to your Form 1040.

## II. DEDUCTIONS AND CREDITS FOR 2008

### HIGH-INCOME TAX BREAKS

IF YOU'RE A high-income type, you're probably painfully aware that many tax breaks are phased out (either reduced or eliminated) as your adjusted gross income, or AGI, increases. That's the price of success, right? Well, not necessarily. Believe it or not, some tax breaks are available to just about anybody—regardless of income. Here are six of them.

#### RETIREMENT PLANS FOR THE SELF-EMPLOYED

IF YOU'RE SELF-EMPLOYED, you may be able to contribute and deduct up to $46,000 for 2008 ($49,000 for 2009) by setting up a simplified employee pension, or SEP. Contributing to a SEP could dramatically reduce your taxable income and save you a bundle. Think you've already missed the boat for your 2008 taxes? Think again. If you don't already have a retirement plan in place, you can still set up a SEP and make a deductible contribution to your account for 2008. And that could be done as late as Oct. 15 if you extend your return for the automatic six-month period.

#### CREDIT FOR OVERPAID SOCIAL SECURITY TAXES

DID YOU HAVE TWO jobs last year and earn more than $102,000? Then you probably contributed too much to Social Security. Your credit will be for the amount you contributed beyond $6,324, which represents your half of the 12.4% Social Security tax based on a maximum salary of $97,500. Getting the money back is easy—just report the overpaid amount (you can tell what that is by looking at your W-2s) on Form 1040, line 65.

#### DEDUCTING ALIMONY PAYMENTS TO YOUR EX

THIS MAY BE SMALL consolation, but if you started alimony payments last year, they're probably deductible. It all depends on the terms of your divorce agreement. Assuming you qualify, you can claim a full write-off of your alimony payments on page 1 of Form 1040.

#### WRITING OFF YOUR GAMBLING LOSSES

SO LADY LUCK UP and left you during your last trip to Vegas, huh? Believe it or not, Uncle Sam feels your pain, and will allow you to deduct your losses up to the amount you've won during the year on Schedule A, line 28. (Your winnings are taxed as regular income.) But beware: If you claim this deduction, you should have written evidence of your losses, just in case you get audited. So try to dig up some evidence (betting tickets, etc.). In the future, keeping a journal of your wins and losses should do the trick. After all, asking that blackjack dealer for a receipt might be tricky.

#### WRITING OFF YOUR INVESTMENT INTEREST

DID YOU BORROW on margin last year? As long as you itemize deductions on your return, you probably can deduct the interest you paid on the account. The deduction for the interest paid to carry taxable investments (so-called investment interest expense) is unaffected by the phase-out rules that apply to most other itemized deductions listed on Schedule A. There's only one small catch: Your investment interest expense deduction generally can't exceed your taxable income from interest, annuities, royalties and short-term capital gains. That said, any excess investment interest expense can be carried over to the following tax year. See IRS Form 4952 (Investment Interest Expense Deduction) for all the details (including a special election to treat long-term capital gains and dividends as investment income).

#### THE DEPENDENT CARE CREDIT

OK—SO THIS LAST tax break is technically subject to some AGI phase-out rules. But truthfully, nearly everybody who claims this credit is partially "phased out." What's left is still a great tax break.

If you worked last year and paid someone to take care of your under-age-13 child, you could be eligible for this credit. Keep in mind, if you're married, both spouses must work, unless one is a student. Additionally, neither of you could have contributed to a child-care flexible spending account (through your employer) to cover the same expenses last year.

If your income (married or single) exceeds $43,000 then you can take a credit equal to 20% of your child-care expenses. However, the credit limit is $600, if you have one child, or $1,200, if you have two or more. (If you earned less than $43,000 you may be entitled to a larger credit.) Thankfully, the definition of child care is generous—it can cover anything from summer day camp to a babysitter. See Form 2441 for details. Claim your credit on line 48 of Form 1040.

## REFUNDABLE AMT CREDIT COULD MEAN SAVINGS

IF YOU'VE BEEN socked with a big alternative minimum tax, or AMT, bill in the past, you may be in luck. Thanks to a little-known provision, you could actually get a refund.

Typically, taxpayers are hit with a big AMT bill because they exercised some lucrative incentive stock options (ISOs). Unlike the regular tax rules, the AMT rules tax you on the "bargain element" when you exercise an ISO. The bargain element is the difference between the fair market value of the ISO shares on the date you exercise the option and the exercise price. The regular tax rules don't tax the bargain element until you actually sell your ISO shares. So your AMT bill can be bigger (sometimes much bigger) than your regular tax bill in a year when you exercise in-the-money ISOs. Naturally, the IRS insists that you pay the larger AMT amount.

A few years ago, lots of folks exercised in-the-money ISOs and wound up paying huge AMT bills for the privilege. If you were one of them, you could get some of that AMT money back. Here's how:

### REGULAR AMT CREDITS

ONE WAY AMT victims are allowed to offset some of their pain is through the AMT credit. The amount of AMT triggered by exercising ISOs generally results in a credit you can use to lower your tax bills in future years. Any unused AMT credit can be carried forward indefinitely.

Under the general rules, however, you can only use as much of the credit as it takes to reduce your regular tax liability to the point where it equals the AMT. So even if you have a big AMT credit, it does absolutely no good in years when you owe the AMT, and it only does a minor amount of good in years when your regular tax bill is just a little larger than your AMT bill (the typical situation). Therefore, under the general rules, you might die before you ever get a substantial break from your AMT credit.

### TAPPING INTO LITTLE-KNOWN REFUNDABLE AMT CREDITS

FORTUNATELY, THERE'S A huge favorable exception to the general AMT credit rules. Under this exception, unused AMT credits that are more than three years old become refundable, which means you can use them to reduce both your regular federal income tax bill and your AMT bill and then collect any leftover credit amount in cash. You can take advantage of the refundable AMT credit rules when you file your 2008 Form 1040.

The refundable AMT credit amount for a particular tax year only includes unused AMT credits that were generated more than three years earlier. These are also referred to as long-term unused AMT credits. So for the 2008 tax year, you can only have a refundable AMT credit if you have unused AMT credits that were generated more than three years earlier --which means in years prior to 2005. (For newer AMT credits, you're stuck with the less-favorable general rules.)

The refundable AMT credit amount for the current year is limited to the greater of:

- 50% of the long-term unused AMT credit amount carried into that year (for 2008, this means the amount of credits generated in pre-2005 years) or
- The amount of refundable AMT credit for the preceding year (for 2008, this means the refundable AMT credit amount, if any, from your 2007 Form 1040).

However, the refundable AMT credit for the current year cannot exceed the long-term unused AMT credit carried into that year. Sound confusing? The following example should clarify how the limitation rule works. Under this simple scenario, the entire long-term unused AMT credit was generated in the same year.

**EXAMPLE:** Say you generated a whopping $150,000 AMT credit in 2004 when you exercised some profitable ISOs. For 2008, the entire $150,000 amount counts as a long-term unused AMT credit, since the whole amount was generated before 2005. For 2007, you had no refundable AMT credit–because your credit was not yet old enough.

Your 2008 refundable AMT credit amount figured under the annual limitation rule is $75,000 (0.50 x $150,000). You can collect the entire $75,000 simply by filing out a Form 8801 (Credit for Prior-Year Minimum Tax) and including it with your 2008 Form 1040. By "collect" I mean you can use the $75,000 credit to reduce your 2008 federal income tax bill (including any AMT) to as low as zero. Any leftover credit amount will be sent to you in cash.

For 2009, your long-term unused AMT credit amount is the $75,000 left over from 2008. Under the annual limitation rule, the entire $75,000 is refundable (because it equals the 2008 refundable credit amount). So you can collect the entire $75,000 simply by filing your 2009 Form 1040.

When all is said and done, you get to collect the whole $150,000 over two years. Not bad.

Note: Things get more complicated when you have credits that were generated in several different years. However, once the credit from any particular year is over three years old, you can always collect it over a two-year period (if not sooner) under the refundable AMT credit rules.

**MY ADVICE:** Don't miss out on this credit if it's available to you. And if you have significant bucks at stake, consider hiring a tax pro to get the numbers right.

## THREE OFTEN OVERLOOKED TAX SAVERS

AS UNPLEASANT AS filing one's taxes may be, don't let the desire to simply get your taxes done keep you from making sure you get every tax break you're entitled to.

Here are three commonly overlooked ways to save:

### SELLER-PAID MORTGAGE POINTS

DID YOU BUY a home in 2008? Then be sure to review your paperwork to see if the seller paid some (or all) of your points when you took out a mortgage to finance the deal. If so, you're in luck. Believe it or not, you're entitled to deduct those seller-paid points even though someone else paid the tab. (You aren't going to find a much better deal than this in the U.S. tax code.)

Claim your deduction on line 12 of your Schedule A (or on line 10 if the seller-paid points were reported to you on Form 1098). You must then lower the tax basis of your home by the amount of your deduction. This will slightly increase your gain when you eventually sell the home, but chances are pretty good that it won't matter. After all, with the relatively generous home-sale-gain exclusion privilege (up to $250,000 for singles and up to $500,000 for joint filers), it's quite possible you won't owe any federal capital-gains tax when you sell.

### SELLING GRANDMA'S STUFF

IF YOU SOLD SOMETHING last year that you inherited, understand that your tax basis for gain or loss purposes generally has nothing to do with what your benefactor paid for the asset. And that's probably going to save you a bundle in taxes. With inherited items, your tax basis is usually the asset's fair-market value as of your benefactor's date of death. In other words, your tax basis is adjusted to that value, which is usually a very taxpayer-friendly outcome for assets owned for a long time, like a house or stocks.

Suppose your grandmother died on April 5, 2007, and you inherited shares of General Electric, which you subsequently sold in 2008. To figure out your tax gain or loss on those shares, do you have to go back and figure out what Grandma paid for her original shares back in, say, 1947? No. You simply have to figure out what the stock was trading for on April 5, 2007, and calculate the gain or loss from there.

Occasionally, the estate executor will choose to value the estate's assets as of the "alternate valuation date." In that case, your basis is equal to the asset's fair-market value on the date you received it, or six months after the date of death, whichever came first. One other thing: Gains from inherited capital assets automatically qualify for favorable long-term-gain treatment, regardless of the length of time they were actually owned by you or the person who left them to you.

### ADOPTING A CHILD

IF YOU ADOPTED a child younger than 18 last year, you can generally claim a tax credit for up to $11,650 of adoption-related expenses (such as adoption fees, legal fees, court costs, travel expenses, etc.). The credit reduces your tax bill dollar for dollar.

The only downside is that this deal is phased out for a parent (or parents) with adjusted gross income starting at $174,730 and ending at $214,730. Also, if you're married, you generally must file a joint return to claim the credit. To take the credit, fill out Form 8839 (Qualified Adoption Expenses) and file it with your 1040. Then enter the adoption-credit amount on Line 53 of your 1040.

## GIVE YOUR COLLEGE KID A TAX BREAK

IF YOU EARN A healthy income, then you probably don't qualify for the higher-education tax credits intended to help pay college-tuition bills. However, your college-age child just might.

Both the Hope Scholarship credit (maximum $1,800 for 2008) and the Lifetime Learning credit (maximum $2,000) help soften the cost of postsecondary education. The Hope credit is available only for the first two years of college, while the Lifetime Learning credit can be used at any time and doesn't

even have a degree or workload requirement.

Unfortunately, you can't take both credits for the same student in the same year, and many parents earn too much to be eligible for either one. That's because in tax year 2008, both credits are phased out starting at an adjusted gross income, or AGI, of $96,000 for joint filers and $48,000 for singles. At AGI levels of $116,000 and $58,000, respectively, you're completely ineligible. As you might imagine, plenty of parents fall into this category. But even if you're among them, these valuable credits may not have to go to waste after all.

Here's how: Arrange things so your college-age child can claim one of these credits instead of you. To implement this strategy, you must forgo the dependency exemption deduction for your child ($3,500 for the 2008 tax year). Then the education tax credit becomes the property of your child, whose income is presumably well below the phase-out range.

The now-liberated education credit can cut your college-age child's tax bill by quite a bit. Remember, however, the credit is worthless to your child unless he or she has enough taxable income to actually owe the IRS. This income could be from summer jobs, work-study at school or income and gains from investments held in your child's name.

Also, keep in mind that this strategy makes the most sense when your AGI is quite high. Why? Because your dependency write-off for your college kid is itself partially phased out between an AGI of $239,950 and $362,450 for joint filers and between $199,950 and $322,450 for heads of households. So giving up that dependency deduction on your 2008 tax return may not cost you much. (This strategy does not permit your child to claim an exemption on his or her return; the exemption belongs to you whether you're able to use it or not.)

## III. TAX TRAPS TO AVOID

### WHY OUR #$*! TAX CODE IS SO CONFUSING

OUR TAX SYSTEM is falling apart because it's become way too complicated. Tax breaks are not as helpful as advertised because many taxpayers can't figure out how to use them. Tax increases don't raise the expected revenue because many taxpayers are unwilling to spend extra time and money to comply only to get a bigger tax bill for their trouble.

If you doubt that tax complexity is a huge problem, consider the fact that my personal copy of the Internal Revenue Code takes up over 8,500 pages of very fine print. Then there are many thousands of pages of regulations and other guidance put out by the IRS in efforts to explain how the tax law provisions are supposed to work. Then there are many more thousands of pages of court decisions dealing with unresolved disputes about how they are supposed to work. I can't keep up with all this stuff, even though it's my profession. The average individual or small-business owner has no hope.

And it's getting worse—fast! Just in the last 15 months, Congress passed nine significant new tax laws. Every one of them added more complexity, and there will be more new laws before year-end. This is change we can be disgusted with.

When guys like me who make a living from dealing with tax complications start ranting about too much complexity, it's time for you ordinary citizens out there to demand an end to the nonsense. Here's what you should be howling about to your Congresspersons:

#### BE HONEST ABOUT TAX RATES

MUCH OF OUR TAX system's complexity is caused by stealthy provisions intended to penalize certain categories of taxpayers without explicitly raising anybody's tax rates. That way the politicians can advertise low rates for all while keeping their hands in your pocket. For example:

The dreaded alternative minimum tax, which hits many middle-income folks by disallowing deductions for dependents and state and local income and property taxes.

Tricky rules that can cause you to pay federal income tax on up to 85% of your Social Security benefits—even though you already paid income tax on Social Security taxes when they were taken out of your salary or self-employment earnings.

Phase-out rules that reduce or eliminate the chance for middle-income folks to claim the child tax credit and education tax credits.

I could go on and on, but you get the idea. It's time to tell the politicians to be straight with you by raising or lowering your taxes with easy-to-understand rate changes. The current practice of granting well-advertised tax goodies and then sneakily taking them away from less-favored folks has got to stop.

#### STOP TRYING TO MICROMANAGE THE ECONOMY WITH TAX POLICY

IN GENERAL, LOWER taxes tend to encourage legitimate economic activity, and higher taxes tend to do the opposite. But the politicians want to micromanage.

For example, after the devastating Gulf Coast hurricanes in 2005, Congress enacted a bunch of exceedingly complicated special tax breaks intended to help individuals and businesses rebuild. This was on top of many billions worth of direct relief from the Feds and many billions more from charitable donations. In my opinion, the tax breaks were unnecessary overkill, but they sure added lots more complexity. The beleaguered IRS is still trying to catch up on issuing guidance about how all the special breaks are supposed to work.

#### LOWER THE TAX RATE ON BIG COMPANIES AND ELIMINATE CORPORATE WELFARE

LARGE U.S. CORPORATIONS face a 35% federal income tax rate on their domestic profits. This is one of the highest rates in the industrialized world. As a result, big companies pay untold amounts to lobby Congress for unadvertised tax breaks (better known as corporate welfare) and to devise tax-avoidance strategies (some legit and some not). The high U.S. tax rate also encourages companies to move operations overseas and keep the resulting profits over there. Why? Because they generally don't have to pay U.S. taxes on offshore profits until they bring them home. So they don't.

As a result, the amount of federal income taxes that big corporations actually pay is laughably low. Although I can't prove it, I'm sure that a major reduction in the corporate tax rate combined with an end to corporate welfare would be great for our economy. Plus we could cut a few hundred pages out of the Internal Revenue Code as a bonus. This isn't micromanagement. This is a big idea.

#### PUT "FAIRNESS" IN THE PROPER PERSPECTIVE

A FEW YEARS AGO, the politicians became aware that lots

of grandparents and aunts and uncles are raising children of their relatives. In the name of "fairness" Congress changed the rules to allow these nice grandparents and aunts and uncles to claim tax breaks, like dependency exemption deductions and child tax credits, for the kids they are selflessly supporting. The unfortunate result was rules that are so hideously complicated that I can barely understand them. Ordinary taxpayers have not a prayer. So now you have many cases where divorced moms and dads, along with grandparents and aunts and uncles, are all claiming the same tax breaks for the same kids. This is against the law, but it's up to the beleaguered IRS to issue audit notices and try to sort out the mess.

I can cite other examples of attempts to inject "fairness" into the tax law. Such attempts often result in rules that are too complicated to be effective—which isn't fair to anybody.

### THE LAST WORD

THE PURPOSE OF OUR federal tax system should be to raise revenue in a reasonably predictable, efficient, and fair manner. The current system doesn't do any of these things—mainly because it's too complicated to work right. The problem has reached scary proportions, but don't blame the IRS. It's the politicians' fault. Now is a great time to tell them you want a simpler tax system if they want to keep their jobs.

## TAX-WISE, DEBT FORGIVENESS ISN'T SO DIVINE

BELIEVE IT OR NOT, some lenders are still willing to forgive the debts of beleaguered consumers. While debt forgiveness can help you survive financially, it might also increase your tax bill. Here's what you need to know.

### WHAT IS CANCELLATION OF DEBT INCOME AND HOW IS IT TAXED?

WHEN A LENDER FORGIVES part or all of a debt, it results in so-called cancellation of debt (COD) income. As a general rule, COD income is taxable, and the lender is supposed to report the amount to you, and to the IRS, on Form 1099-C (Cancellation of Debt) for the year when the COD income occurs.

Thankfully, there are some favorable exceptions to the general rule that COD income is taxable. Here are the taxpayer-friendly exceptions that are most likely to help you out.

### BANKRUPTCY EXCEPTION

IF THE COD INCOME occurs while the borrower is in Title 11 bankruptcy proceedings, the income is completely exempt from federal taxation. Title 11 encompasses bankruptcy filings under Chapter 7 (liquidations), Chapter 11 (reorganizations), and Chapter 13 (wage earner filings). Legislation passed in 2005 made it more difficult to file for Chapter 7 bankruptcy protection, thereby making it harder to be completely exonerated from unsecured debts such as credit-card balances. However, COD income can still occur in Chapter 7 cases (just not as often), and it still occurs in some Chapter 11 and Chapter 13 cases as well.

One other thing to remember is that when you enter bankruptcy, a separate legal entity called the bankruptcy estate comes into legal existence. Once that happens, you must file tax returns for the estate, as well as for you personally.

### INSOLVENCY EXCEPTION

WHEN A BORROWER is insolvent (meaning their debt exceeds their assets) but not in bankruptcy immediately before COD income occurs, the COD income is completely exempt from federal income taxation to the extent of the borrower's insolvency. However, when the COD effectively makes a person solvent (because the assets now exceed debts), the COD income is taxable to the extent of that solvency. Any remaining COD income will be exempt from taxation under the insolvency exception.

### HOME MORTGAGE EXCEPTION

LEGISLATION IN 2007 and 2008 created an exception for qualifying cancellations of home mortgage debt during the years 2007 through 2012. Taxpayers don't need to be bankrupt or insolvent to take advantage of this provision, which allows an individual to have up to $2 million of federal-income-tax-free COD income from forgiven qualified principal residence debt. This only includes debt that was used to acquire, build or improve a main residence and that is secured by that residence. Refinanced debt can also qualify for this exception to the extent it replaces debt that was used to acquire, build or improve a principal residence. You must reduce the tax basis of your residence (but not below zero) by the amount of COD income that you're allowed to treat as tax-free under this exception.

### DEDUCTIBLE INTEREST EXCEPTION

IF COD INCOME includes unpaid interest that was added to

a loan's principal and then forgiven, you may be in luck. Any forgiven interest that you could have deducted (had you paid it) is free from federal income taxation. This exception often comes into play with forgiven principal residence mortgage interest, vacation home mortgage interest, and rental property mortgage interest.

### SELLER-FINANCED DEBT EXCEPTION

WHEN COD INCOME is derived from seller-financed debt (meaning mortgage debt that you owe to the previous owner of a property), it is exempt from federal income taxation. However, your basis in the property must be reduced by the amount that you're allowed to treat as tax-free under this provision.

### THE BOTTOM LINE

THERE ARE SOME OTHER more arcane exceptions to the general rule that COD income is taxable, but they are fairly unlikely to apply to most people.

One last thing to know is that the tax code extracts a price for allowing those who are in bankruptcy or insolvent to exempt their COD income from taxation. So-called tax attributes that these taxpayers have, such as capital loss carryovers, tax credit carryovers, and the tax basis of certain assets (used to calculate tax gains and losses and depreciation deductions) may have to be reduced. See IRS Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness), which must be filed with your federal return. You must also file Form 982 if you take advantage of the home mortgage exception.

The good news is the exceptions explained in this article can prevent a major tax hit on COD income, which would really be adding insult to injury.

# IV. RETIREMENT

## MIXED NEWS FOR SENIOR IRA HOLDERS

A LAW PASSED at the end of 2008 suspended the minimum required distribution, or MRD, rules for the 2009 tax year. Unfortunately, the rules for the 2008 tax year were left unchanged. So, if you've recently turned 70½, or if you're older than that, here's what you need to know.

After reaching age 70½ , you're subject to the MRD rules which require you to take annual withdrawals from traditional IRAs set up in your name, including any simplified employee pension (SEP) accounts and SIMPLE-IRAs. And, of course, you have to pay the related tax hit. (Roth IRAs set up in your name do not have any minimum withdrawal requirements.) Failure to take your annual MRD means getting socked with a 50% penalty tax based on the difference between the amount you should have withdrawn and what you actually took out—if anything. This is one of the stiffest penalties in the Internal Revenue Code.

Since so many seniors' traditional IRA balances were hammered by the stock market plunge, there was hope that either Congress or the IRS would grant some relief. Now that we know there won't be any relief for the 2008 tax year, the mandatory withdrawal for that year will be painfully large for many folks. Why? Because the amount you must withdraw is calculated by dividing the total of all your traditional IRA balances as of December 31, 2007 by a life expectancy divisor based on your age at the end of 2008. The problem is, your IRA balances were probably considerably higher at the end of 2007 than at the end of 2008-- meaning you'll be forced to withdraw a larger amount and pay a larger tax hit.

### SPECIFICALLY, HERE'S THE DRILL.

#### IF YOU TURNED 70½ IN 2008

BY APRIL 1 OF THE year after you turn 70½ (April 1, 2009 in your case), you must withdraw your initial MRD. This initial distribution is actually for the 2008 tax year—even though you can take it as late as April 1, 2009. However, you also had the option of withdrawing your initial MRD by December 31, of 2008. Either way, you must calculate the amount of that initial MRD using your IRA balances as of December 31, 2007.

One silver lining: The MRD rules are suspended for the 2009 tax year. Without this change, you would have had to withdraw two MRDs in 2009, unless you withdrew your initial MRD in 2008.

#### IF YOU TURNED 70½ BEFORE 2008

YOU'RE COMPLETELY off the MRD hook for this year, thanks to last year's law change. Next year, you will have to withdraw an MRD by December 31, 2010 (based on your IRA balances as of the end of this year).

#### IF YOU WILL TURN 70½ IN 2009

YOU'RE COMPLETELY off the MRD hook for this year, thanks to last year's law change. Next year, you will have to withdraw your initial MRD by December 31, 2010 (based on your IRA balances as of the end of this year).

#### IF YOU INHERITED AN IRA

IF YOU INHERIT an IRA (including a Roth IRA), you must follow a special set of MRD rules for beneficiaries to avoid getting socked with the 50% penalty tax. These rules apply regardless of your age. The good news: You won't have to take any MRD in 2009, thanks to last year's law change.

## TAX TIPS: SENIORS, DON'T FORGET APRIL 1

ARE YOU AN IRA owner who turned 70½ last year? If you haven't already started tapping your traditional IRA, then April 15 isn't the only IRS deadline you need to heed this year. You're also required to take your first minimum withdrawal no later than April 1. That's right, April Fool's Day. But this is no joke.

The tax law states that you must start taking mandatory payouts from traditional IRAs (but not from Roths) no later than April 1 of the year after the year you turn 70½. So if you turned 70½ in 2008, that deadline is rapidly approaching. Of course, this also means you get stuck with the resulting income-tax bills. (The whole idea here is to make people who would otherwise leave their IRAs untouched to start taking taxable withdrawals.) And if you fail to take at least the minimum withdrawal amount by April 1, the IRS can sock you with a penalty equal to 50% of the shortfall. So this little rule isn't something you can afford to ignore.

Now, if you already took IRA withdrawals last year (or ear-

lier this year) that equaled or exceeded the amount of your initial required minimum withdrawal, then you're blissfully unaffected by the April 1 deadline. You would have had to take your next withdrawal by the end of this year, but thanks to a recent law change that suspends minimum required distributions for 2009, you won't have to take another withdrawal until 2010.

If you didn't take a withdrawal last year, then you'll need to figure out how much to withdraw from your IRA and do so by April 1. To help you calculate your initial required minimum withdrawal, use a joint life-expectancy figure which is generally based on your age and someone 10 years your junior. (Even those who don't have a designated beneficiary use the joint-life-expectancy figure.) After you take your withdrawal for 2008, you won't have to take your second distribution until 2010 (you'll have to do so by Dec. 31 of that year).

Keep in mind that the IRA minimum-withdrawal rules also apply to simplified employee pension (SEP) accounts and Simple IRAs because they're also considered traditional IRAs for this purpose. Roth IRAs, on the other hand, are exempt from the minimum-withdrawal rules as long as the original account owner is alive.

## HOW TO DEDUCT IRA LOSSES

IF YOU'RE LIKE MOST IRA owners, you've taken a sizable hit. While it may feel like little consolation, there is a chance you can claim a tax deduction to ease your pain. With traditional IRAs, getting a write-off is possible but not terribly likely. Roth IRA owners, on the other hand, will have a much easier time. Here's what you need to know.

### DEDUCTING TRADITIONAL IRA LOSSES

ACCORDING TO THE IRS, you have a tax loss from your traditional IRAs when the following conditions are met:

- You liquidate all the traditional IRAs set up in your name.
- Your total tax basis in the accounts—which equals the sum of your nondeductible contributions (if any)—exceeds the liquidation proceeds. Since you only get tax basis from nondeductible contributions, it's fairly unlikely that you'll have a tax loss even if you've lost your shirt. However, it can happen (as example 1 below illustrates).

Let's say you do have a tax loss. The IRS says it's classified as a miscellaneous itemized deduction. As such, it gets thrown into the pot with other miscellaneous deductions—such as investment expenses and fees for tax advice. Only the excess of total miscellaneous deductions over 2% of adjusted gross income (AGI) can be claimed as a write-off.

Even if you clear that hurdle, you're still not in the clear. You could lose part of the write-off due to an unfavorable phase-out rule for high-income individuals. Finally, the write-off is completely disallowed for alternative minimum tax (AMT) purposes. So if you're hit with the AMT, some or all of the hoped-for tax savings will vaporize.

**EXAMPLE 1:** You own one traditional IRA that has plummeted in value. Unusually enough, you funded the account with $11,000 in nondeductible contributions, so it has a tax basis of $11,000. When you liquidate the account, you receive just $6,000. At this point, you have a potentially deductible tax loss of $5,000 ($11,000 - $6,000).

The IRS says that $5,000 loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $100,000, the AGI threshold is $2,000 ($100,000 x .02). Say you have $1,500 in other miscellaneous deductions, for a total of $6,500 ($5,000 + $1,500). You can claim a $4,500 deduction on your Form 1040 ($6,500 - $2,000). However, if you're a victim of the dreaded AMT, the deduction is disallowed in the AMT calculation. Your actual tax savings may be little or nothing.

Let's say you aren't getting hit with the AMT. Liquidating the IRA triggers a $4,500 deduction, which reduces your taxable income by that amount. If you're in the 25% federal income tax bracket, the deduction saves you $1,125 (.25 x $4,500). You may reap a state-income-tax savings too. Plus, you've got $6,000 in cash.

The downside is you've caused a permanent reduction in a tax-favored account balance. Are the current tax savings and cash in hand worth it? That's what you need to decide.

### DEDUCTING ROTH IRA LOSSES

ROTH IRAS MUST BE treated separately from traditional IRAs. To have a tax loss from your Roth IRA, the following conditions need to be met (regardless of what's going on with any of your traditional IRAs):

* You liquidate all the Roth IRAs set up in your name.

* Your total tax basis in the accounts exceeds the liquidation proceeds. With Roth IRAs, all contributions generate tax basis because all contributions are nondeductible. For this reason,

you're much more likely to have a tax loss with a Roth IRA than with traditional IRA.

Unfortunately, all the other hurdles mentioned earlier for traditional IRA losses also apply to Roth IRA losses.

**EXAMPLE 2:** You own one ill-fated Roth IRA. It was funded with $20,000 of annual contributions, so it has a $20,000 tax basis. You receive only $9,000 when you liquidate the account. Now you have a potentially deductible loss of $11,000 ($20,000 - $9,000).

As explained earlier, the loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $100,000, the threshold is $2,000. Say you have $1,500 of other miscellaneous deductions for a total of $12,500 ($11,000 + $1,500). You can claim a $10,500 deduction ($12,500 - $2,000). If you're an AMT victim, the deduction is disallowed in the AMT calculation.

Again, let's say you aren't getting hit with the AMT. Liquidating the Roth IRA triggers a $10,500 deduction. If you're in the 25% federal income tax bracket, you save $2,625 (.25 x $10,500). You may get a state income tax benefit, too. Plus you've got the $9,000 in hand. However, you've also caused a permanent reduction in the balance of the most taxpayer-friendly type of account known to humankind. Is it worth it? That's for you to decide.

**WARNING:** If you liquidate a Roth IRA that was funded with a conversion contribution (from converting a traditional IRA into a Roth account), you generally must pay a 10% penalty tax if: (1) the liquidation occurs within five years of the contribution (the five-year period is deemed to start on January 1 of the year you made the conversion contribution) and (2) you're under age 59½. So if you're 50 years old and funded your Roth IRA with a conversion contribution on June 1, 2005, the five-year period is deemed to start on January 1, 2005. Therefore, you'll generally owe the 10% penalty if you liquidate the account before January 1, 2010. If you get hit with the penalty tax, it can wipe out some or all of the tax savings from a deductible Roth IRA loss. So be very careful.

## FINAL WORD

THE SEEMINGLY SIMPLE question of whether you can deduct IRA losses really isn't so simple after all. Please consult your adviser before closing loser accounts in the hopes of gaining some tax savings. All in all, it may be a poor idea unless you desperately need the cash.

# V. INVESTMENTS & CAPITAL GAINS

## TAX TIPS: MAKING THE MOST OF CAPITAL GAINS

IF YOU'RE A stock or mutual-fund investor, then you probably know that investments held for more than a year and sold for a profit are subject to lower tax rates as long-term capital gains. Generally speaking, if you're in the 25% tax bracket or higher, you will owe no more than 15% of your profits to the Internal Revenue Service.

But what you might not realize is that more than just stock and mutual-fund shares are eligible for favorable capital-gains tax treatment. If you sold, say, your vacation time share or your country-club membership, then you just might be pleasantly surprised to discover you'll owe no more than 15% on the gain (assuming that you held the asset for more than a year).

Here's a list of some of the most common types of assets potentially subject to these lower rates:

1. Securities options (as in puts and calls) held as personal investments.
2. Stock of closely held corporations.
3. Collectibles held as personal investments, like baseball cards, stamps, rare coins, art, etc. In this case, a 28% (not 15%) maximum federal tax rate applies.
4. Personal residences (including vacation homes). In this case, the 15% maximum rate generally applies to gains beyond what you can exclude (not pay tax on) under the $250,000/$500,000 home-sale gain exclusion privilege. However, a 25% maximum rate applies to gains triggered by certain depreciation deductions claimed against your property.
5. Vacation time-share interests.
6. Country-club memberships.
7. Personal autos (that aren't collectibles). Keep in mind, this means that you've sold your car at a profit, which is unlikely.
8. Personal-property items (that aren't collectibles) in general—such as jewelry, furniture, a lawn mower and so on.
9. Rental real estate owned by an individual, partnership, limited-liability company or S corporation. (The standard 15% maximum rate applies, but gain from depreciating a property may be taxed at up to 25%.)
10. Land held as an investment by an individual, partnership, limited-liability company or S corporation.
11. Your ownership interest in a partnership or a limited-liability company. In this case, the 15% maximum rate usually applies, although depending on the assets of the partnership or limited-liability company, part of your gain may be taxed at higher rates of up to 35%.
12. Land used in a business owned by an individual, partnership, limited-liability company or S corporation. This could be the actual land that your small business is located on, or it could be land held by your small business, such as an apple orchard.
13. Options to buy investment land when the option is owned by an individual, partnership, limited-liability company or S corporation. This is the option to buy land at a certain price over a set period of time. It could be, for example, that you've purchased the option to buy a plot of land that you think is going to appreciate because of future development in the area.
14. The right to receive money for release of a restrictive covenant in a land deed when the deed is owned by an individual, partnership, limited-liability company or S corporation.
15. The right to a condemnation award when the right is owned by an individual, partnership, limited-liability company or S corporation. This would apply if, say, your property were condemned by the city so that it could take over the land and build a civic building.
16. The right of a tenant to receive a lease-cancellation payment when the tenant is an individual, partnership, limited-liability company or S corporation. This would apply if you were renting property and your landlord cancelled your lease.
17. Contract rights owned by an individual, partnership, limited-liability company or S corporation. For example, you might own a license giving you the right to use a software program. If you can sell that license to someone else for a gain, it will be taxed at no more than 15%.
18. Most other intangible business assets (such as intellectual property, trade secrets, goodwill and so on) owned by an individual, partnership, limited-liability company or S corporation. In these cases, the 15% maximum rate generally applies. However, if the

business intangible was amortized, gains attributable to the amortization deductions are taxed at your regular rate (up to 35%).

19. A stock-exchange membership owned by an individual, partnership, limited-liability company or S corporation. Obviously, there aren't too many of these, but this does apply to regional exchanges as well.
20. Depreciable or amortizable assets used in business—provided the asset is owned by an individual, partnership, limited-liability company or S corporation. Gains attributable to depreciation or amortization deductions are generally taxed at your regular rate (up to 35%). The 15% maximum rate generally applies to the balance of the gain.

## MUTUAL FUND TAX BREAKS

PART OF BEING a smart mutual-fund investor is making sure you walk away with as much profit in your pocket as possible. This means avoiding load funds (usually, anyway) and funds with ridiculously high expense ratios. Now, most readers of SmartMoney.com are already aware of these pitfalls, but one area where many wise fund investors still stumble is with taxes. For starters, many investors don't pay close enough attention to a fund's tax efficiency. And that isn't the only common mistake. Here are a couple more often-overlooked ways to reduce the tax hit to your fund shares:

### ARE YOU INVESTED IN FOREIGN STOCKS OR MUTUAL FUNDS?

IF YOU'VE WORKED in a foreign country or have substantial income from outside the U.S., you probably know all about the foreign tax credit. It's intended to keep you from being taxed on the same income by two different countries. But if you simply invested in some international mutual funds, you may also be able to claim this valuable tax break, since it's quite likely you paid foreign taxes last year (even though you probably didn't know it).

To find out, take a close look at your fund summary statements for 2008. You'll probably have to make some calculations to figure the exact amount of foreign taxes that came out of your account. Fortunately, your fund family should provide you with the information you need to do the math. Usually they'll give you a figure by which you'll multiply the number of shares you own. The payoff is that you're allowed a dollar-for-dollar credit against your U.S. income-tax bill. So while this might seem like a hassle, the extra work is definitely worth the trouble.

If you have direct holdings in foreign stocks or bonds, any foreign taxes should show up on your Forms 1099-DIV and 1099-INT. Assuming that 1) all your foreign taxes were on interest and dividends (including those earned via mutual funds), and 2) the foreign taxes amounted to $300 or less ($600 if you file jointly), things are simple. Just claim your credit by entering the foreign tax amount on Form 1040, line 47.

In all other cases, you must file Form 1116 (Foreign Tax Credit) to claim your rightful credit. Consider yourself warned: This form is pretty nasty, so you may want to get professional assistance if your foreign tax hit was substantial.

### DID YOU SELL FUND SHARES LAST YEAR?

IF YOU'VE INVESTED in a mutual fund, chances are you agreed to reinvest all of your dividends in the fund. It's a pretty painless way to practice dollar-cost averaging. But if you sold some shares last year, don't forget to claim the additional basis from the reinvested dividends in calculating your gain or loss on Schedule D. In other words, because you paid tax on those dividends (even though the cash never actually passed through your hands), the reinvested amounts represent after-tax dollars in the form of additional share basis.

For example, say several years ago you invested an initial $2,000 to buy 100 shares in Fund XYZ. During your ownership period, you received a total of $500 in dividends, which were automatically reinvested to buy 20 more shares of the fund. Then last year, you sold all of your shares. In figuring your gain or loss, the correct tax-basis figure for your 120 shares is $2,500 (your $2,000 initial investment plus the $500 reinvested to acquire additional shares). If you screw up and claim only $2,000 of basis, you'll overstate your gain or understate your loss by $500. The IRS gets more than it should, and you lose out.

Now, your fund company should have provided you with your average basis for all the shares you own, including those acquired by reinvesting dividends. But many investors still overlook this information and use their own (incorrect) figures. So do yourself a favor and take a close look at the year-end statement from your fund family.

## THE TRICKY ART OF DEDUCTING 529 LOSSES

IF YOU'VE BEEN TRYING to save for a son or daughter's college years by investing in a 529 savings plan, you may have suffered major losses this year. If you decide to bail out, the losses may be tax deductible. But be careful: The IRS rules on this are a little hazy.

In Publication 970 (Tax Benefits for Education), the IRS says you can trigger a potential tax-deductible loss when you shut down a loser 529 account. Unfortunately, there's no other official or unofficial guidance. Here's my take:

The loss is potentially deductible when both of the following conditions are met:

- You liquidate all of the holdings in the 529 account(s) that you own under a particular state's plan for a particular beneficiary (college-bound child). Since you own the account(s), the liquidation proceeds go to you rather than the beneficiary.
- The total proceeds from liquidating the account(s) is less than your total basis in the account(s). Your basis in an account equals the amount of money you've contributed to it—assuming you've made no withdrawals. So if you only have one account and have never taken anything out of it, you have a potentially deductible loss if the amount you receive from closing the account is less than what you put in.

It gets even trickier from here. There are additional hurdles to clear before you can collect any actual tax savings.

### MISCELLANEOUS ITEMIZED DEDUCTION TREATMENT

ACCORDING TO THE IRS, your 529 account loss is a miscellaneous itemized deduction. As such, it gets thrown into the pot with other miscellaneous deductions (such as investment expenses). Only total miscellaneous deduction amounts that exceed 2% of your adjusted gross income (AGI) can be written off.

If you clear the 2%-of-AGI hurdle, you're still not home free. You may lose part of your write-off due to a phase-out rule for high-income individuals. And your deduction is completely disallowed under the alternative minimum tax (AMT) rules. So if you're an AMT victim, some or all of the hoped-for tax savings will go up in smoke.

**EXAMPLE:** Say you've put $50,000 into your one and only 529 account. Even though you've never taken money out of it, the account is now worth just $30,000. You're thinking about liquidating the darn thing and hoping for a tax deduction to ease your pain.

**LIQUIDATION RESULTS:** Since you haven't taken any withdrawals, your basis in the account is $50,000. Closing it would mean a $20,000 loss ($50,000 basis - $30,000 proceeds).

**DEDUCTIBLE LOSS CALCULATION:** As mentioned, the IRS says your loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $150,000, the threshold is $3,000 ($150,000 x 0.02). Say you also have $1,000 of other miscellaneous deductions, for a total of $21,000 (529 plan loss of $20,000 + $1,000). You can deduct $18,000 ($21,000 - $3,000). However, if you're an AMT victim, that write-off is disallowed, and your actual tax savings may be whittled down or even eliminated.

**BOTTOM LINE:** For our purposes, let's assume you're not an AMT victim. In your situation, closing the 529 account triggers an $18,000 write-off. If you're in the 28% federal tax bracket, you save $5,040 (0.28 x $18,000). Plus you get back what's left of your money.

### OTHER TAX CONSIDERATIONS

YOU MAY HAVE TO repay state income tax benefits if you collected a state income tax write-off or credit when you invested in your state's 529 plan, then closing the account could mean you'll have to report a previously-claimed deduction in income on your state tax return or repay a previously-claimed credit.

### YOU MAY BE GIVING UP A TAX-FREE RECOVERY

SAY YOUR LOSER 529 account recovers and becomes worth what you've contributed and more. Assuming that you eventually end up draining the account to pay for qualified college costs, you won't owe any federal income tax on the difference between what the account is worth now and the higher value after it recovers.

### DON'T REINVEST TOO QUICKLY

IF YOU LIQUIDATE a loser 529 account to reap some tax savings, don't reinvest in another 529 within 61 days after liquidating the first one. If you do, the IRS may deem it as simply rolling over proceeds from one 529 to another—and some or all of your loss deduction might go out the window.

### BEWARE OF GIFT TAX IMPLICATIONS IF YOU REINVEST

SAY YOU MADE A lump-sum 529 plan contribution a couple years ago and spread it out over five years for gift tax purposes.

If you liquidate the account, you may have to wait until the five-year period is over before making another significant contribution to a new account that is set up for the same beneficiary. Otherwise, you could face adverse gift-tax consequences. (The rules are unclear here.)

### THE LAST WORD

WHILE CLOSING A loser 529 account may cut this year's tax bill, the benefit may be less than you hoped. Plus, there are all of the other issues to overcome. All things considered, the clearest argument for liquidating is when you simply want (or need) your money back and the tax savings (if any) is just a bonus.

## VI. YOUR HOME/REAL ESTATE

### TAX TIPS: THE BENEFITS OF REFINANCING

MANY PEOPLE REFINANCED their mortgages in 2008 (those who did so late in the year locked in rates that hovered near a 50-year low). And some of these cash-strapped refinancers borrowed even more money by taking out a home-equity loan—although the credit crunch and the housing meltdown made those loans much harder to secure.

If you fall into either one of these categories, here's how to make sure you claim all your rightful deductions on your 2008 return.

#### DEDUCTING MORTGAGE INTEREST

SAY YOUR ORIGINAL mortgage was $200,000. On July 1, 2008, you took out a new 30-year, $300,000 mortgage and paid 1½ points, or $4,500, for the privilege. (Each point represents 1% of your total loan amount.) You then used the extra $100,000 from the new mortgage to eliminate some high-interest credit-card bills, pay off your car loans and cover various other expenses.

Assuming your home was worth at least $300,000 when you refinanced, you have, in effect, two new mortgages as far as the Internal Revenue Service is concerned. The first $200,000 of your new loan (the balance on your old mortgage when you paid it off) is treated as "home-acquisition debt." And the interest on this qualifies as an itemized deduction on line 10 of your Schedule A. (Don't forget, however, that if your adjusted gross income in 2008 was greater than $159,950, or $79,975 if married but filing separately, this deduction is subject to the phase-out rules for itemized deductions.)

The remaining $100,000 of your new loan is treated as home-equity debt. The interest on this should also qualify as an itemized deduction on line 10 of your Schedule A. But keep one thing in mind: The IRS only recognizes home-equity loans up to $100,000; you can't deduct the interest paid on principal above that figure.

Also, if the home-acquisition debt plus the home-equity debt exceeded the fair-market value of your home, you generally can't deduct the interest on the excess debt. Say your home was worth $240,000 when you took out that new $300,000 loan. You can deduct the interest on the $200,000 of acquisition debt. However, for the home-equity debt, you can only deduct the interest on $40,000. So you can deduct 80% ($240,000/$300,000) of the total mortgage interest on line 10 of your Schedule A. (The interest on the remaining $60,000 of debt is generally considered a nondeductible personal expense, though there are a couple of exceptions, like if you used the loan proceeds to finance your small business.)

#### TALKING POINTS

YOU CAN ALSO amortize the points related to the home-acquisition-debt part of the new loan ($3,000 in our example) over the life of the loan. Say it's a 30-year loan (360 months). Your amortization deduction would be $8.33 a month ($3,000 divided by 360), for a grand total of $99.96 a year. Every little bit helps, right?

What about the points related to the home-equity debt ($1,500 in our example)? You can amortize those in the same proportion as the interest, provided that the home-equity debt is $100,000 or less, and the home's value isn't less than the home-equity debt plus the acquisition debt. Claim the amortization write-off for your home-mortgage points on line 10 or 12 of Schedule A.

This brings us to our last potential deduction. If you previously refinanced your mortgage and paid points, you probably have a good-sized unamortized (or not-yet-deducted) balance for those points. You can generally deduct that entire unamortized amount when you refinance again. For example, say the mortgage you refinanced last year was taken out in a previous refinancing deal done six years earlier, back in 2002. At that time you paid $2,000 in points for your 30-year loan. You should have $1,600 worth of unamortized points left over from the 2002 loan (80% of the original $2,000 amount). On your 2008 return, don't forget to deduct the $1,600 of unamortized points. Claim your write-off on line 12 of Schedule A.

### TAX TIPS: TAX BREAKS ON HOME SALES

YOU PROBABLY ALREADY know that selling your home at a profit provides one of the greatest tax breaks around. Singles can avoid federal income taxes on gains of up to $250,000, and married couples (filing jointly) can exclude up to $500,000. Of course, to qualify you need to have owned and used the property as your main residence for at least two of the past five years.

But what if your ownership period was shorter than that and you sold last year? Fact is, you could still be eligible for at

least a partial break on your 2008 return. Tax law stipulates that if you sold your home because of your job, health considerations or certain unforeseen circumstances (such as a divorce or separation, a pregnancy that results in multiple births or the death of someone whose primary residence is your household), you qualify for a prorated (in other words, reduced) gain exclusion. And this prorated exclusion will probably still be enough to shelter your entire gain.

**EXAMPLE:** Say you and your spouse sold your home last year after owning it for just 18 months. The reason for the sale: job transfer. Luckily for you, the home appreciated even during the short time you lived there (a rarity these days). Under the prorated gain-exclusion rule, you and your spouse can exclude up to $375,000 of profit on your joint return. Here's the math: You owned and used your old home for 18 months, instead of the required 24. Divide 18 by 24, and you get 75%. Three-quarters of the "normal" $500,000 joint-return allowance equals $375,000. Not too shabby–in most cases, that should be more than enough to completely shelter your gain from any federal tax.

The tax results would be the same if the sale of your home were necessary because of health reasons. (If, for example, you developed chronic knee problems and were forced to sell your two-story colonial and move into a one-story ranch-style home.) Just be sure to get a letter from your doctor to back you up should you get audited. And keep that letter with your permanent tax records.

### PRESIDENT OBAMA'S STIMULUS PACKAGE & THE FIRST-TIME HOMEOWNER TAX CREDIT

THE STIMULUS ACT extends the first-time homebuyer credit deal for another five months, covering purchases through November of 2009. It also makes this refundable credit a bit more generous. But the biggest change is that the earlier requirement to pay back the credit over 15 years no longer exists for 2009 purchases.

For a qualified purchase of a principal residence between January 1, 2009 and November 30, 2009, the maximum credit under the revamped rules equals the lesser of: (1) 10% of the purchase price or (2) $8,000 or (3) $4,000 if you use married-filing-separate status. These credit maximums are up from the $7,500 and $3,750 amounts that apply for 2008 purchases.

You're only eligible for the credit if you have not owned a principal residence in the U.S. during the three-year period that ends on the purchase date. If you're married, both you and your spouse must pass this test (whether or not you file jointly). For a newly constructed home, the purchase date is deemed to be the date you move in.

The credit is phased out over the following AGI ranges:

- $75,000 to $95,000 for singles and married folks who file separately.
- $150,000 to $170,000 for married joint-filing couples.

### CREDIT MUST BE REPAID IN SOME CASES

EVEN UNDER THE liberalized new rules, you may have to repay the credit if you sell the home for a gain within three years of the purchase date or stop using it as your principal residence within that timeframe.

### CLAIMING CREDIT FOR 2009 PURCHASE ON YOUR 2008 RETURN

IF YOU BUY A HOME between January 1, 2009 and November 30, 2009, you can choose to treat the deal as if it occurred in 2008. Then you can claim the credit on your 2008 Form 1040 and get the benefit that much quicker. To do so, fill out Form 5405 (First-Time Homebuyer Credit), and check the box to show you want to claim the credit for 2008. Then file Form 5405 with your 2008 return. The 15-year repayment rule won't apply to you even though you're claiming the credit on your 2008 return. You're also eligible for the expanded 2009 credit maximum of $8,000 (or $4,000 if you use married filing separate status) even though you're claiming the credit on your 2008 return.

# VII. FOR BUSINESS OWNERS

## TAX TIPS: DEDUCT YOUR COMMUTING COSTS

SADLY, FOR MOST OF US the cost of commuting between home and work isn't a deductible expense. But some lucky folks are indeed able to do this. Are you self-employed with a home office? Then you just might be able to write off the cost for traveling between your residence and any other location where you conducted work-related business last year.

To take advantage of this tax break on your 2008 return, you must have a home office that qualifies for write-offs because it was your "principal place of business." This means that your home office was used regularly and exclusively as the scene for most of your income-earning activities last year. Alternatively, it would also qualify as your principal place of business if it was used regularly and exclusively for management and administrative functions—provided you didn't make substantial use of any other fixed location for such activities last year. Administrative and management activities are things like preparing client proposals and invoices, strategic planning, market research, keeping up with professional literature and so forth.

For example, say your home office was used regularly and exclusively for administrative and management functions mainly during evening hours. During the day, you also had a "regular office" downtown, which you used for client meetings and as your base for daily operations (but, again, not for administrative chores). Because your home office qualifies as your principal place of business, you can deduct all the costs of commuting between there and your downtown office.

Regardless of whether you had another permanent office location (like the downtown office in our example), you can also always deduct the cost of commuting between your home office and any temporary work locations. These temporary work locations can include the post office, the office-supply store, the bank where you keep your business accounts, client sites and so on.

If you commuted between your home office and work locations by car, you can write off the actual expenses (including depreciation) or claim the standard business mileage allowance (50.5 cents per mile for the first half of 2008; 58.5 cents per mile for the second half of the year). And if you commuted by cab or public transportation, those costs are deductible, too.

Your commuting-expense deductions belong on Schedule C (if you're a sole proprietor or single-member LLC owner) or on Schedule E (if you're a partner or member of a multimember LLC). And keep in mind, write-offs claimed on those business tax schedules are double tax savers, because they reduce both your income and self-employment tax bills. Gotta love that.

## TAX TIPS: A TIP FOR SMALL-BUSINESS OWNERS

ATTENTION SMALL-BUSINESS owners: As you prepare your business tax forms and schedules, don't forget to take advantage of the ultra-generous first-year depreciation write-off for assets bought and put to use during 2008. Here's how it works:

Most small businesses are entitled to the privilege of immediately deducting up to $250,000 of new and used personal-property assets (meaning equipment, machinery, furniture, fixtures and software) under the "Section 179 deduction." Next, calculate your standard depreciation write-off using the cost remaining after subtracting the Section 179 deduction. You do all this by filling out Form 4562 (Depreciation and Amortization).

### BEWARE OF REDUCED SECTION 179 BREAK FOR "HEAVY" SUVS

OUR BELOVED CONGRESS placed a reduced $25,000 limit on Section 179 deductions for "heavy" SUVs with gross vehicle weight ratings (GVWRs) between 6,001 and 14,000 pounds.

The $25,000 limitation doesn't affect vehicles that are not considered to be SUVs under the tax law. For this purpose, "non-SUVs" are defined as vehicles that meet any of the following descriptions.

- Vehicles equipped with a cargo area that is not readily accessible directly from the passenger compartment and that is at least six feet in interior length. The cargo area can be open or designed to be open but enclosed by a cap. For example, many pickups with full-size cargo beds will qualify.
- Vehicles with: (1) an integral enclosure that fully encloses the driver's compartment and load carrying device, (2) no seating behind the driver's seat, and (3) no body section protruding more than 30 inches ahead of the leading edge of the windshield. For example, many delivery vans will qualify.

- Vehicles designed to seat more than nine passengers behind the driver's seat. For example, many hotel shuttle vans and minibuses will qualify.

In summary, vehicles with GVWRs above 6,000 pounds that meet any of the preceding descriptions are still eligible for the full Section 179 deduction of up to $250,000 for tax years beginning in 2008.

## TAX TIPS: WHEN YOUR SPOUSE IS YOUR BUSINESS PARTNER

SOME HUSBAND/WIFE teams have committed to more than just loving each other forever—for richer or poorer. Some have chosen to also become business partners. Trust me, a little tax savvy could definitely help tip that scale toward "richer."

But before I titillate you with the gritty details, let me say upfront that this tip only applies to couples living in the nine community property states (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington or Wisconsin), who run their small business as a husband-wife partnership. If that's the case, then you've been filing Form 1065 (U.S. Return of Partnership Income) with the IRS each year to report your business income and expenses. These business tax items are then split between you and your spouse and shown on separate Schedules K-1 from the partnership (one for you and one for your spouse). Eventually, all the numbers from both of your Schedules K-1s are recombined and included on your joint Form 1040. (Anyone who's done this previously will tell you it's about as much fun as a root canal.)

But here's the good news: The IRS says you can start treating your husband-wife business as a sole proprietorship for federal-tax-filing purposes. This is thanks to little-known IRS Revenue Procedure 2002-69. The upshot is you can choose to report all your business income and expenses on simple-and-easy sole proprietorship Schedule C (Profit or Loss From Business) which you then include with your Form 1040. Then you can (mercifully) forget about that ultracomplicated Form 1065 and those nightmarish Schedules K-1.

And wait—there's more! Treating your husband-wife business as a sole proprietorship instead of a partnership could potentially save you thousands in self-employment (SE) taxes every year. Here's why.

With a husband-wife partnership, both you and your spouse must each file separate Schedules SE for your respective shares of partnership income. Then you must each pay 15.3% SE tax on the first $102,000 of your share of 2008 partnership SE income. If your share of SE income exceeds $102,000, the SE tax rate drops to 2.9%. So if you have a profitable husband-wife partnership, both you and your spouse can each get hit with the maximum 15.3% SE tax rate on up to $102,000 of SE income (total of $204,000). Remember: This is on top of your federal and state income taxes. Ouch.

In contrast, if you treat your husband-wife business as a sole proprietorship, you only have to file one Schedule SE—for the spouse considered to be the proprietor—with your joint return. That means no more than $102,000 of SE income gets hit with the maximum 15.3% rate (any remaining SE income gets taxed at the much-easier-to-swallow rate of only 2.9%).

So which would you prefer: up to $204,000 taxed at 15.3% or no more than $102,000 taxed at 15.3%? Assuming you prefer the latter, simply treat your husband-wife business as a sole proprietorship instead of a partnership—starting with your 2008 return. Do this by filing Schedule C with your 2008 Form 1040 and by ceasing to file a separate partnership tax return on Form 1065. This simple drill could save you thousands in SE tax for 2008 and similar amounts each year in the future.

However, don't make this move without checking with your tax adviser about the other tax implications—including the impact on your state-tax situation (if any). In most cases, however, there won't be any adverse side effects.

**WHO QUALIFIES:** The taxpayer-friendly rules in Revenue Procedure 2002-69 are limited to unincorporated businesses owned exclusively by husband and wife as community property under applicable state law (with no other owners in the picture). If your husband-wife business fits this description, you have the government's official blessing to follow the tax-saving advice in this article.

## VIII. FILING, EXTENSIONS AND REFUNDS

### TAX TIPS: SHOULD I PAY MY TAXES WITH PLASTIC?

WORRIED ABOUT HOW you're going to pay your tax bill? It might be tempting to slap it on plastic.

After all, you can charge your 2008 federal income taxes on a Visa, MasterCard, Discover Card or American Express. What if you want a filing extension? No problem. Just charge what you expect to owe the IRS. And if you owe estimated taxes for tax year 2009, you can charge those, too. In fact, in many states, you can put your state income-tax bill on plastic as well.

Clearly, charging your taxes is convenient. And with the right card, you can even rack up some extra frequent-flier miles or other goodies to boot. So what's the big issue?

The "convenience fee," that's what. It amounts to a hefty 2.49% of the amount you charge. This is in lieu of the fee that merchants pay credit-card companies when you charge your purchases. Only in this case, the "merchant" is the Internal Revenue Service, and Uncle Sam isn't interested in turning 2.49% of his revenues over to the card companies. That means you foot the bill. Until now, you've probably been blissfully ignorant of merchant fees, but you'll become painfully aware of their bite when they come directly out of your own pocket. The money is collected by one of the two vendors that facilitate these transactions (Official Payments Corp. and Link2Gov Corp.) and split with the card issuers.

Granted, paying $9.96 for the convenience of charging a $400 tax bill to your credit card isn't really a sin. But what about paying $124.50 on a $5,000 tax bill? And unless you pay off that bill within your credit-card issuer's grace period, you'll start getting charged interest (often at 13% or more annually). Bottom line? You can probably find a better way to dig up the money to pay your tax bill.

Perhaps your credit union, your parents or your rich brother-in-law. Also, don't overlook the IRS itself. You may qualify to set up an installment-payment plan with the government. If so, this may be the cheapest way to go. You'll be charged a $52 setup fee (assuming you arrange for automatic payments out of your checking account) and then a monthly interest rate on the outstanding balance. Currently, that interest rate is 0.667% per month (which equates to 8% annually). However, the interest rate is subject to change every quarter. File IRS Form 9465 to get that ball rolling.

Of course, if you have a credit card with a low APR—say 5% or less—this could turn out to be the cheaper option. That is, provided you pay off your tab in a reasonable amount of time (i.e., before that introductory rate jumps up to something much higher). If so, visit officialpayments.com or pay1040.com to process your payment.

### TAX TIPS: MORE TIME FROM THE TAX MAN

TICK, TOCK. Uncle Sam's deadline is looming, and you aren't nearly ready to file your taxes? Now could be the time to come up with a backup plan. Fortunately, the Internal Revenue Service has some sympathy for procrastinators: The paperwork for filing an extension is simple, and it will keep the Feds off your back all the way until Oct. 15, 2009. In other words, the IRS will give you an automatic six-month extension.

So what's the catch? In order to complete the paperwork, you have to come up with an estimate of your total tax liability for the 2008 tax year. You also need to know exactly how much you've already forked over to the tax man in the form of withholdings from paychecks, estimated tax payments and so on. And if it turns out that you owe money, you're going to have to ante up, based on your tax estimate. (See our previous tip for advice on what to do if you can't pay your bill.) Now, for some folks, once you've completed the exercise of coming up with an estimate, you might as well just go ahead and file your taxes. But if your taxes are complicated or if you're still waiting for information you need to complete your return, filing for an extension can be a major stress reducer.

Approval of your extension application is automatic, as long as the estimate of your 2008 tax bill is "reasonable." (You'll be OK if your estimate was accurate based on the information you had at the time.) Just keep in mind, you'll be charged interest (currently at a 5% annual rate) on any outstanding balance until you file your return and cough up the remaining part you owe. If your estimate is off, you'll also be charged a 0.5% a month "failure-to-pay" penalty.

If you're still interested in extending, you must notify the IRS that you want an extension by the April 15, 2009 deadline. You can do this by filling out Form 4868 (Application for Automatic Extension of Time To File U.S. Individual Income Tax Return), which you can download from the IRS web site.

## TAX TIPS: BORROWING FROM UNCLE SAM

WORRIED THAT YOU don't have enough cash to pay your tax bill this year? Well, the worst thing you can do is miss the deadline while you try to scrounge up the money you need. Rest assured that if you fail to file on time, Uncle Sam will get very cranky and smack you with combined interest rates and penalties that are more what you'd expect from, say, Tony Soprano.

A better course of action? Get a loan. And remarkably, Uncle Sam himself may be your best source. Generally speaking, the interest rates charged by the Internal Revenue Service are comparatively low and most people who apply for an IRS loan are granted one.

As Tony might say, here's what you're gonna do. First off, you should still file your 2008 return by April 15. Be sure to include Form 9465 (Installment Agreement Request) with your return. On that form, you can suggest your own easy payment plan to the IRS. Assuming you owe less than $10,000 and are proposing to pay the total over 36 months or less, it's virtually automatic the IRS will accept. (The exception is when you haven't been current on your taxes during the last five years, in which case the IRS may be less than enthusiastic about agreeing to a deferred-payment arrangement.)

Of course, paying late is going to cost you something. When you receive an approval notice (which should happen within 30 days), you'll be charged a one-time $52 setup fee (assuming you agree to automatic payments from your checking account). You'll also be subject to interest charged on your deferred payments (which is currently 5% annually, subject to quarterly adjustments), plus a "failure to pay" penalty of 0.25% a month. Together, those two charges equate to an 8% annual interest rate on your unpaid tax balance.

That may sound like a lot, but it's probably less than what you're paying on your credit cards. (Too many people look at that tax bill and figure they can just slap it on plastic.) Moreover, if you don't file at all, you'll face the outrageously expensive 5%-a-month "failure to file" penalty. It continues to accrue until it equals 25% of your unpaid tax balance. That's an awfully heavy price to pay when you could just apply for a loan.

Keep in mind, if you owe more than $10,000 with your 2008 return or will need more than 36 months to get caught up, the IRS will usually require you to fill out some financial disclosure forms. Still, the agency is generally pretty reasonable about agreeing to installment payment terms you can live with.

### BORROWING FROM ESTIMATED TAXES

IF YOU ARE ONE of those lucky people who get to pay the tax man not once but four times a year, you too can borrow from Uncle Sam. As you probably know, estimated payments are the government's way of getting even with people when withholding from their paychecks (if any) doesn't come close to keeping up with what they owe. These are usually people who are one (or more) of the following: self-employed, earning a fair amount or more from taxable investments or taking withdrawals from tax-deferred retirement accounts. (Pay-ins for the 2009 tax year are due on April 15, June 16, Sept. 15 and Jan. 15, 2010.)

So what happens if you can't pay or can only afford a partial payment? To be honest, not much. You're simply charged interest on the shortfall, which currently is 5% annually (subject to quarterly adjustment). The only requirement is that you must catch up on your estimated payment obligations by April 15, 2010. Otherwise, the IRS starts piling a 0.5%-a-month penalty on top of the interest charge.

With an interest rate this low, not paying your estimated taxes offers a reasonable source for a short-term loan. After all, the interest rate is certainly much lower than what many commercial lenders and credit-card companies charge.

## TAX TIPS: DON'T LEND UNCLE SAM MONEY

DO YOU HAVE a juicy tax refund coming your way this year? Or were you once again blown away by how much you owe? It could be a sign that the amount your employer is withholding from your paycheck is out of whack. Ideally, you should owe Uncle Sam a small amount each year come tax time. If you're getting a large refund, you've given the Internal Revenue Service an interest-free loan of your money for the previous year—and we're sure you could have come up with a better use for that money than that. On the other hand, if you owe more than 10% of your total tax bill, you could owe an interest-charge penalty for failing to cough up enough in advance of filing your return. And clearly, that's not an ideal situation either.

### HERE'S WHAT YOU NEED TO DO TO MAKE SURE YOU DON'T GET SURPRISED AGAIN THIS TIME NEXT YEAR:

### MY BILL IS TOO BIG!

IF YOU WORK FOR an employer (as opposed to being self-employed), correcting your withholding amount should be easy.

Start by examining your paycheck to see how many exemptions you've claimed. (If it's not listed on your paycheck, someone in human resources should be able to help you.) If you claimed too many exemptions, your withholding won't be enough to cover this year's tax bill. (That is, assuming your tax situation is similar to last year's.) So you may want to refile your W-4 with your employer, with fewer exemptions. This would translate into more withholding from each paycheck. You can get a new Form W-4 from your employer or print one out from the IRS web site.

Keep in mind, if you also have income from self-employment or investing, that could be the reason for your tax underpayment. If so, your fix is to start making estimated tax payments for this year or increase the estimated payments you already intended to make. For the 2009 tax year, estimated payments are due on April 15, June 15 and Sept. 15 of 2009, and Jan. 15 of 2010. You must file Form 1040-ES with each payment. Once again, you can download the form at the IRS web site.

### MY REFUND WAS AWESOME!

WHILE TAX UNDERPAYMENTS can be a nasty surprise, you should be almost as distressed to discover you'll be getting a massive refund. What should you do to avoid giving the IRS another interest-free loan this year? Do the exact opposite of the advice given to folks who are in the underpayment scenario. In other words, you may need to increase the number of exemptions claimed on your Form W-4 or reduce your estimated tax payments. Or both. But don't get carried away and create a big underpayment. Generally, your payments for the 2009 tax year (via withholding and/or estimated payments) should be enough to cover whichever of the following is the lower figure:

1. 90% of your ultimate 2009 tax bill, or
2. 100% of your 2008 tax bill if your 2008 adjusted gross income, or AGI, was $150,000 or less; 110% if your AGI was over $150,000.

## FILING YOUR TAX RETURN ONLINE FOR FREE

FILING A TAX RETURN is about as fun as a migraine headache, but now there's a pain reliever: Many U.S. taxpayers can file online, free of charge.

Why the gift? Online filing (which automatically does the math that many filers get wrong) significantly cuts down on errors, saving the IRS time and money. And for taxpayers, it has the added advantage of offering refunds within 10 days for those who use direct deposit. (With paper returns, that typically takes six to eight weeks.)

To qualify, the one overarching requirement is that you must have adjusted gross income of $54,000 or less. Beyond that, the 19 online-tax-software companies that have partnered with the IRS to offer this service may have added additional restrictions, such as age limits or state residency requirements.

So what's the catch? First, to use these services for free, taxpayers must access them through the IRS Free Filing web site. If you go directly to the company's site, you'll end up paying the regular filing fee (usually about $20 or so). To make sure you're not going to be hit with that fee, go through the IRS web site every time you log on to your account.

Also, if your taxes are fairly complicated, you might want to shell out the extra cash for a paid service that includes some extra bells and whistles. For example, with TurboTax Deluxe (which is available through its web site for $29.95) you'll get help calculating your deductions with the company's deduction maximizer—something that is not available through its free file program.

Finally, be sure to read all the fine print carefully. Chances are you'll be pitched additional fee-based services (like audit protection or refund-anticipation loans) that you may not need. And if you want to file your state return along with your federal one, prepare to pay up because most of these preparers charge for state returns.

# IX. LOOKING AHEAD: YOUR 2009 RETURN

## IRAS ARE BETTER THAN EVER AS A RETIREMENT TOOL

ONLY A FEW YEARS AGO, IRA contributions were limited to a measly $2,000. Plus, strict income limits prevented many folks from being able to contribute to deductible or Roth IRAs at all.

No more. Favorable changes to the IRA contribution rules have eased these limitations considerably. So if you haven't considered the IRA as a powerful retirement savings tool, it's time to change your thinking.

### CONTRIBUTION RULES FOR TRADITIONAL IRAS

FOR 2009, you can contribute up to $5,000 to a traditional IRA. Even better, if you'll be age 50 or older as of Dec. 31, 2009, you can contribute up to $6,000.

If you're married, the same limits apply to your spouse if he or she wants to fund a separate IRA. As a result, the two of you can together contribute up to $10,000 or maybe even $12,000.

Whether you're single or married, and whether you're age 50 or younger, the current IRA contribution limits are generous enough to take seriously (which was not necessarily the case just a few years ago).

### HERE ARE THE REST OF THE TRADITIONAL IRA CONTRIBUTION GROUND RULES.

- After turning age 70½, you can't make any more contributions. However, Roth IRA contributions are still allowed (more on that later).
- You, and/or your spouse if you're married, must have earned income at least equal to what you contribute.
- If you are unmarried and covered by a retirement plan in 2009, your eligibility to make a deductible traditional IRA contribution for this year is phased out between adjusted gross income (AGI) of $55,000 and $65,000. However, you can contribute to a traditional nondeductible IRA regardless of income.
- If you're married and both you and your spouse are covered by retirement plans in 2009, your eligibility to make a deductible traditional IRA contribution is phased out between joint AGI of $89,000 and $109,000. Ditto for your spouse. However, you can both contribute to traditional nondeductible IRAs regardless of income.
- If you're married and only one spouse is covered by a retirement plan in 2009, the covered spouse's eligibility to make a deductible traditional IRA contribution is phased out between joint AGI of $89,000 and $109,000. The noncovered spouse's eligibility is phased out between joint AGI of $166,000 and $176,000. However, you can both contribute to traditional nondeductible IRAs regardless of income.
- These AGI phase-out ranges are considerably higher than they were just a few years ago.

### CONTRIBUTION RULES FOR ROTH IRAS

THE ANNUAL CONTRIBUTION limits and the contribution deadline for Roth IRAs are the same as for traditional IRAs. But the rest of the rules are different:

- After age 70½, you can still make Roth IRA contributions—as long as you (and/or your spouse if you're married) have earned income at least equal to what you contribute.
- For 2009, eligibility to make Roth IRA contributions is phased out between AGI of $105,000 and $120,000 for unmarried folks. For married joint filers, the phase-out range is between joint AGI of $166,000 and $176,000.
- Eligibility to make Roth IRA contributions is unaffected by whether you (or, if you're married, your spouse) are covered by a retirement plan.
- You can also consider the idea of converting a traditional IRA into a Roth IRA. To be eligible for the conversion privilege, your AGI must be $100,000 or less (not counting the extra taxable income triggered by the conversion). The same $100,000 limit applies if you're single or a married joint filer.

### BOTTOM LINE

YOU CAN CONTRIBUTE more to your IRA than ever before, and you have a better chance of deducting contributions to your traditional IRA than ever before. While in the not-too-distant past contributing to IRAs was barely worth the effort, it's definitely worth the effort now.

Ready to go? Good! The IRA contribution deadline for the

2009 tax year is April 15, 2010. However, you can make your contributions any time between now and then—unless you've already done it. (You can make a contribution for your 2010 tax year as early as Jan. 1, 2010.) Of course, the sooner you stash some cash in a traditional or Roth IRA, the sooner you will start collecting the tax benefits.

## TAPPING YOUR IRA PENALTY-FREE

ALTHOUGH 59 1/2 is generally the magic age for starting to receive IRA distributions without getting hit with the federal 10% premature withdrawal penalty tax (whether you continue to work or not), there are some circumstances under which you can get at your IRA funds even earlier without the penalty. Here's a rundown:

### ANNUITIZE YOUR IRA

ONE WAY TO TAKE money from your traditional IRA without incurring the 10% penalty is to "annuitize" your account. The way this works is that for five years, or until you turn age 59 1/2 (whichever is longer), you take annual cash withdrawals based on your life expectancy, as predicted by the IRS. To see how much time the IRS thinks you have left, visit the IRS web site.

Here's an example. If the IRS actuarial tables predict you will live for another 20 years, then you can withdraw ½0th of the balance in your account the first year. Then about 1/19th of your new balance the second year. And so on. During the payout period, your distribution schedule cannot change or you will be hit with the 10% penalty. Once the payout period has ended, you can modify the schedule, take a lump payment or stop taking distributions altogether. If you do decide to take early withdrawals, consult a tax expert who has some experience in planning for penalty-free IRA distributions.

### WITHDRAW ROTH CONTRIBUTIONS

THE ROTH IRA allows penalty and tax-free withdrawals of contributions for any reason. But remember, once you've taken out that money, you don't have the option of replacing it. For 2009, your Roth IRA contribution is limited to $5,000 or $6,000 if you will be age 50 or older at the end of the year (less if your adjusted gross income exceeds $166,000 if you file jointly; $105,000 if you are single).

### TAKE A 60-DAY LOAN

YOU CAN WITHDRAW funds from your IRA for up to 60 days tax- and penalty-free as long as you return the funds to an IRA by the end of the 60-day period. The IRS looks at this as a nontaxable rollover. Just make sure that the funds are back in an IRA within the 60 days, otherwise it will be treated as a withdrawal that is subject to taxes and penalties. Also, if you follow this strategy, you can only do it once within a 12-month period for the account in question.

### SPECIAL PENALTY-FREE WITHDRAWAL SITUATIONS

- First-time home purchase: Up to $10,000.
- Qualified education expenses: For you, your spouse, your kids or even your grandkids. Approved expenses include post-secondary education, tuition, books, supplies and, if the student is enrolled at least half-time, room and board.
- Disability: To qualify for a disability exemption, you must prove that you are incapable of working.
- Unreimbursed medical expenses: Expenses must exceed 7.5% of your adjusted gross income.
- Health insurance for the unemployed: Only after 12 consecutive weeks of collecting unemployment benefits.

**A FINAL NOTE:** Before you start dipping into your retirement stash, you should explore other options including a standard bank loan. If you must withdraw funds from an IRA, avoid paying taxes by withdrawing contributions from your Roth IRA first. And tap a tax-deductible IRA last. Above all, use these tax-sheltered accounts as a last resort. And before you raid your retirement savings, make sure you are leaving enough to support your actual retirement.

## BORROWING FROM YOUR IRA

LOOKING FOR AN interest-free loan for 60 days or less? One option is to borrow from your IRA.

Done right, it's a tax-free deal, and you won't incur any interest charges. Done wrong, you'll trigger income taxes and maybe a 10% penalty too while decimating your retirement stash.

The way it works is this: You take the money out of your traditional or Roth IRA and then replace the cash (the same amount that you withdrew) within 60 days. Make sure to put traditional IRA money back into a traditional IRA, and put Roth IRA money

back into a Roth IRA. You must also comply with the one-year rules explained below. If you do these things, the withdrawal of IRA money and subsequent redeposit is treated as a tax-free rollover transaction—even though it's effectively the same as taking out and repaying a short-term loan from your IRA.

### HERE ARE A FEW THINGS TO WATCH OUT FOR:

#### WATCH OUT FOR THE 60-DAY RULE

THE 60-DAY RULE is no joke. The money you've withdrawn (borrowed) must be redeposited back into an IRA within 60 days. Otherwise, the withdrawal is treated as a garden-variety taxable distribution, and you can't put the money back into your account. To add insult to injury, you'll generally face an additional 10% penalty tax if you're under age 59½, and you may owe state income tax, too. So avoid unnecessary stress by redepositing the money with at least a day or two to spare. Just so you know, the 60-day period starts on the day after you receive the withdrawal (the borrowed amount).

**EXAMPLE 1:** Say you want to take advantage of the borrow-from-your-IRA strategy by withdrawing some money on 6/1/09. The 60-day period begins on 6/2/09, and it ends on 7/31/09. No extension is allowed for weekends or holidays.

#### WATCH OUT FOR THE ONE-YEAR RULES

TWO TAX RULES are designed to prevent folks from repeatedly using the tax-free short-term IRA loan strategy with the same accounts. If you run afoul of these rules, all the tax advantages are lost.

First, you can only take a withdrawal from a particular IRA and then redeposit the money tax-free (into that account or another one) once during any one-year period. If you withdraw money from the same IRA twice during a one-year period, the second withdrawal is treated as a garden-variety taxable IRA distribution. That means it can't be redeposited, so you will owe income taxes and possibly a 10% penalty.

Second, if you've redeposited money back into a particular IRA, money withdrawn from that account within one year is treated as a taxable distribution with the same dire tax consequences.

For purposes of both of these rules, the one-year period starts on the date you receive an IRA withdrawal (not on the date you redeposit the amount back into an IRA).

Hopefully, these complicated one-year rules won't matter to you, but here's an example just in case:

**EXAMPLE 2 :** Say you have three traditional IRAs: IRA-1, IRA-2, and IRA-3. After reading this brilliant article, you decide to do the short-term tax-free loan deal by withdrawing $10,000 from one of your IRAs on June 1, 2009 and then redepositing the money by no later than July 31, 2009 to comply with the 60-day rule (see Example 1).

However, that's not necessarily the end of the story. Say you previously took money from IRA-1 on October 1, 2008 and then redeposited it back into IRA-2 tax-free on November 30, 2008. Let's assume IRA-3 hasn't had any such activity in recent years. Under the first one-year rule, you can't take any more money out of IRA-1 before October 1, 2009 if you want to get tax-free treatment by putting it back into an IRA. Under the second one-year rule, you can't take money out of IRA-2 before October 1, 2009 if you want to redeposit that money tax-free.

Therefore, in this example, you must withdraw the $10,000 out of IRA-3 to successfully execute a tax-free deal. Why? Because no amount has been taken out of IRA-3 within a year of October 1, 2008 and put back (so you're good on the first one-year rule). Nor has any amount been redeposited into IRA-3 within a year of October 1, 2008 (so you're good on the second one-year rule, too). To keep things simple, I recommend putting the $10,000 back into IRA-3 (by the July 31, 2009 deadline).

#### WHAT'S THE IMPACT ON YOUR TAX RETURN?

GOOD QUESTION. You must report the entire amount of any IRA withdrawal on line 15a of your Form 1040 for the year of the withdrawal. If you then redeposit the amount tax-free, you enter a taxable amount of zero on line 15b. Write "Rollover" next to line 15b. Now the IRS has been properly notified about your tax-free short-term IRA loan deal, and everyone is happy.

Given the potential tax traps, you may want to look for other alternatives before using this strategy to solve short-term cash flow problems. But done right, it can be helpful in a cash crunch.

## TIME TO TWEAK YOUR ESTATE PLAN

IF YOU'VE BEEN doing some estate planning over the past few years, chances are you breathed a little sigh of relief when

2008 ended.

To be brutally blunt: Dying in 2009 is a less taxing event than dying in 2008. That's because effective Jan. 1, the federal estate-tax exemption jumped to $3.5 million for anyone who dies in 2009—up from $2 million last year. So you can shelter up to $1.5 million more ($3 million more if you're married) from any federal estate-tax hit than if you had passed away in 2008. Yup, this is morbid. But it's welcome news to your heirs.

That said, you need to be careful. This leap in the exemption could throw your estate plan out of whack. Without a careful review of your arrangements, part of your estate could be allocated in ways you didn't intend.

But before I go any further, let me just make a plea to all of you who took a look at that $3.5 million figure and decided this article definitely does not apply to you. Sure, $3.5 million sounds like an awful lot of money. But you might be wealthier than you think. For federal estate-tax purposes, your estate includes your home, cars, retirement accounts, taxable investment accounts, collectibles and so forth.

Perhaps more important, it also includes any death benefits from personal life-insurance policies you own, including those on your own life. (If you have the power to change beneficiaries or coverage amounts, you own the policy.) With life-insurance coverage thrown into the mix, the odds are much higher that your estate exceeds the seemingly generous $3.5 million exemption. So if you don't already have an estate-tax savings strategy in place, now may be the time to create one. For assistance in getting started, see our estate-planning section.

For those who already have an existing estate plan, here's how the new biggie-sized exemption could affect you—along with advice on how to avoid potential danger zones.

### MARRIED? YOU MAY BE FUNNELING TOO MUCH—OR NOT ENOUGH—INTO YOUR BYPASS TRUST

IF YOU'RE MARRIED, your current estate plan may include a bypass trust arrangement. This common estate-planning tool is used to ensure that both you and your spouse take full advantage of your respective estate-tax exemptions. The way most plans work is that an amount equal to the current federal estate-tax exemption automatically goes to a bypass trust when the first spouse dies. Typically, the trust beneficiaries are the children of that spouse.

Since you name the beneficiaries of the bypass trust, the amount used to fund the trust is included in your gross estate for federal estate-tax purposes if you die before your spouse. However, that amount is then fully sheltered by your estate-tax exemption. The result: no federal estate-tax bill. So far, so good.

But here's the rub: Many wills don't specifically state how much will go toward funding the bypass trust. Instead, it's just whatever current federal tax law provides as the exemption amount. But with the exemption suddenly jumping to $3.5 million from $2 million, your bypass trust could wind up with a lot more money than you intended—and your spouse with a lot less.

For example, say you have a $4 million estate. Your will stipulates that a bypass trust is to be funded with an amount equal to the current federal estate-tax exemption. So if you pass away, a whopping $3.5 million would automatically funnel into the trust. Your spouse would get the remainder of your estate, which would be only $500,000. Had you died in 2008, your spouse would have received $2 million.

While your spouse has the right to dip into the bypass trust to meet reasonable financial needs, it doesn't make sense to leave the window open for future problems when it's so easy to close it. Worst-case scenario: Your spouse gets into a legal hassle with your kids regarding what's "reasonable." The solution here is simply to revise your will to stipulate a specific figure to fund the bypass trust should you die before your spouse.

If you already specify an amount, make sure you don't have the opposite problem: too little money going into the bypass trust. Say you have a $4 million estate. Your will stipulates that if you die before your spouse, $2 million (the old exemption amount for 2008) would automatically flow into the trust. Your spouse would get the remaining $2 million. But she may not need or want all that money if she has a substantial estate in her own right. While the $2 million figure used to make sense, you can now put more into the bypass trust and thereby take advantage of the larger $3.5 million exemption.

The solution in this case is to amend your will so that the bypass trust will be funded with the upgraded $3.5 million amount if you die before your spouse. Under the amended plan, your kids would get $3.5 million—instead of just $2 million—free of any federal estate-tax hit. Plus, your full $3.5 million exemption would be utilized instead of partially going to waste.

### UNMARRIED? YOU MAY BE LEAVING TOO MUCH TO CHARITY

IF YOU'RE SINGLE and your estate is worth more than $3.5 million, you need to do some planning—that is, unless you want Uncle Sam to be one of your main beneficiaries.

One way to tackle this problem is to leave just enough to charity to reduce your taxable estate to the magic $3.5 million figure. That way, the expanded $3.5 million exemption would wipe out any federal estate-tax bill. (Note: Your existing will might call for leaving just enough to charity to reduce your estate to the old-law exemption amount of $2 million).

The solution? You can now leave $1.5 million more to friends and relatives (and $1.5 million less to charity) while still leaving zero to the U.S. Treasury. I'm not advising you to leave less to charity. I'm just letting you know that you now have the option of leaving more to friends and relatives without triggering a federal estate tax bill.

### THE CURRENT SHAPE OF THE FEDERAL ESTATE TAX

THE FEDERAL ESTATE tax will remain in existence until 2010 when it scheduled to be repealed. But that's only for 2010. It will come back with a vengeance in 2011.

At least, that's how the law reads right now. I personally doubt we will ever see the promised repeal even for one year. I also doubt the estate tax situation in 2011 will be as bad as scheduled. Bet on Congress to permanently install a $3.5 million exemption sometime before 2010.

In any case, here's a breakdown of the current rules:

| YEAR | EXEMPTION | MAXIMUM TAX RATE |
|---|---|---|
| 2008 | 2,000,000 | 45% |
| 2009 | 3,500,000 | 45% |
| 2010 | UNLIMITED | TAX IS REPEALED |
| 2011 | 1,000,000 | 55% |

## TIPS CAN HELP YOU WEATHER ECONOMIC STORM

WHEN IT COMES TO retirement savings, preserving principal has always been a key concern. But these days, with unprecedented market swings tearing into investors' savings, it's even more important.

One way to protect your nest egg from the ravages of both inflation and deflation is to invest a portion of your portfolio in U.S. Treasury Inflation Protected Securities (TIPS). TIPS are typically sold with terms to maturity of five, 10, and 20 years. They pay cash interest twice a year at fixed rates. For example:

* The five-year TIPS maturing on 4/15/13 pay interest at the stated annual rate of 0.625% and are currently trading at a discount in the secondary market to yield about 1.2%.

* The 10-year TIPS maturing on 1/15/19 pay interest at the stated annual rate of 2.125% and are currently trading at a premium to yield about 1.9%.

### TIPS IN AN INFLATIONARY ENVIRONMENT

IN TIMES OF INFLATION, TIPS principal balances are adjusted upwards twice a year based on changes in the Consumer Price Index. You receive the higher inflation-adjusted principal balance at maturity so inflation won't hurt you. That wouldn't be the case if you follow the knee-jerk conservative investment strategy of buying regular U.S. Treasury notes or bonds. Buy them and bad inflation could hurt you badly.

With TIPS, you receive cash interest payments twice a year. Each payment equals half the stated annual interest rate times the inflation-adjusted principal balance at the time of the payment. So your interest payments go up with inflation, too.

### TIPS IN A DEFLATIONARY ENVIRONMENT

If you buy TIPS with care and hold them to maturity, your investment will do OK even if there's significant deflation. During these times, TIPS principal balances are adjusted downward twice a year. Interest payments are also adjusted downward because they are based on declining adjusted principal balances. (The stated interest rate itself doesn't change.)

However, even if there's severe deflation, the results from owning TIPS won't be too bad—you'll still get interest payments and you'll still get full face value at maturity.

**EXAMPLE:** Say you buy at face value $50,000 of 10-year TIPS that pay 2% stated interest. If you hold to maturity and inflation runs at an average of 7% during your ownership, the annual return will be about 9% (2% interest + 7% inflation adjustment). If you instead buy at face value $50,000 of regular 10-year Treasury notes that pay 3% interest, your annual return will be 3%.

If there's deflation, the return on TIPS will still be positive, but it will be less than 2% (because the interest payments will go down as the adjusted principal balance deflates). With regular Treasurys, deflation does you no harm. You'll get your 3% no matter what.

**BOTTOM LINE:** TIPS have a big advantage over regular Treasurys if there's significant inflation and a much smaller disadvantage if there's significant deflation.

### BUYING NEWLY ISSUED TIPS VERSUS OLDER ONES

WHEN YOU BUY newly issued TIPS directly from the government, nothing bad can happen to the principal—assuming you buy at face value (or below) and hold onto them until maturity. At maturity, you'll receive full face value even if there's heavy deflation.

But if you buy older TIPS in the secondary market, you'll have to pay for the accrued inflation adjustment to the principal balance. The problem is that amount can vaporize with deflation. The way to avoid this risk is to buy TIPS when they are issued or shortly thereafter (assuming you can buy them at face value or below). That way the accrued inflation adjustment will be little or nothing, and you'll have less to lose in the event of deflation.

### TAX IMPLICATIONS

WHEN YOU HOLD TIPS in a taxable account, you must pay current federal income taxes on both the cash interest payments and the inflation adjustments (if any) to the principal balance. Paying current taxes on the inflation adjustments isn't a great way to go—because you won't actually collect those inflation adjustments in cash until the TIPS matures or you sell them in the secondary market. To avoid this problem, hold your TIPS in a tax-advantaged retirement account, such as a traditional or Roth IRA, 401(k) or SEP.

### HOW TO BUY TIPS

THE MINIMUM FACE value for TIPS is $1,000. Larger denominations are available in $1,000 increments. TIPS are marketable securities, so they can be easily bought and sold in the secondary market through a brokerage firm. Just be aware that you'll have to pay a commission. However, these fees tend to be reasonable.

Original issue TIPS can be purchased from the government through the online Treasury Direct program. However, the Treasury Direct option is only available for TIPS purchased for taxable accounts, which, as I explained above, is generally inadvisable.

One thing to keep in mind with TIPS is that market prices fluctuate due to changes in prevailing interest rates, supply and demand, and other factors. If you don't intend to hold TIPS to maturity, you must understand that market prices can and do change on a daily basis, and there's no certainty about how much you'll be able to sell TIPS for in the secondary market.