January 3, 2009

Dear Tax Client:

It is hard to believe that we are already near the end of 2008 and tax season will be starting shortly after the new year. We have seen many events unfolding in 2008 that historians will reflect upon for years to come, the presidential election, the economic downturn (can we say recession yet?), record numbers of bankruptcies and foreclosures, government bailout plans, and a whole host of new tax legislation to try to ease the pain. Adding to the confusion, states like California have elected not to incorporate many of the new Federal tax laws, so there will be plenty of differences between your federal and state returns. If there was ever a year to not prepare your own tax return, this would be it. We are busy studying all these new tax laws so that we may continue providing you with the level of professional expertise that you have come to expect each year. Below are some of the highlights of new tax legislation and key numbers as adjusted for inflation.

<u>Reduced Home Sale Exclusion</u>: For sales after December 31, 2008, the $250,000 ($500,000 if married filing joint) exclusion of the gain on the sale of your primary residence will be reduced if there is any non-qualifying use occurring after December 31, 2008. Basically, the IRS is closing the loophole where people would move into a rental for two years and then sell it as a personal residence. It will still be possible to reduce some tax with this strategy, but the taxable gain is based on the percentage of non-qualifying use. If you move into your rental before the end of this year though, you can still qualify for the full exclusion. On the other hand, a loss on selling a rental is deductible but a loss on selling a personal residence is not, so consider the current real estate climate before making such a move.

<u>Surviving Spouse Home Sale Exclusion</u>: For sales after December 31, 2007, a surviving spouse can benefit from the $500,000 exclusion of the gain when selling a primary residence that would otherwise have qualified for the married-filing-joint exclusion had their spouse been alive. The surviving spouse has two years from deceased spouse's date of death to sell the home to qualify for the extended exclusion. After two years, the surviving spouse's exclusion reverts back to $250,000. This particular change in the law may not be very helpful, since real estate values are down and since community property states offer a full step-up in basis of the home to fair market value upon the death of one spouse.

<u>Stimulus Payments/Credits</u>: If you did not receive the full Economic Stimulus Payment that you could have because your 2007 income level was too high or your 2007 tax liability was too low, you might be eligible for a credit on your 2008 return. To prepare your 2008 return, you will need to know how much of a Stimulus Payment you actually received in 2007.

<u>IRA and Pensions</u>: In 2008, the maximum deduction for IRA contributions is $5,000, or $6,000 for those 50 and older. The salary deferral for pensions is between $10,500 and $20,500, depending on age and plan type.

Possible Suspension of IRA RMD: If you haven't yet taken out your required minimum distribution (RMD) for 2008 from your IRA accounts, you may want to wait. Because many people have lost a large percentage of their retirement investments this year, Congress is considering a waiver of the RMD requirement for 2008. They will need to act fast though, since RMDs are required to be withdrawn by December 31^{st}. Either check the IRS website for updates on this, or give us a call around the middle of December.

Auto Mileage Rates: For 2008, the mileage rate changed mid-year to reflect higher gas prices. The rates per-mile thru June 30, 2008 are $0.505 for business use, $0.14 for charity work, and $0.19 for medical and moving expenses. As of July 1, 2008, the rates per-mile are $.585 for business use, $0.14 for charity work and $0.27 for medical and moving expenses.

Depreciation: The Section 179 expensing election received a nice boost on the federal level to a maximum of $250,000 for tax years beginning in 2008, but the California maximum expense election remains at $25,000. Also on federal returns for 2008, we have a return of the 50% bonus depreciation, which allows businesses to immediately deduct half of the cost of new qualifying personal property.

S-Corporation Shareholders: As of January 1, 2009, more than 2% shareholders of an S-Corporation, along with spouses and dependent children, can no longer benefit from Section 125 plans (aka Cafeteria Plans or Flexible Spending Plans).

Education: Congress recently revived the $4,000 higher education deduction for 2008 and 2009. The maximum HOPE and Lifetime Learning credits for 2008 will be $1,800 and $2,000, respectively.

Teachers: For 2008 and 2009, Congress renewed the $250 above-the-line deduction for educational supplies purchased by a qualifying educator.

First-Time Homebuyer Credit: For homes purchased between April 9, 2008 and June 30, 2009, first-time homebuyers could receive a temporary refundable credit of 10% of the purchase price, up to a maximum of $7,500. However, this ends up being an interest-free loan from the U.S. government, as any credit taken must be repaid to the IRS in equal installments over the next 15 years.

Property Tax Deduction: One of the new federal provisions starting in 2008 is an additional standard deduction for real property taxes paid by non-itemizers of up to $500 for single filers and up to $1,000 for joint filers. This will also be in effect for 2009.

Sales Tax Deduction: The deduction for state and local general sales tax was extended through 2009, so continue tracking the sales tax paid on large ticket items like vehicles and home improvements.

Kiddie Tax: For 2008, dependent children under age 19, or under the age of 24 if a full-time student, with more than $1,800 in unearned income will pay tax on the excess at their parent's rates. To complicate things further, California still uses the pre-2006 rules, which only affect children under the age of 14.

Capital Gains and Dividends: The current maximum federal rates, which vary depending on the type of asset sold, are in effect through 2010. For 2008 through 2010, there is a 0% rate (yes, zero) for capital gains and qualified dividends included in taxable income of $32,550 or less when filing single and $65,100 or less when married filing a joint return.

Property Sales: California revised the rules on withholding 3⅓% of the gross sale price on most property, excluding principal residences. For sales after December 31, 2006, a seller may opt to have 9.3% withholding on the estimated gain, though Form 593-E has to be filed to make this election.

Energy Credits: For 2008, Congress extended the $2,000 credit for contractors building energy efficient homes. Homeowners may also qualify for up to $2,000 in credits for installing qualifying solar, geothermal, fuel cell or wind energy producing property, until they expire at the end of 2016. After 2008, the 30% credit for solar electric property expenses is not limited by the $2,000 cap.

Alternative Fuel Credit: A credit for purchasing hybrid vehicles is still in effect for 2008, though the amount depends on the make, model and date purchased. Credits on hybrid vehicles produced by some manufacturers, like Toyota, have already expired since the credit is limited to the sale of the first 60,000 units per manufacturer.

Charitable Contributions: Extending thru 2009, you can make up to $100,000 in tax-free distributions directly to charities from your IRA if you are at least age 70½. For other charitable contributions, last year's rules remain in effect: used clothing or household items must be in "good" condition to have charitable value, all items worth $5,000 or more require an appraisal, deductions for cash donations require a written receipt or a canceled check, but all cash donations of $250 or more require a written receipt.

Alternative Minimum Tax (AMT): For 2008 at least, Congress has extended the higher AMT exemption amounts once more, which should keep more middle-class people from having to pay a tax that was once aimed at only the wealthy.

CA Head-of-Household Credit: California now has a credit for qualifying taxpayers who are seniors filing as head-of-household or parents filing as single but who have joint custody of one or more children.

Normally, our year-end advice would be to accelerate deductions and defer income, which makes sense when tax rates are stationary or even dropping. We are not certain, however, if higher tax rates will be in store in the next year or two because of the shift in power in Washington and the economic downturn. Also, with the drop in the stock market, it may be a good time to look at realizing losses to offset other gains. Keep in mind that your own tax situation can be different from anyone else's. We would be happy to consult with you on how these changes might affect you specifically and help you plan to reduce your taxes before the year is over.

May your Holiday and New Year celebrations be happy ones.

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