Tax Planning Ideas

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In response to the decline in the housing market and the struggles of many American homeowners, Congress recently passed a housing rescue package. The Housing and Economic Recovery Act of 2008, which became law on July 30, is intended to provide relief to homeowners facing foreclosure, to stabilize government-sponsored mortgage enterprises, and to revive the slumping real estate market by offering tax incentives to certain homeowners and homebuyers. However, the legislation also may increase the tax liabilities of other groups of taxpayers. We detail the new provisions in "Congress Approves Sweeping Housing Rescue Package."

When it comes to planning your tax strategies and saving money, reducing your Adjusted Gross Income (AGI) is a great place to start. Your AGI is calculated by subtracting your allowable credits and deductions from your gross income. In "Maximize Your Credits, Deductions, and Exemptions," we explain the basics you need to know in order to lower your next tax bill.

Finally, in "Items of Interest," we review the provisions of another new piece of tax legislation, the HEART Act, which seeks to ease the tax burden for active duty military service members and their families, while closing certain loopholes for wealthy expatriates and federal contractors with operations abroad. Also, we highlight the changes in the standard mileage rates, which were increased for the second half of 2008 as a result of rising gas prices.

As always, we welcome your comments.

Congress Approves Sweeping Housing Rescue Package

Following months of negotiations, in late July large bipartisan majorities in both the House and Senate passed the Housing and Economic Recovery Act of 2008. President Bush signed the bill into law on July 30, 2008. This bill is intended to provide relief to homeowners struggling to avoid foreclosure, prevent the possible collapse of mortgage giants Fannie Mae and Freddie Mac, and inject new life into the ailing real estate market by offering tax incentives to homeowners and certain categories of homebuyers. But, while the legislation contains breaks for some taxpayers, revenue-raising provisions included in the bill could lead to bigger tax liabilities for other groups, especially those who own second homes.

Among the taxpayers who stand to benefit from the new law are first-time homebuyers. Provided they have had no "ownership interests" in a principal residence during the past three years, buyers who purchase a home between April 9, 2008 and June 30, 2009 may claim a tax credit equal to 10% of the purchase price, up to $7,500. The credit must, however, be paid back interest-free in equal installments over 15 years. The entire outstanding amount owed on the credit becomes due if the taxpayer sells the home during this period, though only up to the gain realized in the sale. If the homeowner dies during this period, the debt is cancelled.

Eligibility for the first-time buyer credit starts to phase out for single filers with adjusted gross incomes (AGIs) of $75,000 and for married couples filing jointly with AGIs of $150,000. Single taxpayers with incomes above $95,000 and joint filers with AGIs over $170,000 can no longer claim the credit.

For 2008 only, the legislation provides some tax relief on mortgage interest to homeowners who take the standard deduction on their federal taxes instead of itemizing. Under the

new law, non-itemizing single filers can claim a tax deduction on their state and local property taxes of up to $500, and married couples filing jointly are eligible to deduct up to $1,000. Taxpayers who owe less than these amounts in property taxes are only eligible to claim a deduction up to the amount paid in property taxes.

The new law could, however, mean higher taxes down the line for owners of second homes or rental property. Under the legislation, taxpayers who have a second home that later becomes their primary residence will be permitted to exclude a smaller percentage of the gain if the property is sold within a certain timeframe than was previously the case. This is because, starting in 2009, the law pro-rates the exclusion—$250,000 of the capital gain on the sale for single filers or $500,000 for married couples filing jointly—to reflect the portion of the time that the home is used as a primary residence relative to the total length of ownership.

To help Americans in danger of losing their homes, the law creates a program that will allow some homeowners to trade in their current mortgages for a fixed-rate loan worth no more than 90% of a home's current value. The new loans will be insured by the Federal Housing Administration (FHA) and supplied by FHA-approved lenders only. To qualify for the program, the troubled mortgage must be on a primary residence, and it must have been taken out before January 1, 2008. In addition, distressed borrowers will have to demonstrate that their income-to-mortgage debt ratio was greater than 31% as of March 1, 2008. Participants in the program will have to pay a 1.5% insurance premium to the FHA, and borrowers will be required to share no less than half of their new equity and appreciation with the FHA when the home is sold.

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The legislation also contains new rules designed to curb abuses in the reverse mortgage market, as well as restrictions on the ability of lenders to foreclose on the homes or raise the mortgage interest rates of military veterans who have recently returned from active duty.

Under the new law, the limit on the size of the mortgage loans that can be purchased by government-sponsored enterprises (GSEs) Fannie Mae or Freddie Mac is raised to $625,500, or up to 115% of the local median purchase price. At the same time, the law grants the U.S. Treasury Department the authority to ensure the financial stability of GSEs by extending credit to these companies as needed.

"This legislation will help stabilize the housing market and begin to revive our economy," said Jack Reed (D-RI), a Senate Banking Committee member and author of several provisions of the bill.

"The housing crisis is perhaps the most significant economic issue that we face and this bill will go a long way toward bringing stability and confidence back to the markets," Reed continued. "For the first time in over a generation, we are passing legislation to update, modernize, and strengthen the institutions that undergird both our mortgage and housing markets. I believe it will help stabilize our economy by ensuring access to decent, safe, and affordable housing for millions of American families."

Maximize Your Credits, Deductions, and Exemptions

As you manage your taxes with *both* the near and distant future in mind, one important, constant goal will be to reduce your **adjusted gross income (AGI)**, which equals your gross income (salary, investment earnings, etc.) after your allowable deductions and exemptions. Maximizing your deductions and exemptions, as well as taking advantage of any tax credits available to you, is a great way to start thinking about saving money on your next tax bill.

Credits vs. Deductions

First things first: How is a tax **credit** different from a tax **deduction**? A tax credit reduces your tax dollar for dollar—that is, a $1,000 tax credit actually saves you $1,000 in taxes. By comparison, a tax deduction reduces your *taxable income,* but it is only worth the percentage equal to your marginal tax bracket. For instance, if you are in the 25% marginal tax bracket, a $1,000 deduction saves you $250 in taxes (.25 x $1,000), which is $750 less than the savings with a $1,000 tax credit. The higher your tax bracket, the more a deduction is worth, but a credit is always worth more than a dollar-equivalent deduction.

Tax credits reduce your tax bill, but certain restrictions, such as income limits, may apply. If you have dependent children, you may be eligible to claim a $1,000 **child credit** (for 2008) for each child under the age of 17. Other family-related credits include the **adoption credit** and the **dependent care tax credit**. If you are funding a child's education, or your own, you may be eligible for the **Hope Scholarship Credit** or the **Lifetime Learning Credit**. The Hope Scholarship Credit provides a maximum tax credit of $1,800 in 2008 for college education expenses incurred during a student's first two years. The Lifetime

Learning Credit, which applies to both undergraduate and graduate education costs, could be worth up to $2,000.

All taxpayers may either claim a **standard deduction** or **itemize deductions** for personal expenses such as home mortgage interest. Income limits apply to taxpayers who itemize deductions. In general, a taxpayer claims an itemized deduction when the total of qualified deductible expenses exceeds the standard deduction or if the taxpayer does not qualify for the standard deduction. For tax year 2008, the standard deduction is $5,450 for single filers and $10,900 for joint filers.

Retaining as much of your gross income as possible should be an ongoing objective, not something that happens only at tax time.

How is a deduction different from an **exemption**? Personal and dependent exemptions are reductions in gross income in addition to the standard deduction or itemized deductions. Every taxpayer may claim a personal exemption for him or herself, unless he or she is claimed as a dependent on another taxpayer's return. A married couple filing a joint return can claim two personal exemptions, one for each spouse. Even if one spouse has no income, that spouse is not considered the "dependent" of the other spouse for tax purposes. Exemptions will decrease for high-income taxpayers with AGIs above a certain phase-out threshold.

Above-the-Line Deductions

Retaining as much of your gross income as possible should be an ongoing objective, not something that happens only at tax time. Above-the-line deductions, if you qualify, reduce your adjusted gross income. They are so named because they are taken on your tax form just above the line where you enter your AGI. Possible deductions include contributions to qualified retirement accounts, student loan interest, alimony, early withdrawal penalties, and moving expenses.

Long-Term Capital Gains and Dividend Reform

As an investor, planning your tax strategy ahead of time can have a significant impact on your tax liabilities, particularly since the Tax Increase Prevention and Reconciliation Act (TIPRA) extends through 2010 significant long-term capital gains and dividend tax relief set up by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). For investors in the top four income tax brackets, the long-term capital gains rate has been reduced from 20% to 15%. Qualified corporate dividends will also be taxed at 15% instead of the investor's marginal rate, which prior to JGTRRA could have been as high as 38.6%.

For investors in the 10% and 15% brackets, a 0% rate will apply from 2008–2010. For planning purposes, it is important to note that no changes have been made to the taxation of short-term capital gains, which will continue to be taxed at the investor's marginal rate.

To prepare an effective tax solution, advance planning is key. After all, April 15th is never too far away, and the sooner you begin planning, the greater your savings opportunities will be. Talk to your tax professional to create strategies that are right for *your* situation.

Items of Interest...

The Heroes Earnings Assistance and Relief Tax Act of 2008

Signed into law by President Bush on June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) permanently extends provisions that treat combat pay as earned income for the purposes of the earned income tax credit and that allow reservists called up for at least six months' active duty to take distributions from 401(k)s and other tax-advantaged retirement plans without incurring penalties. Under the HEART Act, employers have the option of amending their flexible spending accounts (FSAs) to permit active duty reservists to take FSA balances as a taxable cash distribution.

The law also provides small employers with a 20% tax credit (up to $4,000) of the salary differential they pay an employee who is called up for active military duty and allows veterans to purchase homes using qualified mortgage bonds, even if they are not first-time homebuyers. The legislation further stipulates that married active duty military personnel who file a joint return are entitled to receive an economic stimulus rebate check, even if the spouse does not have a Social Security number because he or she is a foreign national.

This $1.2 billion tax package is paid for in part by imposing new taxes on wealthy expatriates, increasing the penalties for failure to file tax returns, and closing a loophole sometimes used by American companies with subsidiaries abroad. Under the new law, foreign subsidiaries of U.S. companies performing work under a federal contract are treated as U.S. employers for employment tax purposes.

Following the date of enactment, high net worth individuals who renounce their citizenship or terminate their long-term residency in the U.S. are subject to income tax on the net unrealized gain on their property to the extent that the fair market value of the property on the day prior to expatriation exceeds $600,000. The law also levies taxes on certain types of gifts and bequests made by expatriates and mandates a 30% withholding tax on qualifying deferred compensation to expatriates. The higher penalties for failure to file tax returns will be in effect for returns that are due to be filed after December 31, 2008.

. . .a planning report on ideas, strategies, and arrangements that may increase your spendable income and financial worth

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Standard Mileage Rates Get a Bump

The recent spike in gas prices prompted the Internal Revenue Service (IRS) to increase the standard mileage rate by 8 cents for the final six months of 2008. For business miles driven between July 1 and December 31, the standard mileage rate is 58.5 cents a mile, up from 50.5 cents, which applies to miles driven during the first six months of 2008.

Taxpayers may use the optional standard rates to calculate the deductible costs of operating an automobile for business, charitable, medical, or moving purposes.

The mileage rate for deductible medical or moving expenses also received a six-month bump to 27 cents per mile, up from 19 cents, which still applies to the first six months of the year. The rate for providing services for charitable organizations is set by statute, not the IRS, and remains at 14 cents a mile.

"Rising gas prices are having a major impact on individual Americans. Given the increase in prices, the IRS is adjusting the standard mileage rates to better reflect the real cost of operating an automobile," said IRS Commissioner Doug Shulman. "We want the reimbursement rate to be fair to taxpayers."

Taxpayers may use the optional standard rates to calculate the deductible costs of operating an automobile for business, charitable, medical, or moving purposes. The optional business standard mileage rate is also often used as a benchmark by the federal government and many businesses to reimburse their employees for mileage.

Each fall, the IRS generally adjusts the mileage rate for the next year, but skyrocketing gas prices led to a special adjustment to more accurately represent the true cost of driving in 2008. In addition to gas prices, the IRS considers other factors, such as the cost of new vehicles and insurance, when setting mileage rates.

Thanks for the referrals!

If you think this newsletter would be of interest or help to friends or associates, let us know, and we will be happy to add them to our mailing list.

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