

# TAX PLANNING LETTER



## TAX PLANNING CONSIDERATIONS FOR INDIVIDUALS INCLUDING YEAR-END IDEAS

**▶ INDIVIDUAL INCOME TAXES, WHETHER PAID THROUGH EMPLOYER WITHHOLDING OR QUARTERLY ESTIMATES, ARE PROBABLY ONE OF YOUR LARGEST ANNUAL EXPENDITURES. SO, JUST AS YOU WOULD SHOP AROUND FOR THE BEST PRICE FOR FOOD, CLOTHING OR MERCHANDISE, YOU WANT TO CONSIDER OPPORTUNITIES TO REDUCE OR DEFER YOUR ANNUAL TAX OBLIGATION. THIS TAX LETTER IS INTENDED TO ASSIST YOU IN THAT EFFORT. ALSO, AT THE END OF THIS TAX LETTER IS A LIST OF FEDERAL TAX LAW PROVISIONS TO HELP INDIVIDUALS SAVE AND PAY FOR HIGHER EDUCATION COSTS.**

Your 2009 year-end tax planning begins with a projection of your estimated income, deductions and tax liability for 2009 and 2010. You should review actual amounts from 2008 to assist you with these projections. To the extent you can control the timing of income and deductions between 2009 and 2010, you should make decisions that will result in the lowest overall tax for both years. If shifting income and deductions between 2009 and 2010 does not reduce your overall tax liability, you should try to defer as much tax liability as possible from 2009 to 2010.

This *Tax Letter* discusses planning for federal income taxes. However, state income taxes should also be considered. Your BDO Seidman, LLP or BDO Seidman Alliance\* firm client service professional can be consulted regarding state tax matters.

This *Tax Letter* includes a discussion of various tax incentives that have been enacted or extended during the year by the American Recovery and Reinvestment Act of 2009, enacted on February 17, 2009, and the Worker, Homeownership, and Business Assistance Act of 2009, enacted on November 6, 2009. For a more detailed discussion of the tax provisions of these Acts, please see our Federal Tax Alerts at [www.bdo.com/download.aspx?id=993](http://www.bdo.com/download.aspx?id=993) and [www.bdo.com/download.aspx?id=1187](http://www.bdo.com/download.aspx?id=1187), respectively.

At this writing, Congress is considering additional tax legislation that would, if enacted, extend a number of provisions that would expire at the end of this year. Although Congress routinely extends such expiring provisions, the outcome of this proposed legislation cannot be predicted with certainty.

\*The BDO Seidman Alliance is a nationwide association of independently owned local, regional and boutique firms.

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## ► 2009 VERSUS 2010 MARGINAL TAX RATES

Whether you should defer or accelerate income and deductions between 2009 and 2010 depends to a great extent on your projected marginal (highest) tax rate for each year.

The highest marginal tax rate for 2009 and for 2010 is 35 percent. The tax brackets for 2009 are shown in the box below. Your marginal tax rate can be higher due to the reduction or elimination of itemized deductions and personal exemptions as your adjusted gross income ("AGI") rises above certain levels. These adjustments are discussed in more detail on pages 4 and 12. Projections of your 2009 and 2010 income and deductions are necessary to estimate your marginal tax rate for each year.

## ► SHIFTING INCOME AND DEDUCTIONS INTO THE MOST ADVANTAGEOUS YEAR

You can shift taxable income between 2009 and 2010 by controlling the receipt of income and the payment of deductions. Generally, income should be received in the year with the lower marginal tax rate, while deductible expenses should be paid in the year with the higher marginal rate. If your top tax rate is the same in 2009 and 2010, deferring income into 2010 and accelerating deductions into 2009 will generally produce a tax deferral of up to one year. On the other hand, if you expect your tax rate to be higher in 2010, you may want to accelerate income into 2009 and defer deductions to 2010.

**Planning Suggestion:** You should consider the time value of money when making a decision to defer income or accelerate deductions. Comparative computations should be made to determine and evaluate the net after-tax result of these financial actions.

Moreover, you should consider whether you expect to be subject to the alternative minimum tax ("AMT") for either or both years (see page 14).

## CONTROLLING INCOME

Income can be accelerated into 2009 or deferred to 2010 by controlling the receipt of various types of income depending on your situation, such as:

### FOR BUSINESS OWNERS

- Year-end interest or dividend payments from closely-held corporations;
- Rents and fees for services (delay December billings to defer income); and
- Commissions (close sales in January to defer income).

**CAUTION:** Income cannot be deferred to 2010 if you constructively receive it in 2009. Constructive receipt occurs when you have the right to receive payment or have received a check for payment even though it has not been deposited. Income also cannot be deferred if you effectively receive the benefit of the income; for example, if you are allowed to pledge a deferred compensation account balance to obtain a loan.

Bonuses for work performed in a particular year can be deferred to the next year if an election is made no later than the end of the year preceding the year the work is to be performed. Accordingly, bonuses for work to be performed in 2010 can be deferred to 2011 if the required election is made before the end of 2009.

### FOR INVESTORS

- Interest on short-term investments, such as Treasury bills ("T-bills") and certain certificates of deposit that do not permit early withdrawal of the interest without a substantial penalty, is not taxable until maturity.

**Example:** In November 2009, an investor buys a six-month T-bill. The interest is not taxable until 2010 assuming the T-bill is held to maturity.

### • Interest on U.S. Series EE savings bonds

Other than not being taxable until the proceeds are received, interest on issued Series EE bonds may be exempt from tax if the proceeds of the bond are used to pay certain educational expenses for yourself or your dependents, and the requirements of "qualified United States savings bonds" are met.

2009 Federal Income Tax Rates

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately	Estate & Trusts
10%	\$0 – \$ 16,700	\$0 – \$ 8,350	\$0 – \$ 11,950	\$0 – \$ 8,350	–
15%	\$16,700 – \$ 67,900	\$8,350 – \$ 33,950	\$11,950 – \$ 45,500	\$8,350 – \$ 33,950	\$0 – \$ 2,300
25%	\$67,900 – \$ 137,050	\$33,950 – \$82,250	\$45,500 – \$ 117,450	\$33,950 – \$ 68,525	\$2,300 – \$ 5,350
28%	\$137,050 – \$ 208,850	\$82,250 – \$171,550	\$117,450 – \$ 190,200	\$68,525 – \$ 104,425	\$5,350 – \$ 8,200
33%	\$208,850 – \$ 372,950	\$171,550 – \$372,950	\$190,200 – \$ 372,950	\$104,425 – \$ 186,475	\$8,200 – \$ 11,150
35%	Over \$372,950	Over \$372,950	Over \$372,950	Over \$186,475	Over \$11,150

**Planning Suggestion:** Consider investments that generate interest exempt from the regular income tax. You must, however, compare the tax-exempt yield with the after-tax yield on taxable securities to determine the most advantageous investment. In addition, some tax-exempt interest may be subject to AMT (see page 14), which could lower the tax-exempt yield.

Other ways to defer income include installment sales and tax-free exchanges of "like-kind" investment or business property.

**Planning Suggestion:** If you made a 2009 sale that is eligible for installment reporting, you have until the due date of your 2009 return, including extensions, to decide if you do not want to use the installment method and, instead, report the entire gain in 2009.

## FOR EMPLOYEES

### • Year-end bonuses and deferred compensation

**CAUTION:** The Service will scrutinize deferrals of income between owner-employees and their closely-held corporations. Also, any deferred compensation arrangements must be entered into before the compensation is earned. Additionally, if you own more than 50 percent of a taxable (C) corporation or any stock of an S corporation that reports on an accrual method of accounting, the corporation can deduct a year-end bonus to you only when it is paid.

**Planning Suggestion:** The tax rate for the Medicare Hospital Insurance portion of the social security tax is:

- 1.45 percent for employees
- 1.45 percent for employers
- 2.9 percent for self-employed individuals

This tax is imposed on all employee compensation and self-employed income, including vested deferred compensation, without any limitation or cap. If you are a shareholder in an S corporation, you might be able to reduce the Medicare tax by reducing your salary. However, reasonable compensation must be paid to S corporation shareholders for services rendered to the S corporation.

### • Distributions from retirement plans

Distributions from qualified retirement plans can be delayed (see page 8).

**CAUTION:** Penalties may be imposed on early, late, or insufficient distributions.

### • IRA distributions

Distributions from individual retirement accounts ("IRAs") can be delayed until age 70½ (see page 8). If you have not reached age 59½ and need to take a distribution from your IRA to pay medical expenses, the ten-percent early withdrawal penalty does not apply to the portion of those medical expenses in excess of 7½ percent of your AGI. However, you will have to pay regular income tax on the entire distribution. If you have been unemployed and received unemployment compensation for at least 12 weeks before age 59½,

distributions used to pay any health insurance premiums are not subject to the ten-percent penalty.

If you are planning to purchase a new home, you may withdraw up to \$10,000 from your IRA to pay certain qualified acquisition expenses without having to pay the ten-percent early withdrawal penalty. The distribution is still subject to the regular income tax. The \$10,000 withdrawal is a lifetime cap. If a taxpayer or spouse has owned a principal residence in the previous two years, this penalty-free provision is not available. An eligible homebuyer for this purpose can be the owner of the IRA, his or her spouse, child, grandchild, or any ancestor. Also, penalty-free distributions can be made from IRAs for higher education expenses of a taxpayer, spouse, child, or grandchild.

### • Accelerated insurance benefits

Subject to certain requirements, payments received under a life insurance policy of an individual who is terminally or chronically ill are excluded from gross income. If you sell a life insurance policy to a viatical settlement provider (regularly engaged in the business of purchasing or taking assignments of life insurance policies), these payments also are excluded from gross income.

### • Educational expense exclusion

An exclusion for employer-provided education benefits for non-graduate and graduate courses up to \$5,250 per year is available.

**Planning Suggestion:** If you wish to take university courses, speak with your employer about paying up to \$5,250 of the tuition per year as part of your compensation package.

You may also be eligible for an "above-the-line" deduction (deductible in arriving at AGI, regardless of whether you itemize or use the standard deduction) of up to \$4,000 for higher education expenses if your AGI does not exceed \$65,000 (or \$130,000 if filing a joint return). If your AGI is greater than \$65,000 (or \$130,000 on a joint return), but does not exceed \$80,000 (or \$160,000 if filing a joint return), your maximum tuition and fees deduction will be \$2,000. Once your AGI exceeds \$80,000 (or \$160,000 on a joint return), a deduction will not be allowed. The \$4,000 limit must be reduced for those higher education expenses that are not subject to tax, *i.e.*, United States Government interest used to pay higher education expenses; distributions from state tuition programs (section 529 plans); or distributions from educational IRA plans. The "above-the-line" deduction for higher education expenses is not applicable for taxable years beginning after 2009, unless an extension is enacted into law.

### • Educators' Out-of-Pocket Classroom Expenses in 2009.

Eligible educators can deduct \$250 (subject to various limitations) of their classroom expenses as above-the-line deductions. These are expenses that would otherwise be allowable as trade or business deductions. The balance of the educators' classroom expenses is deductible as an unreimbursed employee business expense, a miscellaneous itemized deduction subject to the two-percent-of-AGI floor. This provision is available for taxable years beginning before January 1, 2010.

- **Damages received for non-physical injuries and punitive damages**

All amounts received as punitive damages and damages attributable to non-physical injuries are gross income in the year received. Legal fees attributable to non-business income or to employment related unlawful discrimination lawsuits are a reduction of gross income, instead of a miscellaneous itemized deduction. Damages received by a spouse, which are attributable to loss of consortium due to physical injuries of the other spouse, are excluded from income.

## CONTROLLING DEDUCTIONS

Itemized deductions, other than investment interest, medical expenses, and casualty or theft losses, are reduced by three percent of the amount by which a taxpayer's 2009 AGI exceeds \$166,800 (\$83,400 for married taxpayers filing separately). However, these itemized deductions are not reduced by more than 80 percent of the otherwise allowable deductions. For taxable years beginning in 2009, this reduction of itemized deductions is limited to one-third of the otherwise applicable reduction. This means that, in 2009, the reduction is one percent of the excess of total itemized deductions over the specified level instead of three percent (assuming that the 80-percent limitation is not applicable). For 2010 the reduction of itemized deductions is eliminated.

**CAUTION:** Because this reduction of itemized deductions may increase your 2009 marginal tax rate, any decision to accelerate or defer deductions must consider this possible effect.

Deductions that may be accelerated into 2009 or deferred to 2010 include:

- **Charitable contributions (cash or property)**

You must obtain written substantiation, in addition to a canceled check, for all charitable donations.

Charities are required to inform you of the amount of your net contribution, where you receive goods or services in excess of \$75 in exchange for your contribution.

If the value of contributed property exceeds \$5,000, you must obtain a qualified written appraisal (prior to the due date of your tax return, including extensions), except for publicly-traded securities and non-publicly-traded stock of \$10,000 or less.

**Planning Suggestion:** If you are considering contributing marketable securities to a charity and the securities have declined in value, sell the securities first and then donate the sales proceeds. You will obtain both a capital loss and a charitable contribution deduction.

**CAUTION:** If you are contemplating the repurchase of the security in the future, you need to consider the wash sale rules discussed on page 6.

On the other hand, if the marketable securities or other long-term capital gain property have appreciated in value, you should contribute the property in kind to the charity. By contributing in kind, you will avoid taxes on the appreciation and receive a charitable contribution deduction for the property's full fair market value.

If you contribute appreciated, publicly-traded stock (with no restrictions) to a private foundation, you are entitled to a charitable contribution deduction for the full fair market value of the stock.

If you wish to make a significant gift of property to a charitable organization yet retain current income for yourself, a charitable remainder trust may fulfill your needs. A charitable remainder trust is a trust that generates a current charitable deduction for a future contribution to a charity. The trust pays you income annually on the principal in the trust for a specified term or for life. When the term of the trust ends, the trust's assets are distributed to the designated charity. You obtain a current tax deduction when the trust is funded based on the present value of the assets that will pass to the charity when the trust terminates. This accelerates your deduction into the year the trust is funded, while you retain the income from the assets. This method of making a charitable contribution can work very well with appreciated property.

If you volunteer time to a charity, you cannot deduct the value of your time, but you can deduct your out-of-pocket expenses. If you use your automobile in connection with performing charitable work, including driving to and from the organization, you can deduct 14 cents per mile (this amount stays the same for 2010). You must keep a record of the miles.

The allowable deduction for donating an automobile (also, a boat and airplane) is significantly reduced. The deduction for a contribution made to a charity, in which the claimed value exceeds \$500, will be dependent on the charity's use of the vehicle. If the charity sells the donated property without having significantly used the vehicle in regularly conducted activities, the taxpayer's deduction will be limited to the amount of the proceeds from the charity's sale. In addition, greater substantiation requirements are also imposed on property contributions. For example, a deduction will be disallowed unless the taxpayer receives written acknowledgement from the charity containing detailed information regarding the vehicle donated, as well as specific information regarding a subsequent sale of the property.

- **Medical expenses**

In addition to medical expenses for doctors, hospitals, prescription medications, and medical insurance premiums, you may be entitled to deduct certain related out-of-pocket expenses such as transportation, lodging (but not meals), and home healthcare expenses. If you use your car for trips to the doctor during 2009, you can deduct 24 cents per mile. Beginning on January 1, 2010, you can deduct 16½ cents per mile. Payments for programs to help you stop smoking and prescription medications to alleviate nicotine withdrawal problems are deductible medical expenses. Uncompensated costs of weight-loss programs and diet food to treat diseases diagnosed by a physician, including obesity, are also deductible medical expenses.

**Planning Suggestion:** If you pay your medical expenses by credit card, the expense is deductible in the year the expense is charged, not when you pay the credit card company. It is important to remember that prepayments for medical services generally are not deductible until the year when the services are actually rendered. Because medical expenses are deductible only to the extent they exceed 7½ percent of AGI, they should, where possible, be bunched in a year in which they exceed this AGI limit. Medical expenses are not subject to the three-percent-of-AGI reduction.

Under certain conditions, if you provide more than ten percent of an individual's support, such as a dependent parent, you can deduct the unreimbursed medical expenses you pay for that individual to the extent all medical expenses exceed 7½ percent of your AGI. Even if you cannot claim that individual as your dependent because his or her gross income is \$3,500 or more, you are still entitled to the medical deduction. Please consult your BDO Seidman or Alliance firm client service professional for details. At the time of publication, the United States Congress was considering healthcare legislation that might affect the medical expense deduction. Accordingly, taxpayers should consult with their BDO Seidman or Alliance firm client service professional to determine the impact of any enacted healthcare legislation on the medical expense deduction.

- **Long-term care insurance and services**

Premiums you pay on a qualified long-term care insurance policy are deductible as a medical expense. The maximum amount of your deduction is determined by your age. The following table sets forth the deductible limits for 2009:

Age	Deduction Limitation
40 or less	\$320
41 – 50	\$600
51 – 60	\$1,190
61 – 70	\$3,180
Over 70	\$3,980

These limitations are per person, not per return. Thus, a married couple over 70 years old has a combined maximum deduction of \$7,960, subject to the normal limitation on medical expenses of 7½ percent of AGI.

Generally, if your employer pays these premiums, they are not taxable income to you. However, if this benefit is provided as part of a flexible spending account or cafeteria plan arrangement, the premiums are taxable to you. The deduction for health and long-term care insurance premiums paid by a self-employed individual is covered in the box on page 10, "Tax Tips for the Self-Employed."

Medical payments for qualified long-term care services prescribed by a licensed healthcare professional for a chronically ill individual are also deductible as medical expenses.

- **General sales and use tax**

For taxable years beginning before 2010, taxpayers may elect to take state and local general sales and use taxes as an itemized deduction, rather than state and local income tax. Taxpayers utilizing this election have the option of deducting actual sales and use taxes paid or using IRS-published tables and then adding the sales tax paid on any "big ticket" item purchases (motor vehicle, boat, aircraft, home).

- **Property taxes, mortgage interest, and points**

Interest as well as points paid on a loan to purchase or improve a principal residence is generally deductible in the year paid. The mortgage loan must be secured by your principal residence. Points paid in connection with refinancing an existing mortgage are not deductible currently but rather must be amortized over the life of the new mortgage. However, if the mortgage is refinanced again, the unamortized points on the old mortgage can be deducted in full. See page 10 for additional information regarding mortgage and other interest payments.

- **Interest paid on qualified education loans**

An "above-the-line" deduction (a deduction to arrive at AGI) is allowed for interest paid on qualified education loans. The maximum deduction is \$2,500. All student loan interest up to the \$2,500 annual limit is deductible. However, in 2009 this deduction is phased out for single individuals with modified AGI of \$60,000 to \$75,000 (\$120,000 to \$150,000 for joint returns).

**CAUTION:** Interest paid to a relative or to an entity (such as a corporation or trust) controlled by you or a relative does not qualify for the deduction.

- **Non-business bad debts**

Non-business bad debts are treated as short-term capital losses when they become totally worthless. To establish worthlessness, you must demonstrate there is no reasonable prospect of recovering the debt. This might include documenting the efforts you made to collect the debt, including correspondence to the debtor to demand payment.

- **401(k) plan contributions**

If your employer (including a tax-exempt organization) has a section 401(k) plan, consider making elective contributions up to the maximum amount of \$16,500 or \$22,000 if over age 50, especially if you are unable to make contributions to an IRA. You should also consider making after-tax, nondeductible contributions to a 401(k) plan if the plan allows, as future earnings on those contributions will grow tax-deferred. A nondeductible contribution to a Roth IRA can also be considered (see page 9).

**Planning Suggestion:** If you are a participant in an employer's qualified plan (which includes a 401(k) plan) and are at least 50 years old, you can elect to make a deductible "catch-up" contribution of \$5,500 to the plan. To make a "catch-up" contribution, your employer's plan must be amended to allow such contributions.

#### • IRA deductions

The total allowable annual deduction for IRAs is \$5,000, subject to certain AGI limitations if you are an "active participant" in a qualified retirement plan. An IRA deduction of up to \$5,000 can be made for a non-working spouse, provided the working spouse has at least \$8,000 of earned income. A catch-up provision for individuals age 50 or older applies to increase the deductible limit for IRAs to \$6,000.

**Planning Suggestion:** Consider making your full IRA contribution early in the year so that income earned on the contribution can accumulate tax-free for the entire year.

**Planning Suggestion:** If money is tight, consider the use of credit cards to make tax deductible year-end payments. However, interest paid to a credit card company is not deductible because it is personal interest (see page 10).

**CAUTION:** If you choose to accelerate income into 2009 or defer deductions to 2010, make sure your estimated tax payments and withheld taxes are sufficient to avoid 2009 estimated tax penalties (see page 16).

## ▶ DEFERRED COMPENSATION

The American Jobs Creation Act of 2004 created new section 409A imposing new restrictions on the timing of distributions from, and contributions to, nonqualified deferred compensation plans. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options, stock appreciation rights, phantom stock plans, and restricted stock unit plans.

As stated in section 409A, restrictions on the timing of distributions from, and contributions to, deferred compensation plans require most individuals to:

1. Make an election to defer compensation in the year prior to the year in which the services related to the compensation are performed. For compensation earned during 2010 an election would have to be made no later than December 31, 2009.
2. Limit the timing of distributions based on one (or more) of six prescribed times or events as follows:
  - a. separation from service;
  - b. disability;
  - c. death;
  - d. a specified time (or pursuant to a fixed schedule);
  - e. change in ownership of the company; or
  - f. an unforeseeable emergency.

A violation of these rules requires a payment of normal income taxes on all amounts previously deferred under the plan at the time of the violation (or vesting if later), an additional tax of 20 percent of the amounts deferred, and interest on the amounts deferred at the underpayment penalty rate plus one percent.

Guidance issued by the Service requires nonqualified deferred compensation plans to conform to the new rules by December 31, 2008; however, plans needed to have been operated in "good faith"

compliance before January 1, 2009, and must be in full operational compliance in 2009.

## ▶ CAPITAL GAINS AND LOSSES

Investment strategies that produce long-term capital gain instead of ordinary income can generate significant tax savings because the maximum tax rate on long-term capital gains is 15 percent. In 2009, if a taxpayer has a net long-term capital gain, a zero tax rate will apply to adjusted net capital gain that otherwise would be taxed at a rate below 25 percent if taxed as ordinary income.

**CAUTION:** The tax law contains rules to prevent converting ordinary income into long-term capital gains. For instance, net long-term capital gains on investment property are excluded in computing the amount of investment interest expense that can be deducted (see page 10), unless the taxpayer elects to subject those gains to ordinary income tax rates. Additionally, if long-term real property is sold at a gain, the portion of the gain represented by prior depreciation is taxed at a 25-percent rate.

Capital losses are offset against capital gains. Net capital losses of up to \$3,000 can be deducted against ordinary income. Unused capital losses may be carried forward indefinitely and offset against capital gains, and up to \$3,000 of ordinary income, in future years.

**Planning Suggestion:** Add up all capital gains and losses you have realized so far this year, plus anticipated year-end capital gain distributions from mutual funds (this amount should be presently available by calling your mutual fund's customer service number). Then review the unrealized gains and losses in your portfolio. Consider selling additional securities to generate gains or losses to maximize tax benefits.

**CAUTION:** Do not sell a security simply to generate a gain or loss to offset other realized gains or losses. The investment merits of selling any security must also be considered.

**Note:** Capital gains and losses are recognized on the trade date, not the settlement date. For instance, gains and losses on trades executed on December 31, 2009, are taken into account in computing your 2009 taxable income.

If a security is sold at a loss and substantially the same security is acquired within 30 days before or after the sale, the loss is considered a "wash sale" and is not currently deductible. However, this nondeductible loss is added to the cost of the purchased security that caused the "wash sale." This will reduce gain, or increase loss, later when that security is sold.

Although present tax law significantly limits a taxpayer's ability to lock in capital gains without realizing the gains for tax purposes, there are still methods by which this can be accomplished. Please consult your BDO Seidman or Alliance firm client service professional for further guidance.

## QUALIFIED SMALL BUSINESS STOCK

A non-corporate taxpayer is subject to a maximum tax rate of 14 percent on gain from the sale of "qualified small business stock." To be eligible, the stock must be issued after August 10, 1993, and must have

been held for more than five years. The gain eligible for this exclusion cannot exceed the greater of ten times the taxpayer's basis in the stock or \$10 million. A non-corporate taxpayer may also elect to exclude the entire gain from the sale of "qualified small business stock" held for more than six months if, within the 60-day period beginning on the date of sale, the taxpayer purchases "qualified small business stock" having a cost at least equal to the amount realized from the sale. The changes in the long-term capital gain rates did not affect the tax treatment of "qualified small business stock" sales. Your BDO Seidman or Alliance firm client service professional can be consulted for more information.

### DIVIDEND INCOME

Qualified dividend income from domestic corporations and qualified foreign corporations is taxed at the same reduced rate as long-term capital gains for regular tax and AMT purposes. The rate reduction for dividend income applies to qualified dividends received in taxable years beginning on or after January 1, 2003, through taxable years beginning in 2010. Thereafter, these rate reductions are scheduled to sunset and the older higher rates for dividend income and long-term capital gains are scheduled to return.

**Planning Suggestion:** For taxpayers who are owners of closely-held corporations or a corporation that was converted to an S corporation, there are some planning opportunities with the new dividend tax rates. Your BDO Seidman or Alliance firm client service professional can be consulted for further guidance.

## ▶ TAX-FREE ROLLOVER INTO SPECIALIZED SMALL BUSINESS INVESTMENT COMPANIES

An individual may elect to avoid tax on gains from sales of publicly traded securities to the extent the sales proceeds are used to purchase common stock or a partnership interest in a specialized small business investment company licensed by the Small Business Administration under the 1958 Small Business Investment Act. The rollover of sale proceeds must occur within 60 days of the sale. The maximum gain that may be avoided annually for a single individual or a married couple filing jointly is the lesser of \$50,000 or \$500,000 reduced by any gain avoided in previous years. The limits are one-half of these amounts for married individuals filing separate returns.

## ▶ SALE OF PRINCIPAL RESIDENCE

For sales of a principal residence, up to \$500,000 of gain on a joint return (\$250,000 on a single or separate return) can be excluded. To be eligible for the exclusion, the residence must have been owned and occupied as your principal residence for at least two of the five years preceding the sale. The exclusion is available each time a principal residence is sold, but only once every two years. Special rules apply in the case of sales of a principal residence after a divorce and sales due to certain unforeseen circumstances. If a taxpayer satisfies only a portion of the two-year ownership and use requirement, the exclusion amount is reduced on a pro rata basis.

**Example:** Husband and wife file a joint return. They own and use a principal residence for 15 months and then move because of a job transfer. They can exclude up to \$312,500 of gain on the sale of the residence (5/8 of the \$500,000 exclusion).

The Housing Assistance Tax Act of 2008 modified the provisions affecting the exclusion of the gain. For sales or exchanges after December 31, 2008, a portion of the gain attributable to a period when the residence is not used as a principal residence will not be eligible for the exclusion. Periods of ineligible use prior to January 1, 2009, will not be considered.

**Planning Suggestion:** If you want to sell your principal residence but are unable to do so because of unfavorable market conditions, you can rent it for up to three years after the date you move out and still qualify for the exclusion. However, any gain attributable to prior depreciation claimed during the rental period will be taxed at a 25-percent rate.

If you own appreciated rental property that you wish to sell in the future, you should consider moving into the property to convert it to your principal residence. You will need to live in the property for two of the five years preceding the sale of the property. As long as you haven't sold another principal residence for the two years prior to the sale, a portion of the gain is excluded. Any gain attributable to prior depreciation claimed will be taxed at a 25-percent rate.

The sale of a principal residence does not qualify for the exclusion if during the five-year period prior to the sale the property was acquired in a tax-free like-kind exchange.

## ▶ EXPANDED AND EXTENDED HOMEBUYER CREDIT

The Worker, Homeownership, and Business Assistance Act of 2009, signed into law on November 6, 2009, extends and expands the first-time homebuyer credit allowed by previous Acts. The Housing and Economic Recovery Act of 2008 established a tax credit for first-time homebuyers that can be worth up to \$7,500. For homes purchased in 2008, the credit is similar to a no-interest loan and must be repaid in 15 equal, annual installments beginning with the 2010 taxable year. The credit phases out ratably if the taxpayer has modified gross income between \$75,000 and \$95,000 if the taxpayer is single and between \$150,000 and \$170,000 for joint filers. The American Recovery and Reinvestment Act of 2009 expanded the first-time homebuyer credit by increasing the credit amount to \$8,000 for purchases made in 2009 before December 1. For homes purchased in 2009, the credit does not have to be paid back unless the home ceases to be the taxpayer's main residence within a three-year period following the purchase.

Under the new Worker, Homeownership, and Business Assistance Act of 2009, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010, and close on the home by June 30, 2010. For qualifying purchases in 2010, taxpayers have the option of claiming the credit on either their 2009 or 2010 return. The maximum credit amount remains at \$8,000 for a first-time homebuyer (a buyer who has not owned a primary residence during

the three years up to the date of purchase). The new law also provides a "long-time resident" credit of up to \$6,500 to others who do not qualify as "first-time homebuyers." In order to qualify as a long-time resident, a buyer must have owned and used the same home as a principal or primary residence for at least five consecutive years of the eight-year period ending on the date of purchase of a new home as a primary residence. The new law raises the income limits for taxpayers who purchase homes after November 6, 2009. The full credit will be available to taxpayers with modified adjusted gross incomes ("MAGI") up to \$125,000, or \$225,000 for joint filers. Those taxpayers with MAGI between \$125,000 and \$145,000, or \$225,000 and \$245,000 for joint filers, are eligible for a reduced credit. Those taxpayers with higher incomes do not qualify.

## ▶ INSTALLMENT SALES OF DEPRECIABLE PROPERTY BY NON-DEALERS

A sale of depreciable property at a gain generates ordinary income to the extent of any depreciation recapture. This ordinary income is fully taxable in the year of sale even if no sales proceeds are received in that year.

**Example:** Taxpayer T, in the 35-percent bracket, sells machinery in 2009 for a \$1 million note payable in 2011. T's gain is \$900,000 (\$1 million less \$100,000 basis). \$800,000 of this gain is due to depreciation recapture. T must report gain as follows:

2009 ordinary gain:	\$800,000
2011 capital gain:	\$100,000
Total gain:	\$900,000

T must pay tax of \$280,000 (35 percent of \$800,000) for 2009, even though the note proceeds will not be received until 2011. Moreover, T's top marginal tax rate for 2009 will likely be higher than 35 percent due to the three-percent-of-AGI reduction of itemized deductions and phase-out of personal exemptions (as modified for 2009).

**Planning Suggestion:** If possible, an installment seller of depreciable property should structure the transaction to receive enough cash by the due date of the tax return to meet the first year's tax on the installment sale. In the above example, T should negotiate to receive an installment payment of at least \$280,000 by April 15, 2010.

## ▶ RETIREMENT PLAN DISTRIBUTIONS

For taxpayers who have attained the age of 70½, an exclusion of up to \$100,000 from gross income is available for IRA distributions that are qualified charitable distributions made directly to a qualifying charitable organization. The distributions must be:

- Made after the IRA owner attains age 70½;
- Made directly to a qualifying charitable organization (public charity); and

- Entirely deductible as a charitable contribution. If the deductible amount is reduced due to a benefit received or if the donor does not obtain sufficient substantiation, the exclusion is not available for any portion of the distribution.

A taxpayer may use his required minimum distribution to fund the donation. The retirement plan distribution exclusion is not applicable for taxable years beginning after 2009, unless extended by Congress.

Participants in qualified pension plans, other than five-percent owners of the employer, can delay taking distributions out of the plan until the later of April 1 of the calendar year after they reach age 70½ or the end of the taxable year in which they retire. Plans may (but are not required to) allow active employees, who are already receiving benefits, to stop receiving them. Distributions would then resume when the employee retires.

Distributions out of a regular IRA can be deferred to a date not later than April 1 of the year after you reach age 70½ (Roth IRAs are not subject to any minimum distribution requirements). If you elect to defer your first IRA distribution to the year after you reach age 70½, that distribution, plus the required distribution for that year, will be taxed in that year.

**Example:** Individual reached age 70½ in 2009 but waited until April 1, 2010, to take the required distribution from his IRA for the year 2009 based on the December 31, 2008, IRA account balance. Individual must also take a distribution by December 31, 2010, for the 2010 year based on the December 31, 2009, IRA account balance, with certain adjustments. Therefore, Individual is taxed on two distributions in 2010. If the second distribution is not made by December 31, 2010, Individual is subject to a 50-percent excise tax on the amount that should have been distributed.

The taxable portion of a qualified retirement plan distribution generally can be rolled over tax-free into a regular IRA or another qualified plan. However, tax-free rollover treatment is not available if the distribution is one of a series of substantially equal payments over a specified period of ten years or more, over the life expectancy of the employee, or over the joint life expectancies of the employee and the employee's beneficiary. Minimum distributions, generally required to begin at age 70½, also cannot be rolled over.

Qualified plans must allow participants to transfer eligible rollover amounts directly to an IRA or other qualified plan in a trustee-to-trustee transfer. If a trustee-to-trustee transfer is not made, the plan is required to withhold a 20-percent income tax on the distributed amount even if within 60 days the employee transfers the distribution to an IRA. This may result in an overpayment of tax, since the amount rolled over is not included in gross income.

**Example:** Employee E retires at age 54 on January 1, 2009, and is entitled to receive a \$100,000 lump-sum distribution from his employer's profit-sharing plan. E does not elect a direct trustee-to-trustee transfer of his \$100,000 to an IRA. At the time of the distribution, the employer must withhold \$20,000 in federal income taxes from the distribution. E receives the remaining \$80,000 on January 10, 2009, and transfers it to an IRA on January 11, 2009.

E will have \$20,000 of gross income, unless he obtains \$20,000 from another source and transfers it to the IRA by March 11, 2009 (within 60 days of receiving the distribution). In addition, if E fails to transfer the additional \$20,000 to an IRA, E will be liable for the ten-percent early withdrawal penalty on the \$20,000 because E was under age 55 (the minimum age for receiving penalty-free distributions upon a separation from service).

## ▶ ROTH IRAS AND EDUCATION IRAS

### ROTH IRAS

The year 2010 will be the year many taxpayers consider converting their regular IRA accounts and certain eligible employer plans to Roth IRAs. This is because prior to 2010 most taxpayers could not convert because of the modified adjusted gross income limit of \$100,000. Effective in 2010, that limit no longer applies.

Prior to discussing conversions of regular IRAs and eligible employer plans we will first discuss regular annual contributions to Roth IRAs and the characteristics of a Roth IRA. Taxpayers under certain income limits are permitted to make contributions to a Roth IRA. Unlike regular IRAs, where contributions are deductible and later distributions are taxable, contributions to Roth IRAs are not deductible and later "qualified" distributions are not taxable. Qualified distributions are distributions made five or more years after the Roth IRA is established, provided the distribution is made after the account owner is at least age 59½, has died or become disabled, or uses the money for a first-time home purchase, subject to a \$10,000 lifetime cap. If the distribution is not qualified, a portion of the distribution may be included in gross income and may be subject to the ten-percent early withdrawal penalty. The penalty applies on the amount of the distribution that exceeds the taxpayer's contributions to the Roth IRA. Roth IRAs are not subject to the minimum distribution rules that apply to regular IRAs when the owner reaches age 70½.

For 2009, taxpayers can contribute up to \$5,000 to a Roth IRA (as long as you have compensation for the year at least equal to the contributed amount). Taxpayers age 50 or older can make additional contributions of \$1,000. Thus, the limit is \$6,000 a year for people who will be age 50 (or older) during 2009. However, the maximum contribution allowance must be reduced by any contributions (deductible or nondeductible) the taxpayer makes to "regular" IRAs.

For single taxpayers, if adjusted gross income is between \$105,000 and \$120,000, the \$5,000 maximum contribution is phased out. Modified AGI in excess of \$120,000 prevent a contribution to a Roth IRA for a single taxpayer. For married taxpayers filing jointly, no contribution can be made if AGI is \$176,000 or more, and the \$5,000 maximum (per spouse) is phased out for AGIs between \$166,000 and \$176,000.

For married taxpayers filing separately, the allowable contribution is phased out for AGIs between \$0 and \$10,000.

As with regular IRAs, contributions to a Roth IRA may be made as late as the due date for filing your income tax return, excluding extensions. Thus, Roth IRA contributions may be made by most individuals for 2009 until April 15, 2010. Unlike regular IRAs, contributions to a Roth IRA may be made even if the taxpayer is over age 70½, and the taxpayer or spouse has earned income at least equal to the amount of the contribution.

Besides contributing new retirement monies to a Roth IRA, certain taxpayers are eligible to convert their existing regular IRAs and eligible employer plans to Roth IRAs. This right to convert from a regular IRA or eligible employer plan is available for taxpayers (single and married filing jointly) whose modified AGI is less than \$100,000 in the year of conversion. Married taxpayers filing separate tax returns are not allowed to convert, regardless of their modified AGI. Starting in 2010, however, the modified AGI limit of \$100,000 no longer applies. Thus, in 2010 all taxpayers, regardless of the size of their income or filing status may convert regular IRAs and eligible employer plans to a Roth IRA.

If a taxpayer converts a regular IRA or eligible employer plan into a Roth IRA, the amount that must be included in the distributee's gross income is the amount that would have been includible in gross income had the distribution not been part of a qualified rollover contribution. A taxpayer converting in 2010 will include one-half of the income from the conversion in 2011 and one-half of the income in 2012 unless an election is made to include all of the income from the conversion in 2010 income. The converted amount is not subject to the ten-percent early withdrawal penalty, provided no distributions are made from the account during the five-year period after the initial conversion.

**Planning Suggestion:** It may be beneficial to convert an existing IRA into a Roth IRA even though income will be accelerated and taxes will have to be paid. The advisability of converting depends on various factors, including the age of the taxpayer, current tax bracket, whether the taxpayer has funds from other sources to pay the income taxes on the accelerated income, and whether the taxpayer intends to withdraw funds from the account after age 59½, or after 70½. Two of the advantages of converting a regular IRA or eligible employer plan into a Roth IRA are avoiding the minimum distribution rules and avoiding income taxes on distributions after death to the beneficiary of the Roth IRA. Any decision to convert should also consider the estate tax effects.

**Additional Planning:** Regular IRAs can be converted to Roth IRAs, and vice versa. Roth IRA conversions for a year must be completed by December 31 of that year. If, upon making the Roth IRA conversion, the taxpayer expected to meet all eligibility requirements (modified adjusted gross income of less than \$100,000 and a filing status other than married filing separately), but by year end does not, then a failed conversion has been made. In order to avoid additional tax and penalties, the amount converted must be recharacterized into a traditional IRA by the due date for filing your return, including extensions.

**Example (1):** Individual D makes a \$4,000 contribution to a regular IRA in November 2009. D files his 2009 tax return on April 15, 2010. Immediately before filing the 2009 tax return, when the value of the IRA has increased to \$4,500, D recharacterizes the account as a Roth IRA. D will be considered to have made a \$4,000 contribution to a Roth IRA for 2009. The \$500 of appreciation is not treated as a contribution to the Roth IRA.

**Example (2):** Individual E converts a regular IRA to a Roth IRA in August of 2009, when the value of the account is \$100,000. On December 18, 2009, the value of the account is \$70,000. E may recharacterize the Roth IRA back to a regular IRA on December 18, 2009 (the election to recharacterize generally can be made as late as October 15, 2010) and it will be treated as if the original conversion in August had not occurred. E can then convert back to a Roth IRA by the later of the next taxable year or after 30 days. Thus, 31 days later on January 18, 2010, E (assuming E otherwise qualifies) can convert the regular IRA to a Roth IRA based on the then values.

These rules are complicated but may provide tax-planning opportunities if securities held in IRAs fluctuate significantly within short periods of time. Your BDO Seidman or Alliance firm client service professional can help you with your Roth IRA questions.

## COVERDELL EDUCATION SAVINGS ACCOUNTS (EDUCATION IRAS)

Education IRAs may be established to help meet the cost of education for certain individuals. For 2009, annual, nondeductible contributions to an education IRA are limited to \$2,000 per beneficiary and may not be made after the beneficiary reaches age 18. Contributions cannot be made prior to the child's birth. Contributions must be made by the due date of the return without extension. Only eligible donors within certain income limits can make contributions to education IRAs. Eligibility is phased out for single donors with AGI between \$95,000 and \$110,000, and married donors filing jointly with AGI between \$190,000 and \$220,000.

Distributions from an education IRA are not subject to tax to the extent the distributions do not exceed qualified education expenses. Qualified education expenses include elementary and secondary school expenses. In the year amounts are distributed from an education IRA, the beneficiary is also eligible for a Hope Scholarship Credit or Lifetime Learning Credit (see box, page 17), provided the same expenses are not used for each. Education IRAs can be rolled over, before the beneficiary reaches age 30, to benefit another person in the same family. If the beneficiary does not use the funds for qualified education expenses by age 30, the money must be withdrawn and will be subject to tax and penalty on the earnings portion.

## ► MOVING EXPENSES

Deductible moving expenses are limited to the cost of moving household goods and personal effects, plus traveling (including lodging but not meals) from your old residence to your new residence. To be deductible, a taxpayer must satisfy a distance test, a length-of-employment test and a commencement-of-work test.

## TAX TIPS FOR THE SELF-EMPLOYED

- Establish a Simplified Employee Pension ("SEP") Plan by the due date of your 2009 return, including extensions. The contribution to the plan must be made by that due date. For 2009, the maximum allowable contribution to a SEP an employee can make independently of an employer is \$5,000 (\$6,000 if a catch-up contribution). However, the maximum combined deduction for an active participant's elective deferrals and other SEP contributions increased to \$46,000.
- Alternatively, establish a Keogh Plan in 2009, before December 31. The full contribution to the plan need not be made until the due date of your 2009 return, including extensions.
- Consider placing equipment in service in 2009 to deduct at least one-eighth of a full year's depreciation. You also may be entitled to currently deduct in full the cost of equipment purchases up to \$250,000 (\$285,000 for qualified enterprise zone property, qualified renewal community property, and qualified New York Liberty Zone property). This limit is reduced by the amount by which the cost of the qualified property placed in service during the tax year exceeds \$800,000. (See our 2009 *Tax Planning Considerations for Businesses Including Year-End Ideas* for further information.)
- A self-employed individual generally may deduct 50 percent of his self-employment tax as a business expense. This deduction may be claimed in addition to itemized deductions or the standard deduction.
- For 2009, 100 percent of medical and long-term care insurance premiums, subject to the limitations set forth on page 5, paid by a self-employed person are deductible from gross income to arrive at AGI.

Moving expenses can be deducted in arriving at AGI instead of as miscellaneous itemized deductions. Thus, these expenses are not subject to the various limitations applicable to itemized deductions and can be deducted in addition to itemized deductions or the standard deduction. Also, deductible moving expenses reduce AGI for purposes of calculating the various AGI-based limitations.

## ► INTEREST EXPENSE

### PERSONAL INTEREST

Interest is not deductible on tax deficiencies, car loans, personal credit card balances, student loans (except taxpayers eligible for the above-the-line deduction for interest paid on qualified education loans) and other personal debts.

### HOME MORTGAGE INTEREST

A full deduction is allowed for:

- Interest on debt used to acquire, construct, or improve a principal or secondary residence to the extent this debt does not exceed \$1 million.
- Other mortgage interest on a principal or secondary residence to the extent the mortgage does not exceed \$100,000. The loan

proceeds may be used for any purpose, except to purchase tax-exempt obligations.

During 2009, the cost of premiums paid or accrued for mortgage insurance on a qualified personal residence is treated as deductible home mortgage interest. The amount allowable as a deduction is phased out for married taxpayers filing jointly with an AGI of more than \$100,000 (\$50,000 for separate filers).

These \$1 million and \$100,000 limits are cut in half for a married taxpayer filing a separate return.

**CAUTION:** These debts must be secured by the principal or secondary residence. Thus, your home is at risk if the loan is not repaid.

A residence includes a house, condominium, mobile home, house trailer, or boat containing sleeping space, commode and cooking facilities. If you own more than two residences, you can annually elect which one will be your secondary residence.

**Planning Suggestion:** Since there is no deduction for personal interest, consider replacing personal debt with a home-equity loan of up to \$100,000 to obtain a deduction for the interest.

These rules apply to interest on debt incurred after October 13, 1987. Interest on mortgages established prior to October 14, 1987, is generally subject to less restrictive rules.

## INVESTMENT INTEREST EXPENSE

If you want to add to your investment portfolio through borrowing, consider borrowing from your stockbroker through a margin loan. The interest paid is investment interest expense and will be deductible to the extent of your net investment income (dividends, interest, etc.). Investment interest expense is not subject to the three-percent-of-AGI reduction. Investment interest expense in excess of investment income may be carried forward indefinitely.

**Planning Suggestion:** Net long-term capital gain (long-term gains over short-term losses) and any qualified dividend income taxed at the 15-percent rate are not included as investment income for purposes of determining how much investment interest expense is deductible, unless you elect to subject the capital gain and dividend income to ordinary income rates.

You should consider switching your investments to those generating taxable investment income to absorb any excess investment interest expense.

Interest expense, to the extent that it is related to tax-exempt income, is not deductible. Interest expense relating to a passive activity, such as a limited partnership investment, is subject to the passive loss limitations on deductibility (see page 12).

## ALLOCATION RULES

Interest payments are generally allocated among the various categories—personal interest, home mortgage interest, investment interest, etc.—based on the ultimate use of the loan proceeds.

**Example:** An individual borrows \$25,000 on margin and uses the proceeds to purchase an automobile for personal use. The interest expense is treated as personal interest.

The Service has issued complex regulations for determining how these allocations are made, which may require maintaining separate bank accounts or other records. Your BDO Seidman or Alliance firm client service professional can help you maximize tax deductions for your interest payments.

## MISCELLANEOUS DEDUCTIONS

Unreimbursed employee business expenses, investment expenses, personal tax advice and preparation fees, and most other miscellaneous itemized deductions, are deductible only if they exceed two percent of AGI. In addition, these deductions may be subject to the three-percent-of-AGI reduction if your income exceeds certain amounts.

**Planning Suggestion:** Consider bunching miscellaneous itemized deductions into a year in which the two-percent-of-AGI limit will be exceeded. However, not all prepaid expenses, such as multi-year subscriptions to financial periodicals, are currently deductible. If possible, also consider paying miscellaneous itemized deductions in a year in which the three-percent-of-AGI reduction is avoided or minimized.

## BUSINESS MEALS AND ENTERTAINMENT

Only 50 percent of an employee's unreimbursed cost of business meals and entertainment qualifies as a miscellaneous deduction. Club dues generally are not deductible; however, dues paid to the following types of organizations generally continue to be deductible:

- Professional associations;
- Civic or public service organizations, such as Kiwanis, Lions, Rotary, or Civitan; and
- Business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

## LEASED AUTOMOBILES

In prior years, the Service permitted salaried employees with unreimbursed business expenses as well as self-employed sole proprietors, partners, and S corporation shareholders to deduct only actual expenses incurred with respect to leased automobiles. Now, the Service allows taxpayers, beginning in the first year a leased automobile is placed in service, to use the standard mileage rate for business activity (55 cents per mile during 2009).

**Planning Suggestion:** Consider claiming the standard mileage rate for leased automobiles. There is less recordkeeping, and the standard mileage rate may result in a larger deduction.

## ▶ CHANGES TO THE FOREIGN EARNED INCOME EXCLUSION AND HOUSING ALLOWANCE

For United States citizens working abroad, beginning in 2006, there are three changes made to the foreign earned income exclusion and housing allowance. They are as follows:

- The income exclusion is indexed for inflation starting in 2006 (rather than 2009).
- The base housing amount used in calculating the foreign housing cost exclusion is 16 percent of the amount of the foreign earned income exclusion limitation. Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income, but the amount of the exclusion is limited to 30 percent of the taxpayer's foreign earned income exclusion.
- Income excluded as either foreign earned income or as a housing allowance is included for purposes of determining the marginal tax rates applicable to non-excluded income.

## ▶ STANDARD DEDUCTION

The 2009 standard deduction is:	
Filing Status	Amount
Single	\$5,700
Married filing joint return and qualifying surviving spouse with dependent child	\$11,400
Married filing separate return	\$5,700
Head of household	\$8,350

An additional \$1,100 standard deduction may be claimed by a married taxpayer (\$1,500 by a single taxpayer) who is at least 65 years old or blind. A further \$2,400 (\$2,800 by a single taxpayer) standard deduction can be claimed if the taxpayer is at least 65 years old and blind.

**Planning Suggestion:** A taxpayer benefits from itemizing deductions only if the deductions exceed the standard deduction. If your itemized deductions fluctuate from year to year, consider bunching your itemized deductions in one year and claiming the standard deduction in other years.

## ▶ PERSONAL EXEMPTIONS

For 2009, a \$3,650 deduction is allowed for each personal exemption. However, this amount is reduced by two percent for each \$2,500 (\$1,250 in the case of a married person filing a separate return), or fraction thereof, that AGI exceeds the following amount. These reductions are also partially restored for 2009 under rules similar to the rules that apply to the three-percent-of-AGI rule for overall itemized deductions. In 2010 there will be no reduction of the personal exemption as a result of AGI in excess of certain thresholds.

Filing Status	2009 Threshold
Head of Household	\$ 208,500
Married filing joint return and qualifying surviving spouse with dependent child	\$ 250,200
Married filing separate return	\$ 125,100
Single	\$ 166,800

A child cannot claim an exemption on his or her return or qualify for a higher education credit if the child's parents claim a dependency exemption for the child on their return.

**Planning Suggestion:** If you pay college tuition for your child but you are ineligible for the Hope Scholarship Credit or Lifetime Learning Credit because your AGI is more than the allowed income limitation (see box, page 17), it may be beneficial to forgo claiming an exemption for your child so that your child can claim the credit on his or her return.

## UNIFORM DEFINITION OF "CHILD"

There is a uniform definition of qualifying child for the purposes of determining the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status for 2004 and later. A child is determined to be a qualifying child of a taxpayer if a residency test, a relationship test, and an age test are met. Pre-2004 law regarding support and gross income tests in determining qualification as a dependent generally does not apply if the child satisfies the uniform definition.

## ▶ ENERGY TAX CREDITS

Individual taxpayers are allowed a nonrefundable income tax credit, up to \$1,500 of aggregate credits in 2009 and 2010, known as the non-business energy property credit, for certain energy efficient property installed in the taxpayer's principal residence. The credit equals 30 percent of the sum of: (i) the amount paid or incurred by the taxpayer during the taxable year for qualified energy efficiency improvements (i.e., building envelope components meeting certain requirements) installed during the taxable year, and (ii) the amount of residential energy property expenditures paid or incurred by the taxpayer during the taxable year. A full discussion of the credit is beyond the scope of this letter.

## ▶ PASSIVE ACTIVITIES, RENTAL AND VACATION HOMES

Losses from passive activities (which, as discussed below, generally include the rental of real estate) are deductible only against passive income. Passive losses cannot be used to reduce non-passive income, such as compensation, dividends, or interest. Similarly, credits from passive activities can be used only to offset the regular tax liability allocable to passive activities. Unused passive losses are carried over to future years and can be used to offset future passive income. Any remaining loss is deductible when the activity, which gave rise to the

passive loss, is disposed of in a transaction in which gain or loss is recognized.

A passive activity is one in which the taxpayer does not materially participate. Material participation is involvement in operations on a regular, continuous, and substantial basis. You are considered to materially participate in an activity if, for example:

- You participate in the activity for more than 500 hours in the taxable year.
- Your participation for the taxable year was substantially all of the participation in the activity.
- You participated for more than 100 hours during the taxable year, and you participated at least as much as any other individual for that year.

In determining material participation, a spouse's participation can be taken into account. Limited partners are conclusively presumed not to materially participate in the partnership's activity.

Rental activities are generally considered passive. However, there are two significant exceptions to this rule (see "Rental Real Estate" below).

A working interest in an oil or gas property is not treated as a passive activity, regardless of whether the owner materially participates, unless liability is limited (such as in the case of a limited partner or S corporation shareholder).

**Planning Suggestion:** Avoid investments producing passive losses unless there is an overriding economic reason to make the investment. If you already have such investments, consider acquiring an investment that generates passive income. If you own a corporation other than an S corporation or personal service corporation, consider transferring investments that generate passive losses to the corporation. The corporation can deduct passive losses against its active business income, but not against its dividends, interest, or other portfolio income.

## RENTAL REAL ESTATE

For real estate professionals, rental real estate activities are not subject to the passive loss rules if, during a taxable year:

- More than 50 percent of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours are spent in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests must be satisfied by the same spouse.

Services performed as an employee are ignored unless the employee owns more than five percent of the employer.

A closely-held C corporation that is generally subject to the passive loss rules will satisfy these tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates. Real property businesses are those involving real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

For non-real estate professionals, another exception to the passive loss limitations exists for rental real estate activities in which the taxpayer

"actively" participates. This requires the taxpayer to own at least a ten-percent interest in the activity. If the taxpayer actively participates in the activity, the taxpayer can offset up to \$25,000 of losses and credits from the activity against non-passive income.

Active participation does not require regular, continuous, and substantial involvement in operations as long as the taxpayer participates in a significant and bona fide way by, for example:

- Arranging for others to provide services such as cleaning; or
- Making management decisions, which include approving new tenants, deciding rental terms, and approving repairs and capital expenditures.

The \$25,000 allowance begins to phase out when the taxpayer's AGI exceeds \$100,000 and is completely eliminated when AGI reaches \$150,000. In that event, the regular passive loss rules determine the amount of any deductible loss. The \$25,000 allowance and AGI thresholds are cut in half for a married taxpayer who files separately and does not live with his or her spouse. However, there is no \$25,000 allowance if a married individual files separately and lives with his or her spouse at any time during the taxable year.

**Planning Suggestion:** If your AGI is approaching \$100,000, consider shifting income to 2010 to obtain a full \$25,000 rental real estate loss for 2009. Consider filing a refund claim if rental real estate losses produce a net operating loss that may be carried back to prior taxable years.

If you think you may be affected by the passive loss rules, you should speak with your BDO Seidman or Alliance firm client service professional. In certain cases with proper planning, the adverse effect of these rules may be minimized.

## VACATION HOMES

Expenses of a rental property are deductible, even if they exceed gross rents and produce a loss. However, the current deduction of such a loss may be restricted due to the passive activity rules discussed above. A vacation home is treated as rental property if personal use during the year does not exceed the greater of:

- 14 days, or
- Ten percent of the number of days the home is rented at a fair rental value.

If personal use exceeds these limits, the property is considered to be a residence. In that event, the deductibility of expenses is limited, although property taxes, mortgage interest, and casualty losses can generally be deducted currently.

**Planning Suggestion:** If you rent your home for less than 15 days during the year, the total rental income you receive is not subject to income tax.

## DISPOSITION OF LEASEHOLD IMPROVEMENTS

When a lessor disposes of leasehold improvements upon termination of a lease, the lessor can generally write off the adjusted basis of those improvements.

**Planning Suggestion:** If you have leases terminating early in 2010 where there is substantial remaining basis in the leasehold improvements, it may make sense to provide the lessees with an incentive to leave before the end of 2009 so that you can write off the remaining basis in the applicable leasehold improvements before the end of 2009.

## ▶ ALTERNATIVE MINIMUM TAX

A taxpayer must pay either the regular income tax or the AMT, whichever is higher. The AMT is imposed at a flat 26-percent rate on alternative minimum taxable income ("AMTI") up to \$175,000 (\$87,500 for a married individual filing separately) and 28 percent over these amounts. Residents in states with higher income taxes (for example, California, Connecticut, Minnesota, and New York) are particularly susceptible to the AMT because these taxpayers lose their state income tax deduction when calculating their AMT liability.

The following exemptions apply for the AMT.

Filing Status	Exemption Amount
Married filing jointly or for a surviving spouse	\$ 70,950
Single or head of household	\$ 46,700
Married filing separately	\$ 35,475

AMT paid on "timing" preferences and adjustments (such as accelerated depreciation) for prior years is allowed as a credit against a later year's regular income tax to the extent it exceeds the later year's tentative AMT. Therefore, this AMT credit cannot reduce the regular income tax below the AMT for that later year.

Generally, nonrefundable personal credits (such as dependent care, elderly and disabled, and education) are allowed only to the extent regular tax liability exceeds the tentative minimum tax, essentially disallowing these credits against AMT. Temporary provisions previously enacted permitting these credits to offset the entire regular and AMT liability have been extended to taxable years beginning in 2009.

**Example:** T's 2008 AMT attributable to timing preferences was \$80,000. T's 2009 regular tax is \$100,000, and T's tentative AMT is \$70,000. T may reduce the regular tax by \$30,000. Generally, T's remaining AMT credit of \$50,000 (\$80,000 less \$30,000) may be carried forward indefinitely. No carryback is permitted.

**Planning Suggestion:** In computing the AMT, a taxpayer may claim depreciation for property placed in service in 2001 and thereafter, using the 150-percent declining balance method (switching to straight-line) and using the same recovery periods as regular tax. This may justify a major acquisition of property before the end of 2009.

A full discussion of the AMT is beyond the scope of this letter. AMT considerations are exceedingly complex and require careful planning. Please consult your BDO Seidman or Alliance firm client service

professional prior to year-end to discuss how the AMT might affect you.

## ▶ STOCK OPTIONS

### INCENTIVE STOCK OPTIONS

An incentive stock option ("ISO") is an option issued to an employee that allows all gains to be subject to long-term capital gain treatment (15-percent maximum federal tax rate) if the taxpayer disposes of the option shares more than two years after the date the option is granted and more than one year after the date the option shares are purchased. Also, the employee must continue to be an employee until at least three months before the option is exercised. If these rules are not met, the gains from ISOs are ordinary income subject to federal tax rates as high as 35 percent.

However, there is a hidden cost to obtaining long-term capital gain treatment from an ISO. The "spread" (the difference between the fair market value of the shares on the purchase date and the option price paid for the shares) must be added into the taxpayer's AMT calculation for the year the options are exercised. Any AMT attributable to the ISO spread generally is allowed as an AMT credit carryforward to offset regular taxes owed in future years. Thus, any AMT attributable to the ISO is effectively a prepayment of tax, not additional tax.

The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 amended the AMT provisions to provide relief to those taxpayers with AMT attributable to the ISO adjustment. Any underpayment of tax that is outstanding as of October 3, 2008, resulting from such an adjustment, and any interest and penalty associated with such underpayment, will be abated. For those taxpayers who have paid the AMT on ISOs there will be no abatement or refund. Those taxpayers are provided relief in the computation of their minimum tax credit.

**Planning Suggestion:** If you are planning to exercise ISOs before December 31, 2009, consider deferring the exercise until after that date and sometime before April 15, 2010. Any AMT on such exercise would likely not be due until April 15, 2011, after the required one-year holding period for the stock has been met. At that time the option shares can be sold at long-term capital gains rates, with a portion of the proceeds used to pay the 2010 AMT liability.

If you have exercised an ISO in 2009 and the value of the stock has decreased, consider a sale before the end of 2009. This should reduce the AMT effect. The sale must be to a non-family member and the stock cannot be repurchased for at least 30 days.

### NONQUALIFIED STOCK OPTIONS

When a taxpayer exercises a non-qualified stock option ("NQSO") that does not have a readily ascertainable fair market value at the time of issuance (generally the case where the option or the option stock is not publicly traded), the spread (the difference between the stock's fair market value and option price) is taxed as compensation income. When the taxpayer sells the NQSO stock, any subsequent appreciation is taxed as long- or short-term capital gain depending upon the stock's holding period. Because the spread is taxed as ordinary income,

taxpayers in the highest marginal federal tax bracket are taxed at 35 percent on the spread.

**Planning Suggestion:** If a taxpayer expects to be subject to AMT for 2009 and no AMT credit carryforward is expected, the taxpayer should consider exercising NQSOs. The accelerated ordinary income may be taxed at a maximum federal rate of 28 percent as opposed to 35 percent. In addition, all future appreciation is capital gain. When making this decision, the potential tax savings should be compared to the opportunity cost of accelerating the income taking into account the time value of money.

## ▶ CHILDREN'S TAXES

Unearned income of a child under age 18, exceeding \$1,800 for 2009, is taxed at the parents' top rate rather than at the child's rate ("kiddie tax"). Earned (compensation) income received by a child under age 18 (for years prior to 2006 the age was 14) is taxed at the child's rate.

For 2009, the kiddie tax will also apply to full-time students who have not attained the age of 24 by the end of the taxable year and non-full-time students who have not attained the age of 19 by the end of the taxable year, but in either case, only if the child's earned income does not exceed one-half of the amount of the child's support.

A child with earned income may claim a standard deduction up to \$5,700 and may be eligible for the \$5,000 deductible IRA contribution. Therefore, the child may earn \$10,700 without paying federal income tax. The child should also consider a contribution to a nondeductible Roth IRA.

**Planning Suggestion:** If you own a business, consider hiring and paying a salary to your child. This income will be taxed at the child's rates, and the payment will be deductible by your business. This technique can be used to fund a college education. Of course, the child must perform services to earn the compensation, and the compensation must be reasonable for the services provided.

If the child is 18 or over, this compensation will be subject to social security tax. It will also be subject to federal unemployment insurance tax if the child is 21 or older. The child's compensation could also be subject to state and local income and payroll taxes.

A child under age 18 is not required to file a tax return if the child only has interest and dividend income up to \$950, has not made estimated payments and is not subject to backup withholding. However, the parents must include the child's income exceeding \$1,900 on their tax return.

**CAUTION:** A child under 18 who has capital gains or earned income must file his or her own tax return. Estimated taxes may have to be paid during the year if withholding taxes are not sufficient to cover the child's tax liability.

A child who can be claimed as a dependent on his or her parents' return cannot claim an exemption on his or her own return. However, the child is allowed a standard deduction equal to \$950 or the amount of the child's earned income up to \$5,700, whichever is greater.

If the child is age 18 or older (24 or older if a full-time student, but only if the child's earned income does not exceed one-half of the child's support), income exceeding the standard deduction or itemized deductions will be taxed at the child's rates.

**Planning Suggestion:** Consider making gifts of growth stock or Series EE bonds (which can defer taxation of the interest until maturity) to a child under age 18 (or 24, if appropriate). These investments can be converted to investments producing current income after the child reaches 18 (or 24, if appropriate). The resulting income will be taxed at the child's rates rather than the parents' top rate. Further, parents in the higher tax brackets should consider making gifts of income-producing property to a child who is 18 (or 24, if appropriate) or older to take advantage of the child's lower tax bracket (see "Year-End Gifts" on page 16).

**Reminder:** Your income tax return must report social security numbers for all children whom you claim as dependents. A social security number can be obtained by filing an application on Form SS-5 with your local Social Security Administration office.

If you claim a dependent care credit, you must report the service provider's social security or employer identification number on your tax return. You should use IRS Form W-10 to obtain this number from the provider.

## ▶ ADOPTION EXPENSES

Up to \$12,150 for 2009 of eligible adoption expenses are allowed to be claimed as a nonrefundable credit. The credit limitation is the same for special-needs children (children that cannot or should not be returned to the home of the birth parents because of specific factors, or who could not otherwise be adopted because of certain conditions). The credit is per adoption, not per year. Thus, if a person adopts two children in 2009 and incurs \$25,000 of qualified expenses, the credit limitation is \$24,300. The adoption credit is phased out for higher income individuals with modified AGI between \$182,180 and \$222,180. The credit is allowed against AMT.

## ▶ NANNY TAX REPORTING

If you paid \$1,700 or more to a person 18 or over for household services during 2009, you are required to report his or her social security and federal unemployment taxes on your personal tax return. These amounts are reported on Schedule H.

These employment taxes must be paid by the due date of the return, April 15, 2010, without extensions. Since these taxes are part of your income tax liability, your estimated taxes or withholding must be sufficient to cover them.

**Planning Suggestion:** Because the \$1,700 amount applies to each household employee, if possible, try to keep payments to each person below \$1,700 per year. You can also give your household employee up to \$120 per month for expenses to commute by public transportation without this amount counting towards the \$1,700 threshold or being included in the employee's gross income.

**CAUTION:** Payments to household employees may also be subject to state unemployment and other state taxes.

## ▶ ESTIMATED TAXES

Generally, all individuals must make quarterly estimated tax payments if they have income that is not subject to withholding. This includes individuals who are self-employed or retired or who have investment income, such as interest, dividends, and capital gains. It also includes partners and S corporation shareholders.

The law provides several safe harbors for determining the minimum estimated tax that must be paid to avoid penalties. In 2009, the safe harbor percentage remains 100 percent of the 2008 tax for individuals with 2008 AGI under \$150,000 (\$75,000 for married filing separately), but increases to 110 percent of the 2008 tax liability for individuals with 2008 AGI over those amounts. In the converse situation where an individual expects 2009 income to be lower than 2008 income, the individual can avoid penalties by paying estimated taxes for 2009 in an amount equal to at least 90 percent of projected 2009 tax liability.

**Planning Suggestion:** Deferring a large gain from December 2009 to January 2010 may postpone all or a portion of the federal tax payment on that gain to April 15, 2011. Unless you are subject to AMT, it may be beneficial to pay estimated state income taxes on a 2009 gain prior to the end of 2009 in order to obtain an itemized deduction on your federal 2009 return.

Two other safe harbor exceptions are available to eliminate penalties for insufficient payments of estimated taxes. No penalty will be imposed for underpayment of estimated taxes if the unpaid tax liability for the year (after taking into account any withholding) is less than \$1,000. In addition, if your income varies throughout the year, you may use an annualized installment method to reduce or eliminate potential penalties.

The same rules apply to certain estates and trusts.

**Planning Suggestion:** If you have underpaid an installment of 2009 estimated taxes, increasing a later installment will not completely eliminate the underpayment penalty. However, increased withholding on year-end salary or bonus payments may be used to make up the underpayment. That is because withholding on compensation is deemed paid evenly over all quarters of the year.

**Note:** Voluntary withholding of income taxes from social security payments and certain other federal payments is permitted. This withholding may eliminate the need to file quarterly estimated payments for certain retired persons.

## ▶ YEAR-END GIFTS

The end of the year is the traditional time for making gifts. For 2009, you may give up to \$13,000 to a person without incurring any federal gift tax liability. The \$13,000 annual limit applies to each donee. Thus, you may make \$13,000 gifts to as many people as you like. If you are married, you and your spouse can give \$26,000 to each person, if your spouse consents to splitting the gift or if you give community property. To qualify for this annual exclusion, the property must be given outright to the donee or put into a trust that meets certain conditions.

In addition to the annual exclusion, the lifetime unified gift tax credit allows each person to transfer \$1 million for 2009 by gift without incurring any gift tax liability. Using this credit now will keep future appreciation on the transferred property out of your estate. However, using the lifetime credit against 2009 gifts reduces the credit available for future years.

In addition to gifts subject to the annual exclusion and the lifetime credit, direct payments of tuition made on another person's behalf to a university or other qualified educational organization are also excluded from gift tax, as are direct payments of medical expenses to a medical care provider.

**Note:** You should consider using appreciated property in making gifts. If the recipients are in lower income tax brackets than you, income from the transferred property, including any gain on sale, will be taxed at lower rates.

**Planning Suggestion:** It is generally unwise to give property that has declined in value. Rather, you should sell the property and realize the tax benefits of the loss.

All outright gifts to a spouse (who is a United States citizen) are free of federal gift tax. However, only the first \$133,000 of gifts to a spouse who is not a United States citizen are excluded in the total amount of taxable gifts for 2009.

You should coordinate your year-end gift giving with your overall estate planning. Your BDO Seidman or Alliance firm client service professional can assist you with these matters.

## ▶ CONCLUSION

An annual physical examination is important for maintaining good health. Likewise, an annual financial examination that includes year-end tax planning can enhance your financial well-being. Your BDO Seidman or Alliance firm client service professional is available to help you achieve your tax and financial objectives.

## TAX PROVISIONS RELATING TO HIGHER EDUCATION COSTS

The Taxpayer Relief Act of 1997 and the Economic Growth and Tax Relief Reconciliation Act of 2001 added several provisions to the federal tax law to help moderate-income individuals and families save and pay for higher education costs. These provisions are as follows:

Provision	AGI Limitation Single/Joint	Description
Hope Scholarship Credit	\$60,000/\$120,000	Tax credit of up to \$1,800 per student for each of the first two years of college
Lifetime Learning Credit	\$60,000/\$120,000	Tax credit of up to \$2,000 per taxpayer for university juniors, seniors and graduate students
Higher education expense deduction	\$65,000/\$130,000	Above-the-line deduction for qualified higher education expenses up to \$4,000 with adjustments
Education IRAs	\$110,000/\$220,000	Income exemption for accumulated earnings from annual nondeductible contributions of \$2,000 per beneficiary used to pay for higher education expenses
Regular IRAs	Unlimited	Penalty-free distributions from regular IRAs used to pay higher education expenses
Education loans	\$75,000/\$150,000	Limited above-the-line deduction for interest on qualified education loans
State tuition programs	Unlimited	Earnings accumulated from contributions to qualified state tuition programs distributed
Student loan cancellations	Unlimited	Exclusion for student loan cancellations by tax-exempt organizations in prescribed situations

Individual taxpayers may claim an income tax credit equal to the sum of the Hope Scholarship Credit (up to \$1,800 for 2009 per student) and the Lifetime Learning Credit (per taxpayer, up to \$2,000), for higher education expenses at accredited post-secondary educational institutions paid for themselves, their spouses and their dependents. For 2009, these credits are reduced ratably at modified AGI between \$100,000 and \$120,000 on joint returns, and between \$50,000 and \$60,000 on other returns. Both credits cannot be claimed in the same year with respect to any one student. Neither credit is available for married taxpayers who file separate returns.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your individual needs

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