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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS *Alert*™

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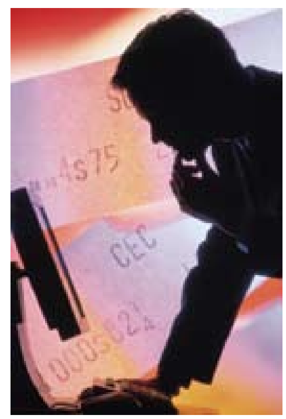
Year-end Tax Planning for a Volatile Stock Market

For many investors, this has been a frustrating year with various market sectors adversely shaped by record energy costs, a volatile housing finance market, and government intervention. As we look toward year-end, unless market conditions change dramatically, many of us will see a year-to-date decline in our investment portfolio. But, there may be a way to turn some of those underperforming stocks into tax-saving write-offs.

First, taxpayers are generally allowed to offset capital gains and losses from investment (e.g., stock) sales to arrive at a net capital gain or loss figure for tax computation purposes. If you have already generated sufficient stock sale losses this year to offset your stock sale gains, you have likely eliminated the tax bill on those gains.

Next, let's look at "harvesting" some capital losses to generate additional tax savings. When taxpayers have a net capital loss (capital losses exceeding capital gains), the IRS allows them to offset up to \$3,000 (\$1,500 if married filing separate returns) of those losses against income from other sources (e.g., wages). This \$3,000 write-off could generate up to \$1,050 (\$3,000 × 35%) in tax savings for someone in the highest tax bracket. So, if you have up to \$3,000 in excess capital losses from investment sales and the ordinary taxable income from other sources (e.g., wages) to offset it, you are already in line to save some tax dollars. If not, consider selling some of those underperforming stocks that have taken up residence in your portfolio, generate up to \$3,000 in excess capital losses, and consider the resulting tax saving an early holiday gift from the IRS.



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Finally, what about unfortunate taxpayers who have sufficient capital losses to offset their capital gains and the \$3,000 of income from other sources, but have additional net capital losses remaining? Taxpayers in this situation might consider selling profitable positions in their portfolio to offset those remaining net capital losses and eliminate or reduce any tax due from the profitable sales transactions. If they decide not to sell a profitable position or positions to offset losses in excess of \$3,000, those excess losses can be carried forward indefinitely to future years.

But, you might be thinking, "Not so fast with the selling. I'm a long-term investor. I'll just hold on

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Taxpayer Scores Major Court Victory

During the past few years, several mutual insurance companies, companies owned by their policy holders, have converted to stockholder-owned companies by issuing stock directly to their policy holders who, in turn, forfeited any rights to the company's accumulated capital. This process is referred to as a demutualization. The IRS has always attributed a zero cost basis to stock received in a demutualization and required that stockholders recognize the entire proceeds as taxable income if they sold their stock (i.e., no portion was allocated to a tax-free return of capital). Taxpayer attempts to attribute a cost basis to stock received in a demutualization and, thereby, decrease their taxable gain, have failed.


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However, in a recent U.S. Court of Federal Claims trial, a taxpayer took on the IRS to obtain a refund of taxes previously paid when stock received in an insurance company demutualization was sold. The taxpayer claimed there was a cost basis in the insurance company stock derived from premiums paid over several years. The IRS, however, stuck with its standard policy, allocated a zero basis to the taxpayer's stock, and denied the refund claim. Thus, according to the IRS, the proceeds received from the stock sale were 100% profit.

The Court of Claims agreed with the taxpayer's valuation expert, concluding the amount received by the taxpayer from the sale of the insurance company stock was actually less than the cost basis. Therefore, the taxpayer did not realize any taxable income on the sale of the stock in question, but only a return of cost basis, and was entitled to the requested full refund of the taxes previously paid.

Although it's too early to assess the long-term ramifications of this decision and what the IRS might do going forward, it could have a positive impact for numerous taxpayers in similar situations.

White-Collar Crime Detection

The FBI maintains a website at *www.fbi.gov/whitecollarcrime.htm* to assist those interested in learning how to deter or detect white-collar crime. The FBI states on the website: "Today's con artists are more savvy and sophisticated than ever, engineering everything from slick online scams to complex stock and healthcare frauds. Here you can learn more about the many white-collar crimes we investigate, how to protect yourself from common scams, and what to do if you think you've been victimized."

Individuals and business owners alike can benefit from information on major programs and interesting cases available on this website.

Year-end Tax Planning

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and wait for a healthier stock market." That's fine, but you might consider selling some stocks now to generate a current tax saving, and then buying them back at a future date to maintain your profit potential. Just don't forget about the wash-sale rules, which disallow loss recognition if you repurchase the same stock within 30 days of the sale. If you are concerned that the stock you sell might make a rapid comeback before the 30-day wash sale period expires, consider purchasing, concurrently with the sale transaction, the stock of another company or an exchange traded fund (ETF) in the same industry sector to maintain your profit potential.

In summary, a year-end review of your investment portfolio might not be all that thrilling, but it could result in current tax savings, increased investment returns in the long run, and the opportunity to make the best of a bad situation.

Year-end Tax Planning Strategies for Individuals and Business Owners

As we approach year-end, there is still time to take action to lower your 2008 tax bill and add to your tax-advantaged retirement accounts. Listed below are a few ideas to get you started. This is by no means an exhaustive list, so please contact us for additional ideas.

Make the Standard Deduction Work for You. If your itemized deductions are just at or below the standard deduction (currently $10,900 for joint filers and $5,450 for singles), they don't generate any tax benefit for you. However, you can bunch itemized deductions from two calendar years into a single tax year to take full advantage of them and exceed the standard deduction that year. Then you can take the standard deduction the next year. Following this two-year pattern results in greater deductions overall. Deductions that work well for this strategy include charitable contributions, property taxes, the fourth quarter estimated state income tax payment, and your January mortgage payment.

Consider Selling Appreciated Securities. It may be a good time to *consider* selling capital assets (e.g., common stock) with a low cost basis. The maximum capital gains tax rate is 15% for gains from the sale of qualifying assets held more than one year. In fact, taxpayers in the 10% and 15% ordinary tax brackets can take advantage of a 0% capital gains rate for the first time in 2008. The 15% maximum tax rate is available for both the regular and alternative minimum tax (AMT). In addition, *qualifying* dividends received during 2008 will generally be taxed at the 0% or 15% capital gain rates.

Contribute to Your IRA. You can contribute up to $5,000 ($6,000 if you are age 50 or older by year-end) to your IRA in 2008 if certain conditions are met. For married couples, the combined contribution limits are $10,000 ($5,000 each) and $12,000 ($6,000 each if both are age 50 by year-end) when a joint return is filed, provided one or both spouses had at least that much earned income. In addition, contributions to traditional IRAs may be tax deductible subject to specific conditions and limitations.

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Contribute to Your Employer-Sponsored Retirement Plan. The 2008 annual deferral limit for qualified retirement plans is $15,500. If you are at least age 50 by year-end, you can contribute an additional $5,000 to 401(k), 403(b), and 457 plans. These contributions normally decrease your taxable income and the income taxes thereon.

50% Bonus Depreciation. Thanks to recent legislation, qualifying equipment, which includes most tangible personal property and software and certain leasehold improvements acquired and placed in use during 2008, is eligible for an immediate 50% bonus depreciation deduction. This is in addition to the normal depreciation deduction on the remaining balance.

Section 179 Expensing Option. For eligible business property, the Section 179 (election to expense otherwise depreciable assets) limit was recently increased to $250,000 for tax years beginning in 2008 only. However, the Section 179 deduction phases out, dollar-for-dollar, after eligible equipment purchases reach $800,000 for the same period. So, the $250,000 deduction is completely phased-out when eligible equipment purchases total $1,050,000.

Take Advantage of the $8,000 Additional Qualified Vehicle Deduction. Qualified vehicles acquired and placed in service during calendar year 2008 only are eligible for an increased depreciation deduction of up to $8,000. This deduction is in addition to the normal maximum of $2,960 for qualified automobiles and $3,160 for qualified trucks or vans.

Retaining Key Employees

Unless you have capable successors and employees, your closely held business may not survive your departure if key employees leave instead of adapting to the new owners and management. Therefore, a business succession plan should be in place and contain strategies to identify, retain, and reward key employees.

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There are numerous methods for retaining and rewarding a key employee's commitment, loyalty, and hard work. The most effective incentives are usually monetary and include, but are not restricted to, the following types of incentives.

Incentive Stock Options. Incentive Stock Options (ISOs) can provide key employees additional compensation through the opportunity to share in the appreciation of the company's stock value. ISOs are usually granted to the employee at no cost with an exercise price at or above the stock's current market price; however, they might have alternative minimum tax implications.

Nonqualified Stock Option. A nonqualified stock option (NQSO) is an option that specifically states it is an NQSO or one that does not meet the requirements of an ISO. Like an ISO, you can use an NQSO to provide key employees additional compensation through the opportunity to share in the appreciation of the company's stock value.

Restricted Stock. A restricted stock plan transfers stock to an employee subject to certain restrictions. Often, the shares are transferred to the employee at little or no cost, but are subject to forfeiture if the employee fails to fulfill the terms of the plan. A common restriction requires employees to forfeit their shares if they terminate employment within a certain number of years.

Stock Appreciation Right (SAR). A stock appreciation right (SAR) is the right to receive compensation based on the increase in value of a specified number of the employer's shares of stock. When an SAR is exercised, the company usually pays the employee cash equal to the stock's appreciation, although payment can be made in shares equal in value to the appreciation. Because the employee does not have to spend any cash to benefit from the plan, he or she may prefer an SAR to a stock option, which often requires cash to exercise. However, the employee does not receive any dividends paid on the company's outstanding shares with an SAR.

Please contact us to discuss the characteristics and tax aspects of these plans.