

Dear Valued Client:

As the end of the year approaches, it is a good time to think of planning moves that will help lower your tax bill this year and possibly the next. Factors that compound the challenge include the stock market's swoon, the difficult economic climate we're in right now, and the strong possibility that there will be tax changes in the works next year. In fact, there might even be another economic stimulus package carrying tax changes enacted before the end of this year.

The indisputably good news we are certain of is that Congress has acted to "patch" the AMT problem for 2008, has retroactively reinstated a number of tax breaks, and has created new tax breaks that go into effect for the 2008 tax year (including a tax credit for first-time homebuyers, a non-itemizers' deduction for state and local property tax and a non-itemizers' deduction for certain disaster losses).

Retroactively reinstated and extended tax breaks: All of the following tax breaks had expired at the end of last year. The new law retroactively resuscitates them so that they apply for 2008, and also extends them for one year so that they will apply for 2009 as well:

- The option to claim an itemized deduction for state and local general sales taxes instead of the itemized deduction for state and local income taxes.
- The above-the-line deduction for qualified tuition and related expenses for higher education paid during the tax year.
- The up-to-\$250 eligible educator's above-the-line deduction for books, supplies, computer equipment, etc., used by him or her in the classroom.
- The up-to-\$100,000 annual exclusion from gross income for taxpayers age 70 1/2 or older who make direct transfers of otherwise taxable individual retirement account (IRA) distributions to qualified charitable organizations.

We have compiled a checklist of actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your particular situation, but you will likely benefit from many of them. We can narrow down the specific actions that you can take once we meet with you to tailor a particular plan. In the meantime, please review the following list and contact us at your earliest convenience so that we can advise you on which tax-saving moves to make:

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Don't forget you can set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.
- If you become eligible to make health savings account (HSA) contributions in December of this year, you can make a full year's worth of deductible HSA contributions for 2008.
- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, and then buy back the same securities at least 31 days later. It may be advisable for us to meet to discuss year-end trades you should consider making.

Larry D. Smith, C.P.A.
Mark D. Scheaffer, C.P.A.
Bryan W. Whisler, C.P.A.
William H. Kelley, C.P.A., ret.
William L. Hardesty, C.P.A., ret

Members

American Institute
of Certified Public
Accountants
Private Companies
Practice Section

Indiana CPA Society

Address

5240 Elmwood Avenue
Indianapolis, Indiana
46203-5990

Telephone

317.788.1571

Facsimile

317.787.3082

Email

khs@khscpa.com

Website

kelleyhardestysmithandco.com

- Postpone income until 2009 and accelerate deductions into 2008 to lower your 2008 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax breaks for 2008 that are phased out over varying levels of adjusted gross income (AGI). These include IRA and Roth IRA contributions, conversions of regular IRAs to Roth IRAs, child credits, higher education tax credits, the above-the-line deduction for higher-education expenses, and deductions for student loan interest. Postponing income also is desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may pay to actually accelerate income into 2008. For example, this may be the case where a person's marginal tax rate is much lower this year than it will be next year.
- If you believe a Roth IRA is better than a traditional IRA, and want to remain in the market for the long term, consider converting traditional-IRA money invested in beaten-down stocks (or mutual funds) into Roth IRAs if eligible to do so. Keep in mind, however, that such a conversion will increase your adjusted gross income for 2008.
- It may be advantageous to try to arrange with your employer to defer a bonus that may be coming your way until 2009.
- If you own an interest in a partnership or S corporation you may need to increase your basis in the entity so you can deduct a loss from it for this year.
- Consider using a credit card to prepay expenses that can generate deductions for this year.
- If you expect to owe state and local income taxes when you file your return next year, ask your employer to increase withholding of state and local taxes (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2008.
- Those facing a penalty for underpayment of federal estimated tax may be able to eliminate or reduce it by increasing their withholding.
- You may be able to save taxes this year and next by applying a bunching strategy to "miscellaneous" itemized deductions, medical expenses and other itemized deductions.
- Estimate the effect of any year-end planning moves on the alternative minimum tax (AMT) for 2008, keeping in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. This includes the deduction for state property taxes on your residence, state income taxes (or state sales tax if you elect this deduction option), miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as for medical expenses, are calculated in a more restrictive way for AMT purposes than for regular tax purposes. As a result, in some cases, deductions should be deferred rather than accelerated to keep them from being lost because of the AMT.
- If you are thinking of making energy saving improvements to your home, such as putting in extra insulation or installing energy saving windows, postpone your move until 2009. A credit of up to \$500 may be available for such improvements if made next year (but not this year).
- Substantial tax credits are available for installing energy generating equipment (such as solar electric panels or solar hot water heaters) to your home. The credits are available whether you spend the money this year or

next, but if you're installing solar electric property, and will be spending more than \$6,667, the credit will be larger for expenses made in 2009 rather than 2008.

- If you are thinking of buying a hybrid vehicle eligible for a tax credit, check to see if it's eligible for the credit, and, if so, purchase it before year-end.
- You may want to pay contested taxes to be able to deduct them this year while continuing to contest them next year.
- You may want to settle an insurance or damage claim in order to maximize your casualty loss deduction this year.
- If you are self-employed and haven't done so yet, set up a self-employed retirement plan.
- You can save gift and estate taxes by making gifts sheltered by the annual gift tax exclusion before the end of the year. You can give \$12,000 in 2008 to an unlimited number of individuals but you can't carry over unused exclusions from one year to the next.
- If you're thinking of donating a used auto to charity, you may want to inquire whether the charity plans to sell the car or use it in its charitable activities; the latter may yield a bigger deduction for you.
- If you are age 70½ or older, own IRAs (or Roth IRAs), and are thinking of making a charitable gift before year-end, consider arranging for the gift to be made directly by the IRA trustee. Such a transfer can achieve important tax savings.
- If you are receiving Social Security benefits, there are a number of steps you can take to reduce or eliminate tax on your benefits.
- Consider extending your subscriptions to professional journals, paying union or professional dues, enrolling in (and paying tuition for) job-related courses, etc., to bunch into 2008 miscellaneous itemized deductions subject to the 2%-of-AGI floor.
- Depending on your particular situation, you may also want to consider deferring a debt-cancellation event until 2009, electing to deduct investment interest against capital gains, and disposing of a passive activity to allow you to deduct suspended losses.

These are just some of the year-end steps that can be taken to save taxes. Again, by contacting us, we can tailor a particular plan that will work best for you.

Very truly yours,

Kelley Hardesty Smith and Co.

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