Year-End Tax Alert

2008 Year-End Tax Planning – Changes in Tax Laws Require Changes in Strategies

2008 represents a very unique year in terms of federal and state tax law changes. The federal "Rescue Package" passed during September provided approximately $150 billion of tax incentives for a wide variety of taxpayers and industries. California's budget crisis resulted in a less business-friendly result – and California taxpayers are faced with over $5 billion of new taxes, suspended tax breaks (including suspension of NOL deductions and limits on tax credit utilization for 2008 and 2009) and accelerated tax deposit requirements.

In addition to the many federal and state tax changes that are already effective for 2008, taxpayers can expect numerous additional changes as a result of President-elect Obama taking office in January and the California Legislators reconvening to address new state budget challenges.

President-elect Obama is expected to increase tax rates on wages and other ordinary income to 39.6% or higher, capital gains rates to 20% or more and possible increases in payroll and retirement plan taxes.

Governor Schwarzenegger has announced a number of California tax proposals, including a 1.5% increase in the sales tax rate, expanding sales tax to certain services, an increase in the oil severance tax, an increase in alcohol and other excise taxes, and a potential three-fold increase in auto license fees.

These current proposed changes will require business owners and higher income employees to more carefully plan for both 2008 and 2009 in order to minimize overall taxes.

Following are a number of suggested tax panning ideas for businesses and employees.

Business Planning:

Profitable Businesses:

Deferring Income: If your business uses the ***cash method of accounting***, you may be able to defer billing for your products or services. Or, if you use the ***accrual method***, you can delay shipping products or delivering services (provided that's acceptable to the client) until the beginning of the 2009 tax year. You can also make year-end shipments "FOB destination", rather than FOB shipping point, to delay the transfer of title until next year; however, you must weigh certain legal and insurance issues.

Accelerate Depreciation: Determine whether your purchases may be eligible for Section 179 expensing (up to $250,000 in the year the asset is placed in service) and/or 50% bonus depreciation. If you have recently purchased or built a building or remodeled an existing space, consider a cost segregation study. Both ***accrual and cash basis*** taxpayers can secure large first year deductions with minimal cash outlay.

Cash Basis Expense Acceleration: Accelerate certain deductible expenses for your **cash basis** business into the current year by charging deductible business expenses on credit cards (not store revolving charge accounts) or cutting checks before year-end. That way, you'll create 2008 tax write-offs even though the actual credit card bills won't be paid until 2009.

Accrued Expense Acceleration: If you report on the ***accrual basis***, you have more freedom to accelerate deductions into current year. Look at deducting bonuses and vacation pay that you don't plan on paying

until early next year (within the first 2½ months of 2009) provided the employees do not own greater-than-50% interest in the business for C Corps. Accrued bonuses for any shareholder of an S Corp cannot be deducted until paid.

Inventory Write-offs: Depending on your accounting methods, you should check inventory for goods that have been damaged or become obsolete. The drop in market value of the inventory can provide your company with additional current-year deductions.

Review business bad debts: A general reserve for bad debts is not deductible, but ***accrual basis*** taxpayers can write off accounts receivable in the year in which they become uncollectible. Take advantage of writing off all or a portion of accounts at year-end to generate deductible losses.

Distribute Corporate Earnings: If you operate a profitable C corporation, with the threatened increase in dividend and capital gain rates to 20% or more (from the current 15%), you may want to consider distributing a portion of the accumulated earnings (E&P) by year-end.

Contribute to a retirement plan: Adopt or increase funding of "qualified retirement plans". Both **accrual and cash basis** taxpayers can obtain 2008 tax deductions for retirement plan contributions made by the extended due date for the return. Contribution limits vary by type of plan.

Charitable Contributions of Inventory and Computers: Any business can take advantage of an enhanced charitable deduction (greater of 50% of fair market value or cost basis) for contributions of food and inventory to qualified charities. Through 2009, C Corps can claim enhanced charitable deductions for donations of educational books to public schools. They can also claim these deductions for donations of computer equipment, including software, to certain schools and public libraries. Generally, contribution deductions up to 10% of taxable income can be claimed; however, this limit is removed for contributions made to charities assisting 2008 Midwest Flood victims.

Cash-Strapped Businesses:

Net Operating Loss: While losses are usually undesirable, they are a fact of life for many businesses this year. Tax losses can be useful for tax planning purposes. Net Operating Losses (NOLs) may be carried back two years to generate a current tax refund, which can provide the business with a cash infusion in times of loss. Any loss not absorbed in the prior two-year period is then carried forward for up to 20 years. California will not allow tax loss carrybacks until 2011. Note that California has temporarily suspended the use of business NOL carryovers from prior years to the 2008 and 2009 tax years.

Quick Refund of Estimated Tax Payments: Instead of having to wait until the 2008 corporate tax return is filed (in mid-to-late 2009) to receive a refund, corporations can apply for a "quick" refund by filing IRS Form 4466 with the IRS immediately after the close of the tax year. The IRS is required to act upon a refund application filed this way within 45 days from the date of filing.

Check Your Stock and Debt Basis on Pass-Thru Entities: If your pass- thru entity is anticipating a tax loss this year, the loss will not be deductible on your personal return unless you have adequate basis in your S Corp stock, LLC or Partnership interest. If you do not have sufficient basis, you can make an additional capital contribution, or a loan (direct shareholder loan if S corporation), to the entity before the end of the entity's tax year to increase your basis.

Appreciated Assets: Corporations that are now expecting losses in a year that was originally thought to be profitable should also consider triggering gains on appreciated assets that the corporation no longer wants or needs. The current year losses can shelter these gains. Note for C Corporations, capital losses can be used to offset capital gains and, in addition, capital losses not used can first be carried back three years to offset prior year capital gains and generate additional refunds, if any. If not used, they can be carried forward five years. S Corp, Partnership and LLC gains and losses flow through to the equity owners.

Valuation Opportunities: The decline in the value of businesses and assets can allow for some valuable estate tax planning opportunities, in terms of moving assets around a family or into a Trust.

Hiring Credits: Virtually every business is entitled to claim hiring tax credits if they hire employees meeting certain demographic criteria. The federal Work Opportunity Tax Credit (up to $2,400/$4,800 per qualified employee) and Welfare-to-Work ($8,500 per qualified employee) programs are available to businesses operating in any state or industry. There are also over 8,500 distinct geographic regions that allow federal and state Location Based Incentive Credits (LBIC) ranging from $500 to $15,000 of hiring credits, as well as other incentives such as equipment credits, property tax breaks, sales tax breaks, and/or "tax holidays". Ninety percent of these credits are overlooked by taxpayers, but can have a significant impact.

Individual Planning:

Accelerating Deductions into the Current Year: If you're a ***cash basis*** taxpayer, consider making an estimated state tax payment before December 31, so you can deduct it this year rather than next year. But, be sure to consider the alternative minimum tax (AMT) consequences. On the other hand, if you expect to be in a higher income tax bracket next year, you may be better off accelerating income into the current year and deferring deductions into the next year. Prepayment of mortgage interest, real estate taxes, medical costs and business expenses can also result in large 2008 tax benefits. ***Charging on a credit card by December 31st will allow a 2008 write-off***.

Establishing a new Retirement Plan: Calendar year taxpayers wishing to establish a qualified retirement plan generally must adopt the plan no later than December 31, 2008. However, a SEP Plan may be established by the due date of the tax return (including extensions), and a SIMPLE plan must be established no later than October 1, 2009 to allow 2008 deductions. ***Payments can be made in 2009 and still result in a 2008 write-off.***

Bunching of Deductions: You may deduct more of your medical and miscellaneous itemized deductions by bunching two years of expenses into one year so you exceed the deduction floor (7.5% of AGI for medical) and 2.5% for miscellaneous itemized deductions. Please note that taxpayers subject to AMT may not benefit from this strategy.

Distributions From Pass-Through Entities: If your pass-through entity borrows money from the bank or other lender to make distributions to you and other co-owners, such distributions may be taxable if you violate the aforementioned tax basis rules. There may also be limitations placed on the deductibility of the interest expense paid by the entity on the debt. If you anticipate basis issues, it may be more beneficial to document the distributed amounts as loans to the equity owners and charge a reasonable rate of interest.

First-time home buyer's credit: This is available to home purchases after April 8, 2008 and before July 1, 2009. The credit is 10% of the purchase price or $7,500, whichever is less (for married people filing separate, this credit is reduced to $3,750). The credit begins to phase out at the $150,000 income level for joint filers ($75,000 for other filers). Those who buy their qualifying home in 2009 have the option of treating the purchase as having taken place on December 31, 2008, allowing them to file an amended return and apply the credit toward their 2008 tax liability, if they wish. Note that this credit has to be repaid, starting no later than the second year after the purchase, so the benefit is temporary.

Consider Accelerating Capital Gains: While the IRS taxes long-term capital gains at a relatively low rate of 15% or less, President-elect Obama proposes raising this rate to at least 20% for individual taxpayers making more than $200,000 a year and for couples making more than $250,000. If the capital gains stem from many years of real estate appreciation or from years spent growing a successful venture, these capital gains can be substantial. Accelerating gains into 2008 might be considered in order to either offset capital losses or take advantage of the current 15% federal rate. An installment sale may also offer reporting flexibility.

Harvesting Capital Losses: You should consider recognizing capital losses that you have in your taxable portfolios [vs. IRAs and 401(k)s] before year-end. You should meet with your financial advisor before year-end and decide which investments to sell in order to offset any gains you were lucky enough to

already recognize during 2008, or may still have in your portfolio. By matching capital losses and gains in the same year, or even generating losses in excess of your gains, your taxes will be minimized and you can repurchase stocks that had gains immediately. Loss stocks you sell and still like can be re-purchased after 30 days in order to avoid the "wash-sale" rules.

With most taxpayers having already realized significant capital losses from investments this year, and capital gain rates likely to increase in 2009 or 2010, business owners, real estate investors and other taxpayers with appreciated assets should evaluate the cost-benefits of accelerating these sales to lock into lower capital gain and ordinary tax rates. Depending on how the rate changes are implemented and specific effective dates, an installment sale structure of real estate or business entity sales may allow for both lower rates and deferral of income.

Donate Stock: Consider donating publicly traded stock that is showing appreciation. If you've held the stock for more than one year, you will be entitled to deduct not just your cost, but the full fair market value. If you sell the stock, pay tax and then make a cash contribution, you will end up being up to 20% to 25% worse off due to the taxes you pay on the gain.

Extract C Corporation Earnings and Profits: If you own a C corporation (or an S Corp that was previously a C Corp) with previously taxed profits retained inside the corporation, you might want to extract it now. If the corporation pays out these earnings and profits to you, you will pay a modest 15% qualified dividends tax rate on the dividends. The qualified dividends tax rate expires at the end of 2010, at which point the dividends from the C corporation earnings and profits will be taxed at your top marginal tax rate (may be 39.6% or higher).

Review your Estate Plan: With the decrease in asset values, this is an excellent time to evaluate your estate plan and consider gifting assets expected to appreciate in value in the future. Since the gift and estate tax is applied to fair market value at the date of gift (or death), today's low valuations of real estate, stocks, businesses and other assets will allow shifting of assets between family members, or other beneficiaries, at a lower overall tax rate.

Create a charitable remainder trust: Consider creating a charitable remainder trust to make a substantial gift to charity while retaining an income stream from the gifted property for life or a period of years. You can receive a current year deduction for a gift that will actually be made in the future. 2009 might offer more advantages with higher tax rates and relatively low interest rates for the short term.

The aforementioned tax planning ideas must be applied based on the specific facts of each taxpayer. It is recommended that a thorough tax analysis be conducted by mid-December to ensure that adequate time is allowed to pay down expenses, properly fund your business, and fine-tune your overall business and personal financial plans.

For more information, please do not hesitate to call Blake Christian, or one of our Tax Managers, at (562) 590-9535. An in-depth year-end planning guide for businesses and individuals can also be downloaded from our website at www.hcvt.com.