For release Monday, January 5, 2009

THE TAX ADVISER

ESTIMATED TAXES: ANOTHER DEADLINE COMING UP

Stay on top of the deadlines for filing federal tax returns and the due dates for making payments. Overlook just one, and you might be smacked with a sizable, nondeductible penalty.

Thursday, Jan. 15, 2009, is a key date for many taxpayers to remember. For individuals whose estimated income tax exceeds $1,000, that's the due date for the final quarterly installment of estimated income tax for 2008 — including any self-employment tax and alternative minimum tax. But it's okay to skip this final payment, provided they submit their 2008 returns and pay their tax in full by Monday, Feb. 2.

Who needs to make estimated payments? Individuals with income from sources not subject to withholding of taxes. This category mostly comprises self-employed individuals who operate businesses or professions as sole proprietorships, in partnerships with others, or as independent contractors, and investors who receive sizable amounts of interest, dividends and profits from sales of assets.

To avoid unnecessary payments, remember to take account of withholding during 2008 on what you or your spouse receive from salaries, wages and other types of compensation. Ditto for an overpayment of taxes in 2007 that you elect to apply to your 2008 bill.

The IRS can exact penalties for failing to pay sufficient tax during the year through withholding or quarterly payments, as well as for failure to pay required installments on time as they become due. It matters not that your final estimated payments are sufficient to erase any balance due when you submit your 2008 1040 form in 2009.

However, there are "safe harbors" or exceptions that excuse you from any penalties for underpayments of more than $1,000 for withheld or estimated taxes. For relief from these penalties, you must satisfy a two-step requirement:

First, make payments by the quarterly due dates — for 2008, by April 15, June 16, Sept. 15, and Jan. 15.

Second, those payments must at least equal *any* of the following three amounts:

(1) 90 percent of the total tax for 2008 (reduced to 66 2/3 percent for qualifying farmers and fishermen).

(2) 100 percent of the total tax for 2007. This is the amount on line 63 of the 2007 1040 form.

The exception based on the prior year's tax is available even if the amount due was zero, provided the return covered 12 months, as it ordinarily would.

As the prior-year exception uses a fixed number, it's the easiest way for most individuals to figure their payments and avoid penalties. To illustrate, your tax payments total $12,000 for 2007 and $15,000 through estimates or withholding in 2008. With those

kinds of numbers, you're home free, no matter how much extra you owe when you file for 2008.

There is a restriction on use of this exception when adjusted gross income for 2007 (the amount on the last line of page one of Form 1040) exceeds $150,000 — declining to $75,000 for married couples who file separate returns. To take advantage of the 100-percent escape hatch, payments must equal 90 percent of the total tax for 2008 or 110 percent of the total tax for 2007 — whichever is *less*.

(3) 90 percent of the total tax for 2008, figured by "annualizing" income actually received by the end of the quarter in question.

The annualizing exception helps those whose incomes unexpectedly increase or fluctuate throughout the year, such as Roth IRA converters who move money out of traditional IRAs and into Roth accounts at year's end, or investors who receive higher than anticipated distributions of dividends and capital gains from their taxable accounts with mutual funds. But be warned: this calculation is complicated.

(Julian Block is a nationally recognized tax expert. To send comments and obtain information about his tax books, go to www.julianblocktaxexpert.com.)

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THE TAX ADVISER
AND THE TRUTH SHALL SET MOST OF YOU FREE
Those of you who are of a certain age or are familiar with the Twentieth Amendment to the Constitution know that U.S. presidential inaugurations did not always take place on Jan. 20. Presidents used to take their oaths of office on March 4.

That happened for the last time in 1933 at noon on a cold and gray Saturday in Washington, when Franklin Delano Roosevelt was inaugurated for the first time. Heavy winter clouds hung over the Capitol as FDR spoke these memorable words: "Let me assert my firm belief that the only thing we have to fear is fear itself — nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance."

But was FDR right when it comes to the IRS? Was he ever audited? Regrettably, I have to tell you that his words evoked snickers at an agency that knows and never forgets that nothing else causes Americans to experience plain old, garden variety, stomach-churning fear like receiving an audit notice.

I am no exception, though my entire adult working life has been in the tax field, including ten years with the IRS, starting in Chicago as a revenue officer (agency lingo for staffers who collect overdue taxes). Some of my more memorable moments were at stores and restaurants, where I opened cash registers and scooped out the contents — a drastic tactic that I employed only after I first dropped by to casually chat and thereby minimize the chances of being fatally mistaken for a robber. Next, while attending law school at night, I became one of the IRS's special agents. These sleuths, popularly known as T-

Men (T-Persons, nowadays, I suppose), investigate criminal violations of the tax laws. Finally, I was an attorney in Washington and New York. Both paper-generating places religiously adhere to Parkinson's Law — an English historian's observation about office organization: Work expands so as to fill the time available for its completion.

Then I became a convert. As a member in good standing on the other side, I wear several hats: syndicated columnist, author of tax guides, and attorney in private practice who strives to alleviate affluent angst about audits.

Most audits take about two to four hours and are completed in just one session. Typically, an inquiry covers just a few items the agency wants to question, such as deductions for contributions and exemptions for dependents, and is soon over, provided you are able to furnish adequate verification in the form of receipts and the like.

Those comforting statistics leave unanswered the question of whether most auditors are reasonable about what is acceptable as proof. I can say that the answer is affirmative, in my experience, which is no comfort to you if your auditor is a zealot — a problem so pervasive that the IRS acknowledges it ought to increase the sensitivity of employees who deal directly with taxpayers. In fact, in the words of a former IRS Commissioner, some staffers "need more training on how to be courteous," which is some news flash you might be thinking: IRS employees can be ill-mannered; file that under Dog Bites Man.

The Commissioner's candid assessment is right on the money, as I can personally affirm. Like other tax pros who go to the mat with the agency, I can recount audit war stories of encounters with IRS personnel who went out of their way to resolve any doubts about whether they are mentally moribund, seriously incompetent and, on frequent occasion, offensively arrogant. Fortunately, most persons singled out for audits soon see lights at the ends of their tunnels. For an unfortunate few, though, those lights signal oncoming trains.

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THE TAX ADVISER

SOCIAL SECURITY TAXES INCREASE AGAIN

The Social Security Administration says that about 11 million workers are going to be dunned for an additional $297.60 in Social Security taxes during 2009. Those payroll taxes also are matched by their employers.

This is caused by an increase in the maximum amount of wages subject to FICA, short for Federal Insurance Contributions Act, levies that are better known as Social Security taxes. The tax hike shows up in the amount of FICA withholdings from paychecks of those with wages above the wage base.

Are you unable to recall nonstop media coverage of President Bush approving the decision by an election-year Congress to risk voter wrath and boost the wage base? The rise rated scant attention because back in the mid-1970s Congress enacted legislation authorizing the adjustment to kick in automatically.

There has been no change in the 7.65 FICA tax rate for both employees and employers. But the latest mandated increase of $4,800 (from a maximum of $102,000 for 2008 to $106,800 for 2009) in the wage base for the 6.2 percent Social Security benefits tax triggered an increase of up to $297.60 ($4,800 times 6.2).

Some other numbers need to be crunched to explain why higher-paid earners must pay even more taxes. The 7.65 percent FICA tax consists of two components with different rates. First, the rate is 6.2 percent for the Social Security benefits portion, the old age, survivors, and disability insurance fund. Second, the rate is 1.45 percent for the Medicare fund, the federal hospital insurance program for the elderly.

In 1993, Congress decided to do away with the ceiling on Medicare's wage base. That is why withholding for Social Security during 2009 ends at $106,800, whereas individuals who earn more than $106,800 must pay Medicare taxes on every dollar of their salaries, wages, bonuses, commissions, vacation pay, etc.

To illustrate the interplay of these numbers, assume Josephine Six Pack earns $106,800 for 2008 and again for 2009. Her tab for Social Security tax: $6,621.60 for 2009, up by $297.60 from $6,324.00 for 2008. Put another way, take-home pay declines by $297.60 for Josephine or anyone else with wages above $106,800, including her spouse, assuming she had the forethought to select a mate with sufficiently high earnings.

Once her wages for 2009 surpass $106,800, Josephine can forget about the 6.2 percent tax, though she still must reckon with the 1.45 percent tax. For each $1,000 above $106,800, she forfeits $14.50 ($1,000 times1.45 percent) to Medicare taxes.

How much must someone receive in salaries, bonuses and other kinds of earnings for Medicare taxes to top Social Security taxes? For 2009, the magic number is $456,662, up from $436,200 for 2008, $416,900 for 2007 and $402,786 for 2006. Going in the other direction, the earned-income tax credit lessens the FICA burden for low-wage workers.

The wage base has gone up every year since 1971, when the figure was $7,800. Back then, the maximum Social Security tax was $405.60. Things have indeed come a long, expensive way since FICA taxes started in 1937, when F.D.R. and Congress capped the tax at $30 for both employer and employee (1 percent of the first $3,000 of earnings). For some years, FICA taxes have exacted a bigger bite than federal income taxes for many middle-income earners.

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THE TAX ADVISER
SOME PRESIDENTIAL WORDS ON FEDERAL INCOME TAXES
Income taxes are such a pervasive and everyday part of our financial lives — and such a central issue in presidential campaigns — that they seem to have been around forever. They have not. Their debut is relatively recent.

Abraham Lincoln created the Bureau of Internal Revenue, the predecessor of today's Internal Revenue Service, and introduced the first U.S. income taxes in 1862 to pay for the North's Civil War expenses. The Confederacy also imposed income taxes. After all, military wars, especially big ones, have to be paid for; at least, that used to be a fact of life.

Mr. Lincoln's levies fell mainly on the well-to-do. There was an exemption from taxes for the first $600 of income. Once beyond that amount, the maximum rate topped off at five percent. The taxes were temporary, not becoming permanent until the adoption of the 16th Amendment in 1913.

In an 1864 address to the 164th Ohio Regiment, Mr. Lincoln said "I apologize for the inequities in the practical applications of the tax, but if we should wait before collecting a tax to adjust the taxes upon each man in exact proportion with every other, we shall never collect any tax at all."

Another Republican understandably went out of his way not to poke fun at the tax collectors. Richard Milhous Nixon, caught up in the struggle to avoid impeachment and stay in office, informed the nation that "The President, when the IRS is concerned, I assure you, is just another citizen and even more so." *Time* magazine waited until the issue that coincided with the tax filing deadline of April 15, 1974, to note Mr. Nixon "offered that wry observation exactly one month ago, when advance warnings had been posted that he might owe half a million dollars in back taxes." He resigned on August 9.

Ronald Wilson Reagan stood out for his ability to make complicated subjects understandable. Mr. Reagan particularly liked to poke fun at the shortcomings of our modern tax system. For instance, he alerted future taxpayers to what awaited them in a talk to students at Northside High School in Atlanta, Georgia, on June 6, 1985: "If our current tax structure were a TV show, it would either be `Foul-ups, Bleeps and Blunders,' or `Gimme a Break.' If it were a record album, it would be `Gimme Shelter.' If it were a movie, it would be `Revenge of the Nerds' or maybe `Take the Money and Run.' And if the IRS ever wants a theme song, maybe they'll get Sting to do `Every breath you take, every move you make, I'll be watching you.' "

Mr. Reagan stayed on message at a joint session of the Canadian Parliament in Ottawa on March 11, 1981: "The American taxing structure, the purpose of which was to serve the people, began instead to serve the insatiable appetite of government. If you will forgive me, you know someone has once likened government to a baby. It is an alimentary canal with an appetite at one end and no sense of responsibility at the other."

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FEBRUARY

TAX PLANNING UNDER A NEW PRESIDENT

There's lots of uncertainty about who will be helped and who will be hurt by the tax package that President Barack Obama will send to a Democratic-controlled House and Senate. Still, there is no doubt that he wants them to approve tax code amendments requiring wealthier Americans to shell out more for taxes.

Which existing breaks deserve to be continued and for how much longer, and what new ones ought to be introduced and how speedily they should go on the books are as much political questions as economic ones. All that is clear is that much debate and political horse-trading will lead to important changes. That acknowledged, nobody knows how promptly same-party executive and legislative branches are going to agree on which sections of the tax code need to be overhauled. Look for intensive negotiations on which revisions should become effective prospectively and which retroactively and just how to word hundreds of amendments. Some revisions will be phased in — the kinds of changes that become effective gradually or only after several years elapse.

In all likelihood, many of the new breaks will be targeted — meaning measures designed primarily to encourage certain kinds of activities and to benefit lower- and middle-income families with young children and aging parents. Tax code overhauls inevitably include targeted measures with fine print and other restrictions that rule out participation by lots of people because, among other reasons, their incomes are deemed to be too high to make them deserving.

Many incentives for retirement and education now on the books are phased out — gradually withdrawn — when adjusted gross income exceeds specified levels that are indexed to reflect inflation. Some examples of phase-outs: the credit for children under age 17, write-offs for contributions to traditional IRAs and deductions for educational expenses. A new phased-out credit is the one for first-time home buyers who purchase a residence between April 9, 2008 and June 30, 2009.

FUNDEMENTALS OF GOOD TAX PLANNING WILL STILL APPLY. Tough economic times require the White House and both Houses of Congress to cut deals on tax rates for capital gains from sales of investments, dividends received by shareholders from corporations and mutual funds and ordinary income from such sources as salaries, business profits, pensions, interest and withdrawals from traditional IRAs, 401(k)s and other tax-deferred retirement plans. Whatever happens to taxes, many time-honored techniques will still work well for most people. Among them is a standard admonition for investors and business owners out to maximize deferral possibilities. Whenever possible, they should avail themselves of tax-deferred retirement arrangements to hold taxable bond funds, REITS or high-turnover stock funds that incur short-term gains. Consistent with that approach, they should use taxable accounts to hold shares of mutual funds that generate long-term gains and dividends — assuming dividends continue to be taxed at the rates for long-term capital gains.

That noted, it is still necessary to run the numbers to see if their allocations are appropriate. Moving too much money into tax-deferred plans can cause them to get hit with more overall taxes when they take money out. In any case, their decisions on what types of investments are best held inside or outside of such plans must jibe with their individual risk tolerance and investment aspirations.

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WHAT'S AHEAD FOR THE MARRIAGE PENALTY

The "marriage penalty" (or, depending on one's point of view, "sin subsidy") is a quirk in the tax code that enrages lots of couples. The penalty compels them to pay greater taxes on their combined incomes than they would as two unmarried single individuals who live together and report exactly the same incomes.

President George W. Bush's tax packages introduced penalty relief for millions of two-income couples. But they authorized relief that is only *partial* and *temporary*. And the most that the Obama administration is likely to do is allow the rules now on the books to stay in effect after their slated expiration in 2010.

One change during the Bush years placates most joint filers by increasing their standard deduction — a flat amount based mostly on filing status and age — to twice the standard deduction for single filers (for 2009, $11,400 for joint filers and $5,700 for single filers, plus an additional deduction for 2009 and 2010 for state and local real estate taxes of as much as $1,000 for joint filers or $500 for other returns). There are additional amounts for individuals who have attained age 65 or are blind. Consequently, two non-itemizers who decide to wed no longer suffer the loss of some of their standard deductions.

But after 2010, this provision sunsets (expires). If allowed to go off the books, the standard deduction for joint filers would no longer be double the deduction for single filers.

Another helpful change for joint filers authorizes a larger slice of their income to be taxed at the 15 percent bracket, rather than the next bracket of 25 percent. After 2010, this provision also expires, unless it is renewed.

Moreover, despite the rules that alleviate the marriage penalty, situations still exist where dual-income couples will lose more to taxes than they would as singles. True, the marriage penalty need not concern couples who each have taxable income under the top end of the 15 percent bracket for singles — $33,950 for 2009. Married or unmarried, they remain within the 15 percent bracket.

But suppose each spouse has taxable income for 2009 of $75,000. As single taxpayers, each person stays well below the top end of the 25 percent bracket ($82,250), whereas if they marry and file jointly, more than $12,000 of their combined income of $150,000 would spill over into the 28 percent bracket, which applies to taxable income between $137,050 and $208,850.

Or suppose each party's taxable income for 2009 is $110,000. As single filers, each is in the 28 percent bracket; as joint filers, they move up to the 33 percent bracket. The

marriage penalty ceases to kick in only when each is in the top bracket of 35 percent — that is, taxable income of more than $372,950, whether single or joint.

The marriage penalty is "one of the major reasons the American people have become so dissatisfied with the income tax. When a tax system departs dramatically from the fundamental values of the people it taxes, it cannot sustain public support," notes Michael Graetz, a Yale law professor and former Treasury Department official. But take heart. Tax-savvy couples can easily sidestep the marriage penalty for 2009; all they need to do is postpone the nuptials to 2010.

(Julian Block is a nationally recognized tax expert. To send comments and obtain information about his tax books, go to www.julianblocktaxexpert.com.)

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STEALTH TAXES: WHAT'S AHEAD?

Throughout the presidential campaign, then-Senator Obama said he wanted to boost taxes for high-income individuals. One of his proposals is to restore the phase-out for personal exemptions and the limitation on itemized deductions on Schedule A of Form 1040 — provisions that are set to expire at the close of 2009.

These cleverly concealed tax hikes first went on the books during the senior Bush presidency and were immediately labeled "stealth" or "backdoor" taxes because they effectively exact more taxes without raising rates. The restorations would boost taxes for individuals with incomes over $200,000 and for families with incomes above $250,000. If the present top rate for income taxes of 35 percent reverts to the pre-2001 rate of 39.6 percent, it would be less than the true top rate of above 40 percent.

The current tax code requires most deductions itemized on Schedule A to be reduced by one percent of the amount by which AGI, short for adjusted gross income, surpasses specified amounts that are indexed, meaning adjusted annually to reflect inflation. AGI is the amount shown on the last line of the first page of Form 1040 after reporting salaries, dividends, interest, pensions and other sources of income and claiming certain deductions such as alimony payments and money moved into retirement plans. The AGI amount is before itemizing for such expenses as charitable contributions or claiming the standard deduction.

For 2009, the specified amount is $166,800. More specifically, this means that every $1,000 of AGI above $166,800 results in the loss of $10 in total itemized deductions. The $166,800 figure drops to $83,400 for married persons filing separately. But going that route does not raise the threshold for a couple to a combined $333,600.

Dependency exemptions start to phase out, that is, gradually disappear, when AGI surpasses certain levels that are also indexed. For 2009, exemptions must be reduced by one percent of the amount by which AGI exceeds: $166,800 for singles; $250,200 for joint filers; $208,500 for heads of household; and $125,100 for married persons filing separately. All exemptions, including those for a spouse and dependents, vanish when

AGI exceeds: $289,300, $372,700, $331,000 and $186,350 for singles, joint filers, heads of household and married persons filing separately, respectively.

After 2009, the reductions of itemized reductions and exemptions expire or sunset. Unless the reductions of one percent are extended beyond 2009, they again become three percent, as they were before 2006.

Abolition of stealth taxes has the support of no less than the top officials of the Internal Revenue Service. For instance, Nina Olson, National Taxpayer Advocate for the agency, said that "the confusing and complex calculations for determining allowable deductions add a significant tax and economic burden to a growing number of taxpayers."

Mind-boggling as the tax law sometimes appears, taxpayers should heed the advice of Donald C. Alexander, a Washington lawyer who headed the IRS from 1973 to 1977 during the Nixon and Ford administrations and died this past February: "As a citizen", Alexander advised, "you have an obligation to the country's tax system, but you also have an obligation to yourself to know your rights under the law and possible tax deductions. And to claim every one of them."

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THE TAX ADVISER

DON'T MISS THE DEPENDENT CARE TAX BREAK

To hold down a job, do you pay someone to care for your child under 13, a disabled dependent of any age, or a disabled spouse? Those payments for child and dependent care expenses may entitle you to a partial tax credit.

Unlike a deduction, which reduces the income on which you figure your tax, a credit is a dollar-for-dollar subtraction from the tax that you would otherwise owe. Calculate the credit on Form 2441, which must accompany your return.

The credit ranges from 20 to 35 percent (depending on your AGI, short for adjusted gross income) of the first $3,000 spent for the care of one person and the first $6,000 for the care of two or more persons. The 20 percent credit applies when AGI exceeds $43,000. Assuming you are liable for Social Security tax payments for housekeepers and babysitters, count those taxes as part of your expenses.

If you are married, both you and your spouse must work at least part time, unless one of you is disabled or is a full-time student. You need not itemize for charitable donations and the like to qualify for the credit.

Your allowable outlays include the entire salary paid a housekeeper, even though the helper's duties do not include acting as a baby sitter or companion for someone in your home. All you need to establish is that the helper's services partially benefit the person

for whom care is being provided — for instance, a fourth grader who is away at school and never physically present while the cleaning of his or her room takes place.

In the case of a child under the age of 13, you can include payments for care outside the home by a nursery school, day-care center, day camp (but not an overnight camp) or the home of a babysitter. Do not include payments for transportation between home and the day-care facility.

MOVING EXPENSES. The key requirement for deducting the costs of a job-related move is that your new job location is at least 50 miles farther from your old home than your previous job location was. To illustrate, if the distance between your old home and your old job is 10 miles, the distance between your old home and your new job has to be at least 60 miles.

There is some leeway on the 50-mile minimum. The IRS does not require you to measure the distance on the basis of a straight line on a map. It's okay to calculate the mileage on the shortest of the routes that you would ordinarily travel.

Deductible outlays include the unreimbursed costs of transporting your family members, pets and belongings to your new home. If you use your car for the move, deduct the actual cost of gas and oil or a standard mileage rate — for 2008, 19 cents per mile for the first six months and 27 cents for the final six months, plus parking fees and tolls.

There is no deduction, though, for any side trips taken for personal reasons, such as stopovers with relatives or sightseeing at Yellowstone while relocating from the West Coast to Connecticut. Your route, cautions the IRS, should be "the shortest, most direct one available by conventional transportation."

The friendly folks at the IRS want to bestow presents on some newlyweds. Suppose the bride and groom lived in different cities last year. After the wedding, the husband moved to the bride's city and got a job. The couple can deduct his moving expenses.

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THE TAX ADVISER

TAKE THE STANDARD DEDUCTION OR ITEMIZE?
Many of you who are about to file returns for 2008 want advice on whether to claim the no-questions-asked standard deduction or to itemize on for outlays like mortgage interest and charitable contributions. Itemizing pays off only when total itemized deductions surpass the standard deduction that you would be entitled to claim anyway.

The allowable standard deduction amounts are based on such variable as filing status and age and are adjusted upward each year to reflect inflation. For 2008, the normal amounts are: $10,900 for joint filers; $8,000 for heads of household; and $5,450 for singles and married persons filing separately. Couples who file separate returns must handle their deductions the same way; if one spouse itemizes, so must the other.

The deduction of $10,900 also is available to a "surviving spouse" — a widow or widower who has a dependent child and is entitled to use joint-return rates for two years after the death of a spouse in 2006 or 2007.

The deductions for individuals who have attained age 65 by 2008's close increase by $1,050 for a married person (whether filing jointly, separately or as a surviving spouse) and $1,350 for an unmarried person. Persons considered blind also are entitled to those additional amounts or double those amounts if they are both 65 and blind.

To illustrate, the deduction rises from $5,450 to $6,800 for a single person who is age 65 or older. It goes from $5,450 to $8,150 for a single person who is at least 65 and blind. On a joint return, depending on whether one or both spouses are at least 65, it increases from $10,900 to either $11,950 or $13,000.

A tax change that went on the books just for 2008 and 2009 allows homeowners who do not itemize an additional standard deduction for state and local real estate taxes. The extra deduction is capped at $1,000 for joint filers or $500 for other returns (or actual taxes paid, if that is less). For example, suppose both spouses are at least 65 and file jointly. Their total deduction is as much as $14,000 — the sum of $10,900 normal deduction, $2,100 for being at least 65 and $1,000 additional deduction for property taxes. Who might benefit from this inconsequential break that is bound to confuse many taxpayers? Those who purchased homes late in the year and have not paid enough mortgage interest and taxes to make itemizing worthwhile, or do not itemize because they have paid off their home mortgages.

Another change also authorized just for 2008 and 2009 helps nonitemizers whose homes, household goods and other properties are damaged or destroyed in places determined to be disaster areas eligible for federal assistance. They can boost their standard deduction by the amount of uninsured losses attributable to natural disasters like hurricanes, fires, floods, earthquakes and landslides. Those kinds of disaster losses are deductible without being subject to the usual requirement that casualty and theft losses are allowable only to the extent they exceed 10 percent of AGI, short for adjusted gross income.

Special restrictions decrease the standard deduction amounts to as little as $900 for individuals (children and elderly parents, mostly) who can be claimed as dependents on the returns of other persons.

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THE TAX ADVISER

CAUTION: AVOID MISTAKES ON FORM 1040

A mistake on your return may mean some time-consuming correspondence that delays your refund check. Worse yet, an error may mean that your return winds up in the audit pile, leaving you to justify your deductions or other facts and figures.

Here are some reminders from the Internal Revenue Service on items to check before you sign and submit your return.

USE CAUTION WITH FILING STATUS. Check the correct boxes for filing status and exemptions. Example: don't check the "Single" box, when the "Head of Household" box is the right one. This is the kind of mistake that the IRS computers are *not* programmed to catch. An unmarried or legally separated person who provides a home for a dependent, such as a child or elderly parent, may qualify for head-of-household filing status, rather than single status, and thereby pay less in taxes.

Married couples cannot switch from joint to separate returns after expiration of the filing deadline (April 15 for most persons). But couples can switch from separate to joint filing within three years after the deadline.

Can you be claimed as a dependent on the return of someone else, such as your parent? As a dependent of another person, you cannot claim an exemption for yourself on your own return.

Are you a noncustodial parent who is claiming a child as a dependent? You need to submit IRS Form 8382 with your return.

CHECK PREVIOUS RETURNS. Review last year's return for any items that could be carried forward. The possibilities include capital losses from sales of investments on Schedule D or a net operating loss from the operation of a business that was claimed on Schedule C.

An example: Suppose you had losses on sales of stocks or mutual funds in 2007.The cap on a deduction for capital losses might have barred a write-off of the entire loss on your return for 2007; after an offset against capital gains, no more than $3,000 of additional capital losses can be subtracted from ordinary income, such as salaries or pensions. But you can apply any unused 2007 losses against capital gains for 2008, as well as apply any remaining losses against as much as $3,000 of ordinary income. Any remaining losses can be used in 2009 and later years.

THE FINAL CHECK. Make sure to firmly attach to your 1040 all required schedules and statements — for example, Schedules A and D. Include your name and Social Security number on any IRS schedules or your own statements. Should the schedules become separated from the return, it will be easier for the IRS to reassemble everything.

Use the pre-addressed envelope that came with your return. If you do not have one, or if you moved during the year, mail the return to the IRS Service Center for the area where you now live.

There is nothing sinister about the bar codes on pre-addressed envelopes. They represent postal ZIP codes and tax form type that allow both the Postal Service and the IRS to machine-sort the envelopes, which is faster and less costly than hand sorting.

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THE TAX ADVISER
MORE TIME TO FILE

This year, the deadline for filing Form 1040 is Wednesday, April 15. Miss the deadline and you could get nicked for a sizable, nondeductible penalty. In most cases, the penalty is five percent of the balance due (the amount that remains unpaid after subtractions for taxes previously paid through withholdings from wages during 2008 and payments of estimated payments) for each month, or portion of a month, that a 1040 is late.

The maximum penalty is 25 percent of the balance due — a truly steep charge. On a balance due of, say, $10,000, that works out to $500 a month. The penalty can reach as much as $2,500 when more than four months elapse before your return reaches the Internal Revenue Service.

Sometimes, the Internal Revenue will forget about a late-filing penalty. To get the agency to waive the penalty, you have to convince it that the delay was "due to reasonable cause and not due to willful neglect." For example, you are unable to complete the return by the deadline because your residence, place of business or records are destroyed due to a fire, flood, other casualty or civil disturbance, or burglary. Another acceptable excuse is the death or acute illness of an immediate family member, or your own serious illness.

What if you do not have sufficient cash on hand to pay the balance due at filing time? Even if you are able to prove it, that is not reasonable cause that will relieve you of the penalty.

No problem if you need extra time to complete your return or just to avoid the late-filing penalty. It is easy to obtain a six-month automatic filing extension, moving the deadline back to Thursday, Oct 15. By April 15, submit simple-to-complete Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return), available at www.irs.gov/pub/irs-pdf/f4868.pdf, or file it by phone (call toll-free 1-888-796-1074), using computer tax preparation software, or through a tax professional.

Form 4868 extends only the time to turn in Form 1040, *not* the time to pay any taxes owed. While the IRS does not require payment by April 15 of the tax you estimate as due, failing to do so means you will owe nondeductible interest, which runs until payment of the tax. It makes no difference that you had a good reason for not paying on time; you will still owe interest. Moreover, you might be assessed a nondeductible late-payment penalty on the unpaid tax. When you finally file your return, be sure to enter any

extension-related payment on Line 67 of Form 1040 as "amount paid with request for extension to file."

The IRS relaxes the rules for those who are unable to fully pay the balance due by April 15. Usually, it is easy to arrange for partial payments in installments by submission of Form 9465 (Installment Agreement Request), found at www.irs.gov/pub/irs-pdf/f9465.pdf. It allows you to request a monthly payment plan and specify the amounts you can pay each month and the monthly due date.

STATE TAX RETURNS. Some states accept Form 4868 for extending their due date; some require their own extension forms. Check the rules of the state in which you have to file returns, including the penalties for any underpayments of taxes.

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For release Monday, April 13, 2009
THE TAX ADVISER
PATCHING THE ALTERNATIVE MINIMUM TAX
Amidst all the partisan squabbling over the size of President Obama's economic stimulus package and the role of tax cuts therein, there was, at least, bi-partisan agreement on the need to address the Alternative Minimum Tax. The snag is that the cost of an AMT fix becomes more expensive every year. And so, just a few months after the historic inauguration, AMT reform already appears to be DOA.

True, during the campaign, then-Senator Obama did not address the issue in detail, saying only that he would consider AMT reforms, such as indexing the AMT exemptions — that is, the amounts of income that escape this tax. Those amounts have never been indexed, whereas regular tax rates are indexed, as are the amounts allowed for personal exemptions and standard deductions. In reality, President Obama would have to do far more to temper the AMT, which snags a steadily growing number of middle-income individuals, forcing them to calculate their taxes both under the regular system and the AMT. And they are nicked for whichever levy is larger.

However, the American Recovery and Reinvestment Act of 2009, enacted this past February, authorized one of those temporary fixes for one year — the so-called AMT patches that raise the exemptions. The measure slightly increases the amounts for 2009 to $70,950 for married couples filing jointly and surviving spouses (up from $69,950 in 2008); $46,700 for single taxpayers and heads of household (up from $46,200 in 2008); and $35,475 for married couples filing separately (up from $34,975 in 2008).

On the plus side, the patch will keep many millions of taxpayers off the AMT rolls this year. The Tax Policy Center in Washington, a joint project of the Brookings Institution and the Urban Institute, estimates that whereas no patch would have caused 30.3 million taxpayers to be dunned for the AMT, the latest patch has decreased that number to 4.6 million.

But the legislation left unchanged the phase-out of exemptions when AMT income exceeds specified levels that vary by filing status — $150,000 for joint filers, $112,000 for singles and heads of household, and $75,000 for married couples filing separately. Moreover, nothing was done about the marriage penalties imposed by the AMT. "The exemption for couples is less than twice the level for singles, and the tax rate brackets are not adjusted for marital status," notes the Tax Policy Center.

Remember, too, that state and local income and property taxes are among the itemized deductions that are *not* allowed for AMT purposes.

The AMT "affects large groups of middle-class taxpayers with no tax-avoidance motives at all, unless one considers choosing to live in a high-tax state or choosing to have children to be a tax-avoidance motive," said Nina Olson, the IRS National Taxpayer Advocate, in an annual report to Congress. She characterized the AMT as "the poster child for tax law complexity." Noting that a tax system must be transparent in order to be perceived as evenhanded, she added: "Yet the complexity of the AMT is such that many, if not most taxpayers, who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments."

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THE TAX ADVISER
WHEN THE IRS MIGHT FORGIVE AND FORGET

To get the IRS to waive a late-filing penalty, you have to convince the agency that the delay was "due to reasonable cause and not due to willful neglect." Is there reasonable cause that excuses a penalty when you rely on an attorney or accountant to make a timely filing? No, according to a decision by the Supreme Court.

It all began when Robert Boyle was appointed executor for the estate of his mother. Although Boyle lacked experience in estate taxes, he had previously acted as executor for the estate of his father.

The attorney whom Boyle hired to handle the legal work for his mother's estate told him of the need to file an estate-tax return, but did not tell him the due date for the return. He provided the attorney with all relevant records and asked several times about the return. The attorney assured Boyle that it would be prepared and filed "in plenty of time." Unfortunately for Boyle, a clerical oversight caused the attorney to miss the nine-month deadline by three months, an oversight that led to a late-filing penalty of $17,000.

The Seventh Circuit Court of Appeals agreed with Boyle that he should be held blameless. Reliance on one's attorney to do the job on time, said the appeals court, is reasonable cause for an overdue return when the taxpayer: (1) Is unfamiliar with the tax law; (2) makes full disclosure of all relevant facts to the attorney that he relies on and

maintains contact with the attorney from time to time during the administration of the estate; and (3) has otherwise exercised ordinary business care and prudence.

But Boyle struck out with the Supreme Court. It unanimously concluded that the taxpayer is stuck with the penalty even when an attorney causes the delay. Congress chose to place the burden of complying with filing deadlines on the taxpayer, not on an attorney or accountant or some other agent or employee of the taxpayer: “One need not be a tax expert to know that returns have fixed filing dates and that taxes must be paid when they become due,” the high court pointed out.

To be on the safe side, the executor or administrator of an estate should ask the lawyer or accountant early and often when federal returns have to be filed and how they are progressing. It is also wise to inquire about state returns.

There is a rose in this bed of thorns. The Supreme Court noted that a different issue arises when a taxpayer relies on the advice of a lawyer or other professional on a question of tax law, such as whether a liability exists. It is reasonable for a client to rely on such advice, though it proves erroneous.

“Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a ‘second opinion’ or to try to monitor counsel on the provisions of the Internal Revenue Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place,” the justices concluded.

So you are on fairly safe ground when you rely on the advice of a tax expert that a return need not be filed. If it turns out that your tax pro goofed, odds are that the IRS will be forgiving.

For instance, the Tax Court refused to approve assessment of a penalty for late filing of an estate-tax return where an executrix was erroneously advised by her attorney that no return was due until a dispute between her and a beneficiary was resolved.

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THE TAX ADVISER

FEAR OF FILING

The law empowers and encourages the Internal Revenue Service to make life decidedly disagreeable for people who intentionally fail to file their returns at tax time. The key federal statute is the Internal Revenue Code, which authorizes the imposition of severe sanctions, both criminal and civil, on those who fail to comply with our “voluntary” system.

First, consider the provisions for criminal offenses. The one most frequently invoked, Code Section 7203, makes willful failure to file a misdemeanor punishable by a fine of as much as $25,000 and a jail sentence of up to one year, or both, plus the costs of prosecution.

For instance, the feds successfully targeted a CPA on failure-to-file charges. An appeals court rejected the CPA's contention that his records were too sloppy for him to file proper returns.

An airline pilot's conviction was upheld by an appeals court, which held that the pilot was not entitled to have the jury hear psychiatric testimony about the pilot's obsession with the idea that payment of taxes is voluntary.

For more serious situations, the feds have the option to bring charges under Section 7201 for willful evasion. This offense is a felony, the punishment for which is a maximum fine of $100,000 and five years in prison, or both, plus prosecution costs.

Because of budget constraints and crowded court dockets, Uncle Sam subjects relatively few taxpayers to criminal prosecutions. So let's look next at what the Internal Revenue routinely does: Slap nonfilers with civil penalties. Those severe, nondeductible penalties are in addition to nondeductible interest charges.

Under Section 6651, the Revenue Service can exact a late-filing penalty — generally, five percent of the balance due for each month, or part of a month, that a Form 1040 is overdue. The maximum penalty is 25 percent of the balance due (the amount that remains unpaid after subtractions for taxes previously paid through withholdings from wages and quarterly payments of estimated taxes).

Example: A balance due of $10,000 means a penalty of $500 a month and as much as $2,500 for a more-than-four-months-tardy return. The severity of the penalty escalates considerably when the IRS accumulates sufficient evidence to establish that the late filing is due to fraud, in which event, the Section 6651 penalty jumps from 25 to 75 percent.

To escape responsibility for civil fraud penalties, taxpayers frequently contend that the first failure to file caused their later failures to file. How come? Because submitting returns for subsequent years would reveal their initial nonfiling to the IRS, which then would press criminal charges — an argument that leaves the courts unmoved.

For instance, the Ninth Circuit Court of Appeals refused to attach any significance to the underlying fear of a criminal prosecution. To do so, observed the court, would "open a Pandora's box of illusory defenses to the fraud penalty."

In addition to the late-filing penalty, the IRS can assess a late-payment penalty. Also, you are liable for interest from April 15 on the balance due. Forget about any deductions for interest on overdue taxes.

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For release Monday, June 1, 2009
THE TAX ADVISER
NET OPERATING LOSSES — WHEN THE BOTTOM LINE IS NOT BLACK
Businesses struggling with the economic downturn benefit from targeted tax relief provisions in the American Recovery and Reinvestment Act of 2009, the economic stimulus legislation signed into law by President Obama in February. An important provision helps small businesses that suffer what are known as NOLs — short for net operating losses — when their expenses exceed receipts. The new tax incentive increases the carryback period for 2008 losses from two years to three, four, or five years.

Undoubtedly, some of you operate businesses that were battered by the recession and lost money in 2008. Or perhaps you started new ventures that ran in the red. Either way, the Internal Revenue Code allows business owners to carry NOLs to other years and deduct them. For 2008 only, these businesses are not bound by the normal two-year carryback. In fact, some red-ink businesses may be able to get refunds of all or part of the income taxes they paid for past years or find that they may be able to trim their taxes in future years.

Code Section 172 specifies two choices — elections, in IRS-speak: One allows businesses that experience NOLs to carry losses back and offset them against previous years' profits, and then to carry them forward and offset against future years' profits. The second choice allows businesses that forego the carryback route to use their NOLs as offsets against future years' profits only, for as many as 20 years.

The year in which NOLs occur determines the number of years they can be carried back — a maximum of two years for losses incurred in 2007 and earlier and as far back as five years for losses incurred in 2008. The Recovery Act retroactively liberalized the carryback rules for NOLs in 2008 and authorized an enhanced option. Businesses that enjoyed profitable years before 2008 can elect to carry back their 2008 losses for two, three, four or five years — whichever proves most advantageous. Such carrybacks are limited to outfits that meet the criteria for "small businesses," meaning those with average annual gross receipts below $15,000,000 for the years 2006-2008. The Act helps all kinds of ventures — anything from full-time and long-established to part-time and newly launched — and they can be conducted through sole proprietorships, partnerships or corporations.

Businesses operating as partnerships or S corporations (corporations that receive pass-through tax treatment similar to partnerships) apply the gross receipts test at the partnership or S corporation level. Technically, partnerships and S corporations do not have NOLs, because the losses are passed through and shared by the partners and shareholders who compute NOLs on their 1040 forms. Therefore, it is the qualifying partners or S shareholders, as the case may be, who make the election.

The Recovery Act left unchanged the two-year carryback cap for losses for years prior to 2008. And the two-year cap is slated to return for post-2008 years.

What happens after 2008? Will our lawmakers decide that a “temporary” carryback for as much as five years ought to be kept on the books for years after 2008? Congress almost always renews temporary provisions — particularly when they benefit beleaguered businesses with negative earnings that might be unable to survive without infusions of cash. And it is clear that operating loans from banks or other conventional sources have become increasingly unavailable.

Detailed information on the complex carryback/carryforward rules is located in IRS Publication 536, *Net Operating* Losses, available on the agency’s Web site, irs.gov, or by calling 1-800-TAX-FORM (829-3676).

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For release Monday, June 8, 2009
THE TAX ADVISER
STEP-UP IN BASIS FOR INHERITED PROPERTY: WHAT’S AHEAD?

Estate planning is important for individuals who own sizable amounts of property. But uncertainty surrounding the estate tax makes it difficult for them to choose and implement strategies to reduce the tax.

Under current law, relatively few estates need to be mindful of the estate tax. Typically, a person can leave everything to his or her spouse, undiminished by any tax, thanks to an unlimited marital deduction. (There are different, less bighearted rules for surviving spouses who are not United States citizens.) In addition to the marital deduction, there is a sizable exemption for property that goes to children and other recipients — $3,500,000 for 2009, up from $2,000,000 for estates of individuals who died in 2006 through 2008. Assets in excess of the exemption are taxed at a top rate of 45 percent.

Back in 2001, President Bush and a bi-partisan Congress cut a deal for the estate tax to disappear in 2010 and reappear in 2011 with an exemption of only $1,000,000 and a top rate of 55 percent for property in excess of $1,000,000. My prediction on what is going to take place after the close of 2009: The tax stays in effect, though with different exemptions and tax rates.

As a candidate for president, then-Senator Obama said he favored the status quo, proposing an extension of 2009’s rules into 2010 and beyond. Congress wants to be more generous. It is considering proposals to significantly boost the exemption to somewhere in the $5,000,000 range and $10,000,000 per couple.

Another problem in planning for 2010 and beyond is that Mr. Bush and Congress created a Twilight Zone for the special break authorized by Internal Revenue Code Section 1014 for inherited assets. They generally are stepped-up in basis from their original cost to their value on the date of death of the previous owner. For heirs, that means forgiveness of capital gains taxes on pre-inheritance appreciation and, on subsequent sales, tax liability only on post-inheritance appreciation.

But starting in 2010 — the year the estate tax officially comes to an end — a cap kicks in on the amount of assets qualifying for a step-up in basis. Under this restriction, there is a step-up just for the first $1,300,000 of assets, increasing to $3,000,000 for assets that go to a surviving spouse.

In the event there is no extension of estate tax repeal, the current step-up system resumes in 2011. But between now and 2011, there might be a further revision or even an undoing of the ceiling on the step up. In the meantime, ceiling detractors maintain that it would introduce costly complexity. According to President Obama's advisors, he wants to retain the current rules. Keep tuned.

Confusing? Sure. But as of now, no advisor is able to provide definitive advice on how to strategize for 2010 and beyond. Like other advisors, I am able to do little more than offer educated guesses about trends several years from now. After all, advisors are obliged to moderate predictions to reflect assumptions about wide-ranging concerns — ballooning budget and trade deficits that weaken the dollar, inflation or deflation, oil prices that increase rapidly and decrease even more quickly, chaotic conditions abroad — particularly in the Middle East — and the potential for terrorist attacks within the United States, to cite just some of the uncertainties. But if you stay on top of what's happening, you can at least be assured of keeping yourself up-to-date and making sure you know what to expect from taxes in the future.

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For release Monday, June 15, 2009
THE TAX ADVISER
CONGRESS SWEARS IT WANTS TO SIMPLIFY THE TAX LAWS
Congress divides bitterly on hot-button issues, such as abortion and same-sex marriages. But our lawmakers always display bipartisan support for proposals to make filling out returns much easier. As you would suppose, hardly any of these proposals for simplification of our Byzantine Internal Revenue Code become law, because these efforts end up — just like previous ones — tangled up in politics. As for the ones that are enacted, most of them tend to add to complexity rather than reduce it.

One of the first proponents of simplification was Senator Elihu Root of New York. Mr. Root's whimsical comment on the 1913 tax act, the introduction of our modern system: "I guess you will have to go to jail. If that is the result of not understanding the Income Tax Law, I shall meet you there. We shall have a merry, merry time, for all of our friends will be there. It will be an intellectual center, for no one understands the Income Tax Law except persons who have not sufficient intelligence to understand the questions that arise under it."

Add to the advocates Senator Robert Packwood of Oregon, a former chairman of the tax-writing Senate Finance Committee, as well as a politician with a flair for a wide range of activities, not all of them admirable. Mr. Packwood made this 1993 entry in his infamous diary, after discovering he was due a $50,000 income tax refund: "The thing

that irritated me...is that I didn't know I was entitled to this...People think I know the tax law. I know the philosophy of the tax law. I don't know the details."

Although renowned for his legislative savvy, he proved to spectacularly incompetent at concealing from the media the embarrassing details of his transgressions toward women. The romantically restless legislator lost his job after it emerged that at least 29 women, including staffers and constituents, accused him of sexual abuse and assault. Unlike another salacious politico-sexual scandal involving an intern, this one ended, after the inevitable twisting in the wind, with his forced resignation. Like many former officials, Mr. Packwood became part of Washington's lobbying industry, known colloquially as "K Street," after the downtown thoroughfare inhabited by trade associations and corporate offices. He prowls the corridors primarily for well-heeled clients with tax issues.

Senator Charles McCurdy Mathias, Jr., of Maryland sought to make the once-a-year affliction caused by the need to grapple with the 1040 less time consuming. To help attain that estimable goal, he sponsored the following legislation, known officially as 3719 (1970): "Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That it is the intent of Congress that, for the relief and assistance of American taxpayers, all forms, schedules, returns, declarations, manuals, instructions, tables and other materials prepared and distributed by the Internal Revenue Service for public use shall be as clear, concise and comprehensible as possible. It is the further intent of Congress that common everyday American English shall be used wherever and whenever possible in all such materials intended or required to be used by large numbers of individual taxpayers."

Fortunately for the national interest, as well as for tax mavens like me who get paid to decipher the Internal Revenue Code and have families to feed, an understandably upset IRS persuaded Congress it would be a dereliction of legislative responsibility to approve such a proposal.

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END The Tax Adviser 6-15-09

For release Monday, June 22, 2009
THE TAX ADVISER
AMENDING TAX RETURNS AFTER APRIL 15

It is not too late to recalculate your taxes if you recheck last April's Form 1040 and discover you overlooked some business write-offs or other tax breaks. There is still plenty of time, in most instances, to redo your return. Here are some reminders on when you can or cannot change your mind after the due date.

ITEMIZING AND THE STANDARD DEDUCTION. Let's say you and your spouse filed jointly and used the standard deduction for taxpayers who do not itemize. Now you realize it would have been advantageous to itemize your payments for state income taxes, interest charges on home mortgages, contributions and the like. Are you stuck

with the standard deduction? No. You can switch to itemizing, provided you do soon a timely amended return.

A special rule applies when spouses file separate returns. Both must use the same method to handle deductions. If one itemizes, so must the other. One cannot itemize, while the other uses the standard deduction.

SEPARATE AND JOINT RETURNS. Suppose you and your spouse filed separate returns. Now, however, the two of you agree that joint filing would have saved taxes. Does the law allow you to switch from separate to joint returns? Yes, although there is a bit of paperwork involved. To switch, you must amend your return — normally, any time within three years of the due date, which is April 15 for most people.

Can you make the opposite switch? No. If you file jointly, you cannot switch to separate returns once the filing deadline has passed.

The decision to file jointly is binding on both spouses. One consequence of that rule is that a spouse who files jointly and then divorces cannot disavow a joint return and file separately, so as to force an ex-mate to pay more taxes.

AMENDING FORM 1040. Those obliging folks at the Internal Revenue Service provide a relatively easy way to amend your Form 1040 without the need to completely redo the return or go through any complicated red tape. Just contact the Internal Revenue for Form 1040X (Amended U.S. Individual Income Tax Return), a simplified form consisting of two pages, plus a set of instructions on how to explain the change you wish to make and compute the refund or balance due.

Form 1040X is available without charge by mail (call 800-TAX-FORM), by fax (call 703-368-9694, not a toll-free call), or download it from the agency's Web site, www (irs.gov). While you are at it, also ask the IRS for Publication 556, which provides helpful information not contained in the instructions that accompany Form 1040X. IRS Publication 910, Guide to Free Tax Services, provides a complete list of booklets and explains what each one covers.

STATE TAX RETURNS. A change to your Form 1040 also might mean that you have to amend your state return. If so, you should file the appropriate state form.

xxx

Death and taxes may be life's only certainties, but at least with taxes, we get a second chance. If you goof on a tax return, the IRS gives you three years to correct it. And if that results in a refund, you'll even get interest on your overpayment. — Medical Economics, Feb. 21, 1994

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THE TAX ADVISER
SOME STRATEGIES FOR HOME-SELLERS

A profit on the sale of your house or condominium qualifies for an “exclusion” from taxes of up to $250,000 in profit on home sales for single filers and up to $500,000 for married couples filing jointly. But anyone with a gain greater than the exclusion cap of $250,000 or $500,000 is stuck with taxes on the excess.

If the IRS questions your sale, the examination will be less traumatic and less expensive if you have kept meticulous records that track your home’s basis — the figure used to determine gain or loss on a sale of the property. Those records should include what you originally paid for your home, settlement or closing costs — such as title insurance fees — and what you later shelled out for improvements, as opposed to repairs.

You cannot claim current tax deductions for your outlays, whether they are classified as repairs or improvements. But while repairs cannot be added to the home's cost basis, improvements can. Result: Improvements eventually lower any taxable profit on a subsequent sale.

Your expenditures qualify as improvements only if they fit within any one of three definitions. They must:

- Add to the value of your home;
- Prolong its useful life; or
- Adapt it to new uses.

Most outlays pass muster under the add-to-the-value test. The possibilities run the gamut from big projects, such as putting a recreation room in your unfinished basement, adding another bathroom or paving your driveway, to small jobs, such as upgrading closets and installing built-in bookcases, new faucets or medicine cabinets.

Basis-increasers include your payments for special tax assessments for improvements that boost the value of your home. They typically include assessments for streets, sidewalks, water mains, sewer lines and public parking facilities. Other projects that might add nothing to value could, nevertheless, prolong the home's useful life. Some examples: putting on a new roof or putting in new plumbing or wiring.

What if your spending adds little or nothing at all to the home's value or does not prolong its useful life? You might still qualify under adapts-to-new-uses, the last of the three tests. For instance, you put a laundry room in your unfinished basement. The area now serves a new use.

Your home’s adjusted basis includes only the cost of permanent improvements. The basis does not include any improvements that are no longer part of the home.

In calculating how much has been spent on improvements, you can include materials for do-it-yourself projects. But you cannot count the value of your own labor or any other labor for which you did not pay.

Repairs simply do not count. Makes no difference how urgent they are. All that repairs do is "maintain your home in good condition," says the IRS. They do not add to its value

or prolong its life. Some examples: repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes.

To the surprise of no one, including the IRS, its precise definitions frequently fail to answer clearly whether particular items ought to be classified as repairs or improvements. That explains why the tax collectors themselves concede that there are lots of gray areas. In their guidelines for home sellers, they note that when "...items that would otherwise be considered repairs are done as part of extensive remodeling or restoration of your home, the entire job is considered an improvement." Translation: Each situation depends on its own facts — and that can work to your advantage.

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END The Tax Adviser 6-29-09

For release Monday, July 6, 2009
THE TAX ADVISER
CALLING FOR TAX ADVICE THE INEXPENSIVE WAY

Internal Revenue Code changes have averaged one-per-day over the past eight years — with 500 revisions in 2008 alone. Who's counting? Nina Olson, the National Taxpayer Advocate, announced the statistics in her annual report to Congress. An independent organization within the IRS, the Taxpayer Advocate Service helps taxpayers resolve complaints with the agency when problems cannot be resolved through normal channels.

Will Advocate Olson's reports convince our lawmakers to draw back from their drawing board? Not during these troubled times. Expect them to enact even more alterations to an already confusing code in the immediate future.

How do individuals who need to focus on tax planning all year long keep on top of all those major and minor modifications? Most decide to become clients of tax professionals. And that kind of advice does not come cheap.

Fortunately, pricey professionals are not the only source of succor for Americans apprehensive about their financial futures and their retirement prospects. There are alternatives that are easier on the pocket. One option is to sign up at places like high schools and community colleges for inexpensive adult education courses on various aspects of personal finance.

It is also possible to obtain advice at no cost from knowledgeable, disinterested professionals. This resource is available to an ever-increasing number of individuals who belong to affinity groups or work for companies that offer such advice. Individuals eligible for assistance can call centers staffed primarily by financial planners who offer advice only — untainted by compensation linked to commissions on product sales.

But what is available for people in need of instant advice who are without access to call-in centers? Thanks to technology, there are person-to-person Internet advice sites that let them talk to experts on topics like taxes and investing. It is important to note, however, that these sites do not vouch for the accuracy of their experts' advice.

A major purveyor of telephone counseling and hand-holding is Keen — a company that describes itself as "Your Personal Advisor," offering live, immediate advice for everyday life. In the interests of full disclosure, I was among the first dispensers of tax advice recruited by Keen, when it debuted in 2000.

Keen's specialists cover a broad range of financial topics — anything from tax-efficient maneuvers that callers can implement themselves, to new theories to test out on real-world advisers, to portfolio diversification strategies.

Keen allows callers to check out advisors' backgrounds and their ratings by previous customers. Another confidence booster is that Keen makes the call to both parties — ensuring that its online oracles are clueless about callers' names, phone numbers and other personal information, unless the callers choose to divulge such details.

What does a service like this cost, and how does one pay? As with most Internet sites, Keen accepts credit cards and bills per-minute, but frequently discounts fees for first-

timers. There is no minimum fee commitment and callers decide when to conclude the conversations, so they are in control at all times. The result is helpful advice at far less than the cost of in-person sessions.

Keen is particularly well suited for several common situations. Its advisors can provide inexpensive reassurance when taxpayers want to verify that information received from their advisors or the IRS is correct or when their returns are being audited.

To contact Keen, go to www.keen.com, or call 1-800-ASK-KEEN (275-5336). If you log on to the Web site and browse its directory of tax advisers, you can select one by clicking on a "Call Now" icon. Or you can follow the voice prompts in the case of the 800-number. That may be all it takes to speak with someone who can staunch the hemorrhaging to the IRS.

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THE TAX ADVISER
TAX AUDIT TIME: WHEN TWO IS A CROWD

Usually, an audit of your return is fairly routine. The IRS will ask you to produce receipts, canceled checks, and similar documentation to verify deductions and other facts and figures.

Come up with the required substantiation and the examiner sends the return back to the files. In fact, the feds frequently close cases without exacting extra taxes. And in many others they even authorize refunds.

But you are probably in hot water when an IRS investigator walks in *unannounced* at your home or office and asks to see your records. Odds are that a surprise audit means the agency suspects you filed a return that is fraudulent.

So should you be targeted for what looks like an out-of-the-ordinary audit, make sure to find out the official designation of the person with whom you are suddenly chatting. Is the Sherlock a revenue agent with the Examination Division or a special agent with the Criminal Investigation Division?

The difference is not academic. Revenue agents conduct routine examinations of dependency exemptions, business expenses, and similar items; ordinarily, special agents are assigned exclusively to investigate suspected criminal violations of the tax laws.

Also be on guard when you receive advance notice of an audit and *two* examiners show up to scrutinize returns. Both may be revenue agents — one a veteran and the other a rookie who's along merely to get some on-the-job experience.

However, the appearance of two examiners often means that a special agent *and* a revenue agent are teamed together on a "joint investigation." This is the bureaucratic

euphemism that the IRS uses to describe what goes on when the agency accumulates evidence for a criminal prosecution that can culminate in a stay in the slammer for as much as five years, as well as a fine of as much as $100,000, for each fraudulent return.

Those sentences and fines, by the way, are *in addition to* the sizable civil penalties for fraud — plus back taxes and interest — that the T-Men routinely exact from cheaters who are spared criminal prosecution.

The IRS sets strict guidelines for its special agents on what they can and should do when they drop in — with or without notice. They are supposed to identify themselves as special agents and to advise individuals of their constitutional rights. The ones that most concern you are "the right to remain silent and to be advised by an attorney."

When you become aware that you have been singled out for a criminal investigation, your options immediately dwindle to *one*: Get the advice of an attorney knowledgeable about criminal investigations *before* you hand over any records or make any statements to special agents. Such disclosures can come back to haunt you when they are pieced together and repeated on the witness stand by government sleuths.

IRS investigators can compel third parties to furnish information about their business dealings with you. In fact, the IRS can obtain information for a year later than the one in issue.

There is no violation of your constitutional rights when an IRS summons forces the disclosure by, among others, an employer of your personnel records, or a bank of records of your deposits, undeposited checks converted into currency, and the dates you entered safe deposit boxes.

Nor are you entitled to damages for harassment and humiliation by IRS agents just because they try to collect overdue taxes. That, predictably, was what a judge told an aggrieved taxpayer.

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THE TAX ADVISER
RED FLAGS FOR IRS AUDITS
What are the chances that your 1040 form will be bounced by IRS computers for an audit? Here are some of the items that increase the likelihood of your return drawing the agency's attention.

SOME POINTERS ON POINTS. Allowable deductions for interest on home mortgages include mortgage points, those additional, up-front fees, also known as "loan origination fees" that lenders charge. But the IRS is on the lookout for borrowers taking impermissible deductions for points.

They are 100 percent deductible in the year of payment, provided you pay them to obtain a loan to buy, build or improve (as when you add or remodel a room) your "principal residence," IRS lingo for a year-round dwelling, as opposed to a vacation retreat or property for which you charge rent.

But in most cases, forget about any immediate deduction for points paid to refinance (with none of the proceeds used to pay for improvements) a mortgage on your principal residence. You must spread the points deduction over the life of the loan.

The IRS knows that ever more refinancers have been succumbing to temptation and claiming their points as if they were fully deductible in a single swipe. The difference is not chopped liver: a year-of-payment deduction of $9,000, as opposed to an annual deduction of just $600 in the case of a15-year loan for $300,000 and $9,000 in points.

RENTAL LOSSES. A complex set of rules drastically restrict these losses. That is why the IRS might demand proof that, among other things, you correctly computed the deduction and satisfied the key requirement of active participation in the rental activity — selecting tenants and supervising property managers, for example. Satisfy those stipulations and you are able to offset as much as $25,000 of losses against non-passive income, such as salary or investment income.

The IRS suspects many landlords make math mistakes. Its apprehension is understandable, as the full deduction of $25,000 is available only for someone whose AGI, adjusted gross income, the amount on the last line of page one of Form 1040, is below $100,000. That threshold is significant because the allowable deduction diminishes by one dollar for each two dollars of AGI beyond $100,000 and disappears completely when AGI tops $150,000.

What if you flunk the AGI test or your participation is passive, as opposed to active? Then the IRS lets you offset the loss only against passive income from, say, a limited partnership or some other kind of tax shelter.

CASUALTY AND THEFT LOSSES. They are another area that has traditionally been minutely scrutinized because many taxpayers misunderstand the convoluted rules. The big hurdle: these kinds of losses usually are deductible only to the extent that the total amount in any one year (reduced by $100 ($500 for 2009) for each casualty or theft) exceeds 10 percent of your AGI.

The IRS is aware of the tendency of some taxpayers to overlook the 10-percent-of-AGI rule. Moreover, the measure of the loss is the *lesser* of (1) the difference in value of the property just before and after the event (for a theft, the value afterward is zero, as you cease to possess any property or (2) the property's "adjusted basis," which often is what you originally paid, when you use it only for personal reasons — family furniture, for instance.

You might reduce the risk of an audit when you claim "red flag" deductions by including a brief written explanation with your return. If you submit documents that help support your statement, attach copies and not originals, because the documents might become separated from your return. Don't submit originals until the IRS actually asks for proof of your deductions.

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For release Monday, July 27, 2009
THE TAX ADVISER
QUOTES ABOUT TAXES
Over the years, a number of my columns have included quotations about our tax system. Those columns prompted many of you to submit your own favorites. Here are some of them:

Will Rogers said this in 1932 about estate taxes: "Congress knocked the rich in the creek with a [72 percent raise in the] income tax, then somebody must have told `em `Yes, Congress you got `em while they are living. But what if they die on you to keep from paying it?` Congress says, `Well, never thought of that, so we will frame one that will get `em, alive or living, dead or deceased.` Now they got such a high inheritance tax on `em that you won't catch these old rich boys dying promiscuously like they did. This bill makes patriots out of everybody. You sure do die for your country if you die from now on."

High on the taxpayers-the-IRS-will-never-forget list is a Miamian, a recent immigrant from Cuba, who found out from a newspaper that her children were worth $3,500 apiece as exemptions for 2008; so she hastened to the closest IRS office, with her two tykes in tow, and asked how quickly her $7,000 would be sent.

The Practicing Law Institute had these observations about business owners who cheat on their taxes: "It is surprising how many `witnesses` or `observers` a taxpayer can create in the process of understating his taxes. A man's mistress can observe that he always pays cash when with her. An estranged wife might have a very good idea of who is being entertained on the `business trip` to Miami. Any bookkeeper told not to record certain payments may be your bookkeeper for life. And it is very difficult to fire an insurance broker who has been giving you kickbacks for years."

"Pay taxes early and do paperwork correctly. When it comes to the IRS, it's not just the substance that counts, it's the form as well." — From an IRS TV commercial

A frustrated Los Angeleno telephoned his local IRS office because he kept getting a negative amount on his return. As he told the IRS, "The instructions said to subtract line 8 from line 7, and when I subtract 8 from 7, I keep getting minus one."

"Death and taxes may be life's only certainties, but at least with taxes, we get a second chance. If you goof on a tax return, the IRS gives you three years to correct it. And if that results in a refund, you'll even get interest on your overpayment." — Medical Economics, Feb. 21, 1994

"Writes of spring: A man has praise, sort of, for the IRS after discovering he could download tax forms from the IRS's Internet pages. 'I am a happy man, and I love you all — until I write the check.'" — The Wall Street Journal, May 1, 1996

A woman asked the IRS for more time to file her return, saying: "My husband and my forms have been misplaced. Please send replacements." Unfortunately, the IRS says, "we could only replace the tax forms."

Since minors can't vote, is it legal to tax their income? That question of "taxation without representation" was posed to the Treasury Department by a taxpayer. Treasury's written reply: "Congress represents all Americans, including those who cannot or do not vote." — U.S. News & World Report, Jan. 9, 1989

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THE TAX ADVISER
THREE TAX BREAKS FOR SMALL BUSINESSES
FIRST-YEAR EXPENSING. The Internal Revenue Code authorizes two ways for small businesses to write off of their outlays for such purchases of equipment as computers and file cabinets.

One is the "standard" route — recovering the cost through depreciation deductions over a period of years. Or they can opt for the frequently-overlooked tactic of "expensing" and deduct a specified amount of equipment in the year of purchase, assuming that is more advantageous.

Let's say a self-employed person's equipment purchases include $12,000 for computers, copiers, tape recorders and the like. Instead of depreciating them over five years, they can be immediately expensed under Code Section 179. A $12,000 write-off lowers taxes by $3,600 for an individual in a top federal and state bracket of 30%.

In my experience advising small businesses, few need to concern themselves with the cap on the Section 179 deduction. For 2009, it is $250,000. The ceiling is indexed, that is, increased yearly to reflect inflation.

The paperwork for first-year expensing is straightforward. Businesses have to complete Form 4562 (Depreciation and Amortization). Self-employed individuals carry the Form 4562 deduction to, and enter it on, the line for "Depreciation and section 179 expense deduction" on the two-page Schedule C (Profit or Loss From Business), which is where they report receipts, along with equipment costs and other expenses, to arrive at a net

profit or loss. Once that has been accomplished, Form 4562 and Schedule C are supposed to accompany Form 1040.

PROFIT FROM PAYING YOUR KIDS. Can your children help out with some of the chores connected with your business? Then a savvy way to take care of their allowances or spending money — at the expense of the IRS — is to pay them wages for work they do on behalf of the business. This is a perfectly legal way to keep income in the family, while shifting some out of your higher bracket and into their lower bracket. A child's standard deduction enables him or her to sidestep taxes on the first $5,700 of earnings for 2009, another one of those amounts that are indexed. The IRS allows this kind of business expense only if your children *actually* render services and you pay them *reasonable* wages.

Code Section 3121(b)(3)(A) authorizes another break. You sidestep Social Security taxes on the wages you pay your children under the age of 18. To qualify for the exemption, you must operate as a sole proprietorship, meaning the lone owner of a full-time or part-time business that is not formed as a corporation or partnership, or do business as a husband-wife partnership. Put another way: No exemption for a family business that is incorporated or a partnership with a partner other than a spouse.

Another break for business owners is that write-offs for equipment purchases and wages save more than just income taxes. They also reduce self-employment taxes owed for 2009 on the first $106,800 of net (receipts minus expenses) earnings.

HEALTH INSURANCE DEDUCTIONS FOR THE SELF-EMPLOYED. Medical expenses usually are allowable only to the extent that they exceed 7.5 percent of adjusted gross income, the figure on the last line of the first page of the 1040 form. But the law allows self-employed individuals to deduct 100 percent of what they spend on medical insurance premiums (including qualifying long-term care coverage) for themselves and their spouses and dependents. This deduction does not reduce self-employment income for purposes of calculating self-employment taxes.

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THE TAX ADVISER
TAX COURT SIDES WITH IRS: TENNIS PRO CAN'T CLAIM COURT CLOTHES
Work clothes and uniforms are deductible only if they are required as a condition of employment and unsuitable for everyday use. That restriction was made expensively clear to nationally ranked Chicago tennis pro Cecil Mella, who lost his match with the IRS on the issue of business write-offs for tennis clothes and shoes.

Cecil worked for two private tennis clubs; both barred players, including instructors, from playing on the courts unless they wore proper attire. He claimed deductions for clothes, including warm-up jackets and pants, shirts with a collar, and shorts that were brief to give maximum freedom of movement and had pockets for tennis balls, as well as shoes,

each pair of which lasted only two or three weeks, and were designed, according to him, to decrease the chances of injuries.

Cecil said he wore the items only when playing or teaching. But the Tax Court, in its unsought role as official interpreter of fashion correctness, noted: "It is relatively commonplace for Americans in all walks of life to wear warm-up clothes, shirts, and shoes of the type purchased by (Cecil) while engaged in a wide variety of casual or athletic activities." As for the shoes' safety functions, the court was not persuaded by his "uncorroborated and vague statements."

Similarly, the Tax Court threw out deductions for business suits bought by Edward J. Kosmal, a Los Angeles deputy district attorney who was planning to leave government service and decided that the right way to impress his future employers and colleagues was to upgrade his wardrobe to a sartorial standard appropriate to that of a "big-time Beverly Hills P.I. {personal injury} attorney." Unquestionably, ruled the court, the clothes were suited to ordinary wear.

Hair dressing outlays are a murkier issue. For instance, Vivian Thomas worked as a private secretary for an attorney who required her to be perfectly coiffed at all times while in the office. So she deducted the cost of twice-weekly trips to the beauty parlor. Sorry, said the Tax Court, but a secretary's coiffure-maintenance costs were nondeductible, even in her case.

But the court sided with Margot Sider, who wrote off the cost of 45 extra beauty-parlor visits that were made, she argued, only because of her hairstyle was an integral part of her job demonstrating and selling "a high-priced line" of cosmetics in a department store to a "sophisticated clientele." When she quit selling cosmetics, she went back to a simpler style.

At her trial, Margot cited a 1963 Supreme Court decision written by Justice John Marshall Harlan: "For income tax purposes Congress has seen fit to regard an individual as having two personalities: one is a seeker after profit who can deduct the expenses incurred in that search; the other is a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."

Margot asserted she had spent the amount in issue as a "seeker after profit," not as "a creature satisfying her own needs." That satisfied the judge, who ruled she was entitled to fully deduct the outlay beyond "the ordinary expenses of general personal grooming."

Back in 1979, actress September Thorp offered an unassailable not-adaptable-for-general-wear defense when the IRS challenged her deduction for makeup: "I'm in 'Oh! Calcutta!' and I have to appear nude onstage every night, so I cover myself with body makeup. I go through a tube every two weeks, and it's very expensive."

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THE TAX ADVISER

BAD DEBT DEDUCTIONS FOR LOANS TO SPOUSES

You are allowed a bad-debt deduction if you have made a loan that becomes worthless, provided a bona fide loan exists. The IRS often challenges write-offs when loans to family members sour, though not always successfully.

UNPAID LOANS AND MARRIAGE. The law presumes that loans from one spouse to another do not create valid debts. To get around that snag, Carolyn Marlett claimed that her marriage to husband Charles was a "relationship maintained for financial convenience only." Hence, her co-signing of a joint income tax refund was a loan to Charles, as were her other "advances" to him.

However, Carolyn could not convince the United States Tax Court that the advances were valid debts. In a 1976 decision, the court noted that she never asked Charles to sign notes or bothered to set an interest rate or repayment schedule.

But the court is not inflexible on this issue. It ruled that June M. Rogers could deduct loans made to her husband, who declared bankruptcy after their divorce. The loans were not gifts; he used the money in an unsuccessful business venture and signed promissory notes for repayment.

CAN AN UNRETURNED ENGAGEMENT RING BE A DEDUCTIBLE BAD DEBT? The court ruled in favor of the government in 1982 in a case involving Jack Wolfson. Jack was a Dallas salesman whose territory included Houston, where he met and ultimately became engaged to Yvonne Gibbs. To seal their engagement, he gave her a diamond ring. But just a week later, she broke things off and sold the ring (a decision triggered by Jack's refusal to honor his promise to reimburse her for the cost of housing her poodle in a kennel during her visits with him in Dallas). Jack sued Yvonne for the ring's cost and won a default judgment of $1,000, which he made no attempt to collect. Instead, the spurned lover took a bad debt deduction for $1,000.

The IRS invoked two arguments to justify its disallowance of the deduction. First, Jack did not offer any proof he tried to collect. Therefore, the debt was not worthless at the end of the year in issue, a requisite for the write-off of a bad debt. Second, simply giving an engagement ring does not create a debt. Approving a bad debt deduction for that act alone "would, in essence, open the doors of litigation to allow every rejected lover to come into the Tax Court and ask it to allow him a deduction" for an unreturned ring. The IRS urged the court not to assume "part of the cost of the romance" of Jack with Yvonne. The judge deemed it unnecessary to rule on the second argument, as he agreed with the first one. Jack offered no evidence of Yvonne's insolvency or other inability to pay during the year in question. Hence, he failed to prove the debt's worthlessness during that year.

DEBTOR'S RETURN TO PRISON RENDERED DEBT WORTHLESS. In 1973, Stewart Oatman loaned $800 to his brother, then in the military and imprisoned in the stockade at Fort Bragg. They had an understanding that the loan would be repaid when the brother "got on his feet." Subsequently, he was in and out of the slammer, until 1978, when his circumstances seemed to change. He then married, had a job, and was on work release from prison. Unfortunately, the brother violated the conditions of his work release and was tossed back into the brig.

Stewart wrote the loan off as worthless, reasoning that the return of his brother to prison in 1978 meant there was no longer a reasonable prospect of repayment. The IRS contended that Stewart did not expect repayment or, if he did, the debt became worthless in a year other than 1978.

The Tax Court accepted Stewart's "credible testimony" that the $800 was a loan made "with the genuine understanding that the amount would be repaid," an expectation that vanished in 1978, when the brother went back to prison.

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THE TAX ADVISER

STANDARD MILEAGE RATES INCREASE FOR 2009

The Internal Revenue Code authorizes deductions for individuals who use their cars for business, moving, medical or charitable purposes. They can choose to write off their actual expenses or use what are known as the optional standard mileage rates.

For business driving, actual expenses include gas, oil, tires, repairs, license tags, registration fees, insurance, garage rent, lease payments and depreciation. As an alternative to claiming actual expenses, you may be able to use a standard mileage rate that is adjusted annually to reflect inflation and gas prices. The rate's advantage is that it eliminates the extra burden of tracking actual costs; records need to be kept only of business miles driven for the year in question. Just to be clear, the IRS definition of "cars" includes vans, pickups and panel trucks.

For 2009, the standard rate is 55 cents per mile. For 2008, it was 50.5 cents for January through June and 58.5 cents for July through December.

Do you qualify to claim both actual expenses and the mileage rate? Then there is just one way to know which option provides a larger write-off: figure your deduction both ways. Usually, actual expense is more advantageous than the per-mile rate, especially when there is a surge in price at the pump or your vehicle is a gas-guzzler. But the reverse can be true for those who have extremely low outlays or scant business mileage.

Employees and self-employed persons who move for business-related reasons and use their cars to transport themselves, members of their households or their belongings are able to deduct actual costs of gas and oil or a standard rate for 2009 of 24 cents. For 2008, it was 19 cents per mile for the first six months and 27 cents for the final six months.

Similarly, individuals who require medical care and drive to and from doctors, hospitals and the like can deduct actual costs of gas and oil or a standard rate for 2009 of 24 cents.

Persons who use their cars to perform services for such charitable organizations as schools and religious institutions can deduct actual costs of gas or oil or a standard rate of 14 cents for all of 2009, a rate set by law, not the IRS.

Besides claiming mileage allowances, remember to take separate deductions for parking fees, as well as bridge, tunnel and turnpike tolls. And drive within speed limits. The feds forbid deductions for traffic tickets. It matters not that you were on the way to an important business meeting.

A business-driving example: For 2009, Dodi drives 10,000 miles and pays $100 for parking and tolls. Her allowable deduction is $5,600 — $5,500 (10,000 times 55), plus $100.

If the IRS examines your returns and scrutinizes car write-offs, it will not dispute standard-rate deductions, as long as you are able to verify the miles driven; the agency disregards actual expenses. So it is prudent to keep glove-compartment diaries or other records in which you list the details of when, how far and why you went, along with charges for parking and tolls.

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THE TAX ADVISER

IMPORTANT TAX CHANGES FOR 2009
There have been lots of changes in the tax rules. Many of them are mandated by indexing — government lingo for annual adjustments to reflect inflation. What follows are the highlights of several changes that might influence your tax planning.

PERSONAL EXEMPTIONS. You get a bigger break just for being you. For 2009, exemptions are worth $3,650 apiece, up from $3,500 for 2008.

REDUCTIONS OF EXEMPTIONS. For upper-incomers the deductions for all exemptions — including those for a spouse and dependents — gradually decline. Exemptions begin the phasing out process when AGI, short for adjusted gross income, exceeds designated amounts. AGI is arrived at after deducting various items, such as alimony payments, moving expenses and contributions to tax-deferred IRAs and other retirement plans.

For 2009, exemptions must be reduced by one percent of the amount by which AGI exceeds: $166,800 for singles; $250,200 for joint filers; $208,500 for heads of household; and $125,100 for married persons filing separately. All exemptions vanish when AGI exceeds: $289,300, $372,700, $331,000 and $186,350 for singles, joint filers, heads of household and married persons filing separately, respectively.

After 2009, the reductions of exemptions expire. Unless the reductions of one percent are extended beyond 2009, they again become three percent, as they were before 2006.

PARTIAL DISALLOWANCE OF ITEMIZED DEDUCTIONS. Most itemized deductibles must be reduced by 1 percent of the amount by which AGI surpasses a specified amount — $166,800 for 2009, up from $159,950 for 2008. Stated differently, every $1,000 of AGI above $166,800 results in the loss of $10 in total itemized deductions. The $166,800 figure drops to $83,400 for married persons filing separately.

STANDARD DEDUCTIONS. The standard deduction is the no-questions-asked amount that is automatically allowed without having to itemize for outlays like state and local income taxes and charitable donations. Just how much of a standard deduction you get mainly depends on a person’s filing status and age. For 2009, the normal standard deductions are: $11,400 (up from $10,900 for 2008) for joint filers; $5,700 (up from $5,450) for married persons filing separately and singles; and $8,350 (up from $8,000) for heads of household.

EXTRA-LARGE STANDARD DEDUCTIONS FOR THE ELDERLY AND BLIND. As for the age variable, deductions are higher for individuals who have reached age 65 by 2009’s close, increasing by $1,100 (up from $1,050 for 2008) for a married person (whether filing jointly or separately) and $1,400 (up from $1,350 for 2008) for someone whose filing status is single or head of household. Persons who are considered blind are entitled to those additional amounts or double those amounts if they are both 65 and blind.

Special restrictions *decrease* the deduction amounts allowed individuals (children and elderly parents, mostly) who can be claimed as dependents on the returns of other persons. For 2009, the standard deduction can be as little as $950 (up from $900 for 2008) for a dependent.

SOCIAL SECURITY TAXES. They continue to take bigger chunks of employees' wages. The Social Security tax of 6.20 percent goes from the first 102,000 of earnings for 2008 to $106,800 for 2009, an increase of $4,800. The Medicare tax of 1.45 percent applies to *all* salaries, bonuses, commissions, vacation pay, etc. A 1993 law change abolished the cap on Medicare's wage base.

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THE TAX ADVISER
SOME IRS BALM FOR SHORT SALES OF HOMES

Congress continues to make changes in the tax code in response to the housing crisis. A key change helps millions of homesellers who owe more on their mortgages than their dwellings are worth. These sellers have negative equity — a condition known colloquially as being upside down or underwater. Legislation that went on the books at the start of 2007 significantly benefits some upside downers and does absolutely nothing for others.

This is how the break works. Suppose Sela Sellers disposes of her residence in a lender-okayed short sale that erases the unpaid part of her mortgage. Or suppose the lending company forecloses on the dwelling, subsequently sells it and cancels a portion of her debt. Generally, the tax code calls for Sela to report partially or entirely forgiven amounts on her 1040 form. Not any more. The Mortgage Forgiveness Debt Relief Act of 2007 includes a provision that allows homesellers like Sela to exclude as much as $2,000,000 of canceled debt.

Sela excludes (sidesteps) taxes only if she satisfies two stipulations. First, the security for her mortgage is her principal residence, meaning the place she ordinarily lives most of the year. Second, she incurs the debt to buy, build or substantially improve her principal residence. There is no relief for Sela's home equity loans or cash-out refinancings, except to the extent that she uses the proceeds to make improvements. Other fine print prohibits relief if her lenders forgive debts on vacation homes and other second homes or rental properties.

Long-standing rules generally require debtors to report all forgiven debts on their 1040 forms, just the same as income from salaries or investments. The Internal Revenue Service taxes forgiven amounts at the rates for ordinary income from sources like salaries. Some forgiven debts sidestep taxes. The law specifies several carefully hedged exceptions. They include bankruptcies and insolvencies.

The exception introduced in 2007 benefits people whose debts are reduced or cancelled in arrangements that are known as loan modifications, foreclosures, deeds in lieu of foreclosure and short sales. This last category is the term for an owner who — with lender approval — sells for a net sales price (gross sales price minus legal fees, broker's commission and other costs) that is insufficient to cover all of the outstanding debt.

In tax lingo, the exclusion is for income from the discharge of QPRI, short for qualified principal residence indebtedness. This means mortgages taken out by owners to buy, build, or substantially improve their principal residences. And the residences are the securities for the debts.

There also is an exclusion for debt reduced through mortgage restructuring, as well as for debt used to refinance QPRI. Here, there is relief, but only up to the amount of the old mortgage principal, just before the refinancing.

Another constraint is that the exclusion does *not* help homeowners who took advantage of the run up in real estate prices to do “cash-out” refinancing, in which they did not use the funds for renovations of their primary residences. Instead, they used the funds to pay off credit card debts, tuition charges, medical expenses, or certain other expenditures.

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THE TAX ADVISER
TAX COURT ALLOWS EXOTIC DANCER TO DEDUCT BREAST IMPLANTS
Just because you incur expenses for business reasons does not mean that they automatically qualify as deductible. The Internal Revenue Code stipulates that these outlays must be "ordinary and necessary" in relation to your business.

Moreover, the law generally categorizes what you spend to improve your appearance, general health or sense of well-being, as nondeductible personal expenses. It should come as no surprise, then, that lots of business-versus-personal disputes wind up being resolved by the courts.

A case in point is that of Cynthia Hess, known as "Chesty Love" in her show biz endeavors as an exotic dancer. The Hoosier hoofer persuaded the United States Tax Court to uphold a deduction for surgical implants to enlarge her bosom.

Fade to when Cynthia, then known as "Tonda Marie," launched her topless career on the night club circuit. She was able to get gigs. But because of a hereditary deficiency, she had to settle for smaller earnings than other, better endowed ecdysiasts. (Look that up in your Funk and Wagnall’s — an admonition that those who, like me, are of a certain age, will remember as one of the running gag lines on ”Rowan and Martin’s Laugh In.”) So Cynthia's agent persuaded a willing client to undergo surgery that enlarged her bust size — first to 56FF and then to 56N. (No, those numbers are not misprints.)

With humongous stats and the new stage name of "Chesty Love," she resumed performing and immediately experienced an uplift in earnings, an increase that was unquestionably fueled by chats with talk-show hosts, such as the celebrated chest connoisseur Howard Stern and Sally Jesse Raphael.

Cynthia's career-enhancing move notwithstanding, her implant deduction fell flat with bluenose bureaucrats. The IRS contended that the Tax Court should characterize the outlays as nondeductible personal expenses.

Get real, responded Special Trial Judge Joan Seitz Pate, who reasoned that for someone like Cynthia, top-heavy breasts are business assets and implants are a necessary "stage prop." Hence, no personal benefit derived by Cynthia from those particular implants, which, Judge Pate pointedly noted, are not the type usually sought by women seeking to enhance their personal appearance. Instead, it was Cynthia's craving for more “checks to barer” that motivated the dancer to undergo surgery that so

enlarged her breasts — each weighs about 10 pounds — that her appearance became "freakish."

Even worse, as Cynthia testified, she and her husband routinely endure off-color, vituperative comments from people they encounter; consequently, she has decided to have the implants permanently removed when her exotic-dancing career ends.

To buttress her decision, the judge compared the implants to work clothes and uniforms, which are allowable only if they satisfy a two-step test: (1) required as a condition of employment and (2) unsuitable for everyday use. It was a cinch for Cynthia to get over the first hurdle; her large, cumbersome breasts are a "costume," needed to retain her employment as a professional exotic dancer.

As for the second stipulation, the court cited Cynthia's testimony that she would remove the implants each day, were that possible. As they cause bacterial infections and other serious medical problems, her understandable preference would be not to "wear" them while offstage.

VERDICT: Implants so extraordinarily large are "useful only in her business" and, therefore, deductible.

(Julian Block is a nationally recognized tax expert. To send comments and obtain information about his tax books, go to www.julianblocktaxexpert.com.)

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THE TAX ADVISER
AS CERTAIN AS DEATH: QUOTES ABOUT TAXES
In one of last July's columns, I offered some quotations about America's tax system. That column prompted many of you to submit your own favorites. Here are some of them.

"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing." — Jean Baptiste Colbert (1619-1683), finance minister for King Louis XIV

"If geese are to be plucked with the least squawking, which is the aim of all taxation, the fatter ones will always tempt politicians more because they have more feathers and there are fewer of them to screech." — The Wall Street Journal, July 28, 1982

Former Sen. Russell Long of Lousiana's definition of tax reform: "Don't tax you, don't tax me. Tax that fellow behind the tree."

"As a citizen, you have an obligation to the country's tax system, but you also have an obligation to yourself to know your rights under the law and possible tax deductions. And to claim every one of them." — Donald Alexander, a former Internal Revenue Service Commissioner

"There are simply not a sufficient number of people available to work for the IRS who have the sophistication and the intellect necessary to handle many of the problems that the service must face." — Jerome Kurtz, a Washington attorney and former IRS commissioner

Former Sen. Robert Dole of Kansas was majority leader in 1995 when he endorsed a proposal to make English the country's official language. Dole's announcement prompted one Washington tax wag to observe that he'd be happy "if they'd just make English the official language of the Internal Revenue Code."

"I'm delighted to pay big taxes. Big taxes mean big income." — H. Ross Perot, The New York Times, April 15, 1988

Former Sen. Robert Packwood of Oregon was chairman of the tax-writing Senate Finance Committee when he made this 1993 entry in his now famous diary, after discovering he was due a $50,000 income tax refund: "The thing that irritated me...is that I didn't know I was entitled to this...People think I know the tax law. I know the philosophy of the tax law. I don't know the details."

"The income tax is just. It simply intends to put the burdens of government justly upon the backs of the people. I am in favor of an income tax. When I find a man who is not willing to bear his share of the burdens of the government which protects him, I find a man who is unworthy to enjoy the blessings of a government like ours." — William Jennings Bryan, in his speech to the Democratic National Convention in Chicago, July 8, 1896

Sen. Max Bacus of Monana at the Finance Committee hearings on enactment of the Tax Reform Act of 1986: "The last time this committee met to review the tax code from top to bottom, Eisenhower was president, Joe DiMaggio was married to Marilyn Monroe, and there were no major league baseball teams west of Kansas City."

"To tax and to please, no more than to love and be wise, is not given to man." — Edmund Burke (1729-1797), British political writer and statesman

Former Sen. Steve Symms of Idaho: "When Congress talks of tax reform, grab your wallet and run for cover."

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For release Monday, September 28, 2009
THE TAX ADVISER
WHAT’S YOUR REAL TAX BRACKET?

For 2009, there are six federal income brackets — 10, 15, 25, 28, 33 and 35 percent. Moreover, the brackets are indexed, that is, they are adjusted annually to reflect inflation, same as the dependency exemptions and standard deduction amounts.

This year, the 10 percent bracket applies to taxable income of *up to* $8,350 for singles and $16,700 for married couples filing jointly. Taxable income — the amount on line 43 of 2008's 1040 form — means what is left *after* wages, pensions and other kinds of reportable income are offset by all allowable deductions and before any credits are claimed.

The next three brackets are: 15 percent (income *between* $8,350 and $33,950 for singles and *between* $16,700 and $67,900 for joint filers); 25 percent (income *between* $33,950 and $82,250 for singles and $67,900 and $137,050 for joint filers); and 28 percent (income *between* $82,250 and $171,550 for singles and $137,050 and $208,850 for joint filers).

The 33-percent bracket kicks in only when income *surpasses* $171,550 for singles and $208,850 for joint filers. Finally, there is the 35-percent bracket on incomes *above* $372,950 for singles and joint filers.

To illustrate how to figure your top bracket, let's look at joint filers Patrick and Nadine Vennebush. For simplicity, assume they declare a gross income of $130,000 solely from wages. Patrick and Nadine receive no other income taxed at reduced rates, such as dividends and long-term capital gains, and are not subject to the alternative minimum tax. Their personal exemptions and itemized deductions aggregate $30,000, leaving them with taxable income of $100,000. So their top federal tax bracket is 25 percent.

Surveys continually disclose that most persons mistakenly believe that because Patrick and Nadine are in the 25-percent bracket, the law entitles the IRS to siphon off 25 cents of every dollar of income they declare. Actually, just the dollars that fall in the 25-percent bracket are taxed at that rate.

The part of their income that falls into the 10- and 15-percent brackets — the first $67,900 — is taxed at 10 percent on the first $16,700 and 15 percent on income between $16,700 and $67,900. Only the part between $67,900 and $100,000 is taxed at 25 percent.

The couple's taxable income can go as high as $137,050 before Patrick and Nadine are nudged into the next bracket, where each added dollar of income is dunned at a 28-percent rate. They are able to ease themselves into the 15-percent bracket only if their taxable income drops below $67,900.

Patrick and Nadine need to crunch more numbers when they are liable for both federal and local taxes. Their combined top bracket is not the sum of their federal, state and city brackets. Rather, it is their top federal bracket, plus the state and city brackets, minus the federal tax savings that becomes available because they can claim the local taxes as itemized deductions on Schedule A of the 1040 form.

Let's say Patrick and Nadine are in a four-percent bracket for state taxes. To determine their top tax bracket, they multiply their 25-percent federal bracket by their state rate and subtract the result (one percent) from their state rate. Then they add the result (three percent) to their federally imposed rate to arrive at a combined rate of 28 percent.

Julian Block is a nationally recognized tax expert. To send comments and obtain information about his tax books, go to www.julianblocktaxexpert.com.)

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Monday, October 5, 2009

THE TAX ADVISER

WILLS: COST AND DEDUCTIBILITY

How much can you expect to pay for legal help when you write or revise a will? How do you find a competent lawyer with the right rate for your pocketbook? And just how much, if any, of the fee will be tax deductible? These are questions I'm often asked.

Your best bet for finding an affordable lawyer to draw up your will is the way most people find an affordable attorney: word-of-mouth recommendations. Obvious sources include relatives, friends or business acquaintances who have had good experiences with an attorney. Legal-referral services run by local bar associations are another option.

Now let's get down to dollars. Your session with an attorney should be straightforward — a discussion of your assets, heirs and wishes. Most lawyers are up-front about their charges for preparing wills. If yours is not, don't hesitate to ask. Fees vary widely, depending on the complexity of the document you need.

On the low end, some legal clinics advertise that they charge between $100 and $200 to draft simple wills for relatively small, uncomplicated estates. In such a will, each spouse typically leaves everything to the other, or, should they die simultaneously, to the surviving children. But if the children are minors, you no longer have a simple will situation.

Many attorneys, however, do charge more for simple wills; though there is no average price, you'll find that fees ranging from $150 to $250 are common. On the plus side, lawyers often draw up wills for a husband and wife at the same time for less than the usual fee for drawing up each spouse's will separately.

Understandably, you can expect the charges to escalate considerably if you have a sizable estate, or if you have property complications and want to use the services of an attorney who specializes in wills, trusts and estate planning.

Ordinarily, the law does not allow you to claim a tax deduction for a will-preparation fee. You may, though, be able to salvage an itemized deduction on Schedule A of Form 1040 for the part of the fee allocable to tax advice on estate planning. There are limits on deductions allowed itemizers for most miscellaneous expenses, a category that includes charges for tax advice. These outlays are allowable only to the extent that their total in any one year is greater than 2 percent of your AGI, short for adjusted gross income. AGI is the amount you list on the last line of page one of Form 1040.

An example: You have an AGI of $100,000 and miscellaneous expenses of $2,500. The 2 percent floor shrinks your deduction to just $500 — what is left after the $2,500 is offset by $2,000, which is 2 percent of $100,000.

If your attorney's services include counseling on strategies to lower taxes, remind the attorney to prepare a bill that shows the breakdown between the nondeductible portion charged for will preparation and the amount charged for tax advice, which is the deductible part that you can include with your other miscellaneous expenditures. That way, assuming you surpass the 2 percent floor, you are able to substantiate your deduction in the event that you are audited. But

forget about any deduction for advice or preparation of returns if you are subject to the alternative minimum tax.

October 12, 2009

THE TAX ADVISER

LATE-FILING PENALTIES

The rules are rough for late filers who submit their Form 1040s after the usual April 15 deadline without first having obtained automatic six-month filing extensions to Oct. 15. The law authorizes the Internal Revenue Service to exact stiff, nondeductible penalties from these tardy taxpayers.

For openers, there is a late-filing penalty. As a general rule, this penalty is five percent of the balance due (after subtracting taxes previously paid through withholding from salaries and estimated payments) for each month that the Form 1040 is late, up to a maximum of 25 percent.

A special rule applies when a Form 1040 is at least 60 days late. The late-filing penalty is $135 (up slightly from $100) or the balance due with the return, whichever is the *lesser* figure. Translation: No late-filing penalty when there is no balance due.

Sometimes, though, the Internal Revenue will forget about penalties for late filings or payments. To get the tax collectors to undo an overdue-return penalty, you have to convince them that there was "reasonable cause" for your tardiness.

So what cause is reasonable? A Revenue Service list of acceptable excuses includes a serious illness or death in your immediate family, postal delays, wrong advice from an IRS employee, IRS tardiness in providing tax forms and instructions, and the destruction of your home, place of business or records due to a fire, flood, other casualty or civil disturbance. Unsurprisingly, not having enough cash on hand to settle the tab at filing time, even if you can prove it, is not reasonable cause that will get you off the hook for a penalty.

Assuming there is no reasonable cause, a measure of relief may be available under what is known as the "timely mailed, timely filed" rule. The IRS treats a tax return as filed on the date it is mailed to the agency. Consequently, it will not assess the usual penalty against a taxpayer whose return is mailed by the filing deadline, even if it is delayed or lost in the mails.

But the IRS warns that this rule does not shield a return that is mailed after the deadline. Worse yet, a late mailing can turn out to be considerably more expensive than you might think if the mail is slow.

The IRS computes the late-filing penalty for a delinquent return from the date it is *received*, not the date mailed. The difference can mean an extra five percent penalty if the return is delayed for as little as one extra day.

This was underscored in a dispute involving a return that was due on April 15, but not mailed until May 14, just under a month late, and not received until May 19, a bit over one month late. The IRS said the penalty should be ten percent rather than five percent, and the United States Tax Court agreed.

Monday, October 19, 2009

THE TAX ADVISER

IT’S A NO-N0 TO PICK UP AN IRS AGENT’S LUNCH TAB

Q. Several years ago, the Internal Revenue Service audited the amounts my wife and I listed for theft losses and charitable contributions. As it happened, there was not much else for the government to ask about. Most of our income was on W-2s that listed our salaries, mainly the salary from a job I then had with General Motors. The audit letter summoned us to a meeting at the local Internal Revenue office.

Today's mail includes a Revenue Service notice that says we are again among the chosen. The next meeting will involve more than just itemized deductions for theft losses and donations to charities, as I was laid off at General Motors and we run our own business. Because the feds also want to take a close look at our voluminous business records, the notice says that an office audit is inappropriate and we are scheduled for a field audit. What does that involve?

A. This type of examination is conducted at your home or place of business or at the office of your attorney, accountant, or other representative. It can involve an extensive examination of your entire return and is usually reserved for persons who file more complex returns that show earnings from businesses or professions.

TIP. If an IRS agent is conducting a field audit at your place of business, don't think the civil servant uncivil just because he or she turns down your offer to pick up the tab for lunch. The agent is merely following instructions spelled out in the official IRS Manual for its employees, a multivolume work with thousands of pages of indecipherable and ever-changing bureaucratese that is sometimes described by IRS staffers themselves as "the world's most confusing publication."

Tucked away in the manual are some tough guidelines that admonish the law enforcers to decline an invitation from John or Jane Q. Taxpayer for a free lunch. Predictably, because the IRS is responsible for the enforcement of legislation that, depending on one's view, is riddled with countless loopholes or contains some appropriate distinctions, the publication makes a few cautious exceptions to the flat prohibition on breaking bread with a taxpayer unless it's Dutch treat.

The manual allows agents to ignore the guidelines and dine for free when "the invitation occurs during the course of an on-site official assignment; the lunch takes place at a company facility where checks are not issued; and there are no public dining facilities in the area where the agent could go for lunch and return within the time normally allotted for lunch periods." Nevertheless, presumably to keep things kosher, an agent who foregoes brownbagging and accepts lunch under these circumstances must explain the purpose and need for accepting the invitation to the powers that be.

As part of this uncharacteristic concession, those swingers at the IRS also say that where circumstances would otherwise make it uncomfortable to refuse, employees may occasionally accept a soft drink, a cup of coffee, or equivalent nonalcoholic beverage.

Monday, October 26, 2009
THE TAX ADVISER

THE HIGH COST OF TOGETHERNESS

The IRS unreservedly blesses business-expense deductions of 100 percent for lodgings and 50 percent for meals when travelers are on a trip that takes them "away from home" overnight. But buried in the fine print is the IRS definition of "home." It is where a person's principal place of business or employment is located, even though his or her family or spouse resides elsewhere.

This should raise no problems for most people; they work at one job in the same place in which they live with their families. But identifying their tax home and whether their outlays for meals and lodgings qualify as away-from-home travel expenses raises troublesome questions for the ever-growing number of two-career couples who now live apart in an effort to keep their jobs or advance their careers.

To illustrate the tax problem, consider the case of George and Mary Leyland who found out the expensive way how the rules can twist and turn. They lived in New Haven, where he worked for the Census Bureau and she was with IBM.

It all began when the Bureau sent George to Boston for a year-long training program at the Harvard Business school. The couple gave up their New Haven apartment and rented one in Boston. They also joined a New Haven club and took a room there for Mary, which George shared when he traveled to New Haven. While George was in Boston, Mary sometimes journeyed there on business for IBM.

At filing time, the couple claimed their tax home was in New Haven, and deducted their Boston expenses. But the IRS viewed the matter somewhat differently. The agency readily conceded that Mary's tax home was in New Haven, as her job location was unchanged. This, of course, entitled her to deduct unreimbursed business expenses while in Boston on assignment by IBM.

But the Tax Court agreed with the IRS that New Haven was no longer George's tax home, since he gave up his apartment there and moved to Boston. True, his Boston assignment started out as "temporary," rather than "indefinite." Nonetheless, the court found that George chose to shift his tax home to Boston, because he was reimbursed by the Bureau when he took his furniture with him and he was paid a per-diem allowance by the Bureau when he traveled from Boston to New Haven on assignment. Therefore, the court determined that he was never "away from home" while in Boston, and his rent and food there were nondeductible. But, of course, that finding did entitle George to deduct unreimbursed business expenses while in New Haven on assignment.

The Tax Court also ruled against Marianne and Donald Felton, an Indiana couple. Marianne was on the faculty of a school located about 100 miles from the town where Donald worked and where they both resided. Usually, Marianne stayed two nights a week at her job site.

The Tax Court held that Marianne's tax home was where she worked. Her decision to live with her husband was made for personal reasons; hence, the travel outlays in issue were nondeductible personal expenses, the court ruled.

Marianne, said the court, "argues that failure to consider personal elements in a case such as hers puts undue strain on two-job families. While her point perhaps is appealing sociologically, it has no basis in law." Translation: As far as the IRS and the courts are concerned, the law is the law, and they are without authority to make exceptions and allow deductions for commuter couples.

Monday, November 2, 2009

THE TAX ADVISER

CHECK NOW ON DEPENDENCY EXEMPTIONS FOR PARENTS.

For 2009, you can claim an exemption of $3,650 for a parent only if he or she has reportable income below $3,650. Suppose your mother's income is below $3,650. Then she does not have to count Social Security benefits as reportable income. But even when her income is below the cut-off, there is another hurdle. Usually, you must provide more than half of mom's total support.

Any money mom spends on her own support counts as part of her total support. This holds true even when the money comes from untaxed sources like Social Security, inheritances or life-insurance proceeds that need not be counted toward her income ceiling. But you have to count only money that she actually *spends* for her support, not money *available to be spent*. So when she receives untaxed funds, it may be necessary to check well before the end of 2009 on whether you furnish more than half her support. Make sure that any money you contribute is allocated to support items like food, shelter, clothing and recreation. Mom should, where possible, save tax-free funds or earmark them for nonsupport items like gifts for grandchildren rather than spend them on herself.

There's a last-minute maneuver that can help if her support contributions appear to be outpacing yours as the year nears its end. In calculating what you spend on support during the year, include the cost of items that you provide by Dec. 31, even though you hold off paying for them until next year — say, a Christmas gift that you pay for with a check sent in Jan.

The tax code authorizes an exception to the more-than-half requirement for siblings who share the expenses of supporting a parent. A multiple support agreement allows one of them to claim the exemption even though no one contributor provides more than half. The children can take turns claiming it, with a Multiple Support Declaration (IRS Form 2120).

Each dependency exemption of $3,650 lowers taxes by almost $550 for someone in a 15 percent income tax bracket (taxable between $16,700 and $67,900 for married couples filing jointly and between $8,350 and $33,950 for single individuals). But someone who runs afoul of the alternative minimum tax loses out on any deductions for dependency exemptions.

Help from the Internal Revenue Service. Authoritative information on federal income tax rules for dependency exemptions, giving greater detail than the instructions you receive with Form 1040, is contained in IRS Publication 501, *Exemptions*, *Standard Deduction and Filing Information*. Publication 910, *Guide to Free Tax Services,* lists all of the agency's booklets. For free copies, call (800) TAX-FORM (allow ten days for mailing) or (703) 368-9694 for an automated fax service, or download copies from its Web site (http://www.irs.gov).

November 9, 2009

THE TAX ADVISER

TIMING PAYMENTS OF ITEMIZED DEDUCTIONS

Tax planning involves a good deal more than just knowing which items are deductible. In plotting your moves, remember that *timing* the payments for your deductibles also has a bearing on the size of your tax bill. Advancing or postponing those payments by only a day at the end of the year can save you a bundle for this and future years.

To illustrate, let's suppose that you will reap a greater savings for 2009 by using the standard deduction rather than itemizing on Schedule A of the 1040 form. Thus, you garner no tax benefit for payments in 2009 for state income taxes or other deductibles. Instead of losing these potential deductions, you can trim taxes for 2010 if you delay these payments beyond Dec. 31 and itemize next year.

The law also allows you to reverse your strategy, should that prove more beneficial. Within limits, you can shift payments for itemized deductions from next year to this year and take the standard deduction next year.

In summary, you bunch itemized deductibles, such as charitable contributions, into one of two years so that they top your standard deduction. Then, for the other year, use the standard deduction if that is more advantageous than itemizing. Put another way, bunching works only when you are able to reduce your itemized deductions below your standard deduction in the nonbunching year. Another complication is that bunching can prove inadvisable if you are subject to the alternative minimum tax.

Payments for medical expenses: Eye the calendar carefully. If you intend to claim medical expenditures, your tax strategy depends on how much you expect to report as AGI, short for adjusted gross income, and the amount of medical payments that you have already made. Because deductions are allowable only for the portion of payments that exceed 7.5 percent of AGI, payments in any single year that fail to top that threshold are nondeductible. So your strategy should be to avoid wasting payments by accelerating or postponing them into one year. Otherwise, they are nondeductible.

Be mindful of these guidelines when payments for tax year 2009 are close to, or already over, the 7.5 percent hurdle and you will incur charges in tax year 2010. Many services can be scheduled at your convenience, such as routine dental cleanings, physical checkups and eye examinations, as well as purchases of extra pairs of eyeglasses or contact lenses. You can also strategize when to pay for medically required home improvements, such as wider doorways and lower kitchen cabinets to accommodate persons in wheelchairs.

To avoid the possible loss of a deduction for 2010 for those payments and to boost your deduction for 2009, just have the services performed and pay for them by Dec. 31 of 2009. This strategy is even more advantageous when you anticipate an increase in AGI for 2010 and, therefore, a higher 7.5 percent threshold.

Ordinarily the feds prohibit deductions for payments made this year for services that will not be performed until next year by doctors, hospitals and the like. But the IRS does allow 2009 prepayments when you have to shell out now for long-term work to be done in 2010 and future years — for instance, orthodontic work on your child.

Monday, November 16, 2009

THE TAX ADVISER

YEAR-END MARRIAGES AND DIVORCES

A wedding is a solemn event that marks a personal commitment. So federal income taxes are probably the last thing on your mind when you are on the threshold of marriage. But it might pay for you to take taxes into account when choosing between a wedding in December of 2009 or one in January of 2010.

Be aware that saying “I do” before or after the stroke of midnight on New Year's Eve can make a significant difference in the size of your tax bill for those two years. The rule — too often overlooked — is that your marital status as of Dec. 31 usually determines your filing status for the *entire* year. In other words, the IRS ordains that you are a married person for all of 2009 even if you should get hitched as late as Dec. 31, or even though you and your spouse may be living apart, absent a final divorce. By the same token, the IRS considers you to be a single person for all of 2009 — even though your divorce or legal separation takes place as late as Dec. 31.

Here’s an example of how and when the so-called marriage penalty (or sin subsidy, depending on one’s point of view) applies. Let’s say that prospective mates John and Mary both work and have similar incomes. If John and Mary wed before the close of 2009, the marriage penalty may compel them to pay more income taxes on their combined incomes than if they remained two swinging singles who shared bed and board and reported exactly the same incomes. The penalty occurs when a married couple’s combined income pushes them into a higher tax bracket than they would have been in if they filed as single individuals.

There is an easy way for John and Mary to sidestep the marriage penalty for 2009. All they need to do is postpone getting hitched until 2010.

Conversely, marriage by Dec. 31 is a smart move when one of them earns the bulk of the income or considerably more than the other. Their taxes as a couple filing jointly usually will be less than if they remained unmarried. They benefit from a tax bonus.

Comparable rules apply to couples contemplating divorce or legal separation. Estranged spouses who divorce in Dec. forfeit the benefits of joint filing for all of 2009. Only couples who are able to grin and bear it through Dec. 31 can save taxes for 2009. What if being single provides an advantage? Then they must undo their marriage by Dec. 31.

A beleaguered IRS readily concedes that there is nothing to stop couples from filing as single persons as long as they get a regular divorce and simply live together out of wedlock. This arrangement has become a socially acceptable way of life for the more than five million couples who fit the Census Bureau description of POSSLQS (pronounced “possell cue”), the acronym for Persons of the Opposite Sex Sharing Living Quarters.

Marriage penalties and bonuses are "one of the major reasons the American people have become so dissatisfied with the income tax. When a tax system departs dramatically from the fundamental values of the people it taxes, it cannot sustain public support,” notes Michael Graetz, a Yale law professor and former Treasury Department official.

Monday, November 23, 2009

THE TAX ADVISER

STAYING IN TOUCH WITH THE INTERNAL REVENUE SERVICE

If you move or otherwise change your address after filing your return, it is advisable to notify the Internal Revenue Service. Submit IRS Form 8822 (Change of Address) to report the change, a step that is supposed to ensure you receive and are able to respond to later IRS mailings — for instance, a bill for additional taxes or a notice that your return has been selected for an audit. Expecting a refund? Also notify the Post Office for your old address. This will help in forwarding your check to your new address (unless you authorized the IRS to directly deposit the refund into your checking account).

All that Form 8822 asks you to provide is your old and new addresses, your full name and Social Security number, and, if you are a joint filer, your spouse’s full name and Social Security number. Mail Form 8822 to the IRS Service Center that received your return, not the Service Center for your current address.

Amended returns. The IRS makes it easy to correct errors of fact or judgment on returns for 2008 and earlier years. A recalculation on IRS Form 1040X (Amended U.S. Individual Income Tax Return) usually takes very little time, plus whatever money is involved if you feel you owe something.

Also use Form 1040X if you now discover that you overpaid. For instance, you are not stuck if you take the standard deduction and later discover that itemizing would have been more

advantageous. Amend your return and switch to itemizing, provided you do so within three years after the return's filing deadline, which is April 15 for most taxpayers.

The same holds true for married couples who file separate returns. They can switch to joint filing as long as they switch within three years after the return's due date. But if they file jointly, they cannot switch to separate returns once the filing deadline has passed. That election is binding on them.

Changing a federal return might also require amending a state return. In that event, file your state's version of the 1040X.

Monitor withholding from salaries. Were you entitled to receive a hefty refund (refunds averaged about $2,700 for returns filed in 2009) or obliged to pay a sizable sum when you settled with the IRS for 2008? Unless you want the same thing to happen again, now is the time to file a new Form W-4 with your employer. Revise the amount subtracted from your pay up or down to make sure that it will be in rough balance with what the tab will be when filing time next rolls around.

Married couples also need to review withholding when one of them returns to work after a jobless spell. Many couples belatedly discover at filing time that the federal tax rate for the first dollar of her earnings is the rate for the last dollar of his earnings. So if one spouse falls into a 30 percent federal and state bracket, the other does, too. To avoid an expensive surprise, they should make sure that sufficient taxes are withheld to cover the tab for their combined incomes.

November 30, 2009

THE TAX ADVISER

TAX TIPS FOR HOME OWNERS

Home improvements: Why it's important to keep track of your spending. Have you made home improvements? They yield no current deductions but are added to your home's cost basis — the figure used to determine gain or loss on a sale of the property. Hence, improvements reduce any taxable profit when you eventually sell.

Like most home sellers, you are well aware of rules that relieve you of taxes on a home-sale gain of as much as $250,000 when you file an individual Form 1040 and up to $500,000 when you file a joint return. But many of you are unaware that anyone with a gain greater than the exclusion threshold of $250,000 or $500,000 is stuck with taxes on the excess. No longer are sellers allowed to postpone taxes on their entire gain by buying another home that cost more than what they received for the one sold.

In the event the IRS questions your sale, the audit will be less traumatic and less expensive if you have kept meticulous records that track the dwelling's basis. Those records should include what you originally paid for your property, plus settlement or closing costs, such as title insurance and legal fees, as well as what you later shell out for improvements, such as adding a

room or paving a driveway, as opposed to routine repairs or maintenance that adds nothing to the place's value, such as painting or papering a room or replacing a broken windowpane.

Some owners of vacation homes should avoid renting them out for more than 15 days. Do you own a vacation home (or year-round home, for that matter) near annual events where rents soar for short periods —- for instance, Indianapolis for the Memorial Day race, Louisville during Derby week, and Augusta during its Masters golf tournament? With the blessings of the IRS, you can rent out your home, pocket the rent checks and sidestep taxes on the rental income. Just make sure to rent out your cottage or condo for less than 15 days during the year, and you do not have to declare any of the income you receive. But go beyond the less-than-15-days limit and all the rental income becomes reportable on Form 1040's Schedule E. Carefully review the rules; the tax collectors can be sticky.

Another break for vacation-home owners ends. The law allows individuals who sell their principal residence (year-round home) to escape taxes on a profit of as much as $500,000. To qualify for the exclusion, they must own and use the dwelling as a principal residence for at least two years out of the five-year period that ends on the sale date. Previously, they could claim an exclusion, then occupy a vacation dwelling for two years and qualify for another exclusion. Legislation that took effect at the start of 2009 limits the amount of the exclusion when a second home becomes the principal residence. In the case of sales after 2008, the new rules prohibit any exclusion for post-2008 periods of "nonqualified use" — IRS lingo for periods during which the former second home was not used as a principal residence.

Losses on home sales. Because of the depressed housing market, there has been an unceasing increase in the number of sellers suffering losses on sales of personal residences.

The tax code has always prohibited write-offs for such losses. It treats them as nondeductible personal expenditures. Contrary to what many owners mistakenly believe, mortgage debts do not enter into the calculation of gain or loss on a home sale.

Monday, December 7, 2009

THE TAX ADVISER

HELPING TWO PARENTS: HOW TO NAIL DOWN ONE EXEMPTION

Do you contribute toward the support of another household that includes two or more relatives -- for instance, your father and mother? An Internal Revenue Service ruling provides an easy way for you to arrange support contributions in a way that will give you a dependency exemption of $3,650 for 2009 for at least one of them.

Suppose your parents live apart from you and their total support outlay comes to $20,000 — $10,000 each. The breakdown of the $20,000 is that you contribute $7,600 and the remaining $12,400 comes from their Social Security benefits and other tax-free sources.

With that set of numbers, make sure to designate *one* of your parents as the specific recipient of your payments. Otherwise, you lose out on any exemption for either

parent because you flunk the support test, which requires you to contribute more than half of their total support for the year.

CAUTION. It makes no difference that your $7,600 contribution is well over half the $10,000 support for either one of your parents. The snag in this situation is that an Internal Revenue auditor, in the absence of a designation by you of *one* parent as a specific recipient, routinely splits your contribution between your father and mother and will assume you provided $3,800 for each. Under that approach, you are not entitled to an exemption for either parent, unless you are able to overcome the IRS assumption with after-the-fact proof that your $7,600 was actually spent on one of them alone.

By the time the IRS gets around to an audit of your return, of course, it is usually impossible to show such proof. But there is an easy way to avoid the problem. An IRS ruling allows you to make a before-the-fact designation of your contributions as intended specifically for the support of, say, your mother. Usually, you do not have to prove that the designated amount was spent only on her.

Odds are, though, that an IRS examiner will refuse to go along with a verbal agreement between you and your mother that is not backed up by some written memo or other record that you prepared at the time you made your support contribution. So if you are paying only for your mother's support, be sure to note this on your checks for her.

TIP. Whenever possible, you should make the payments directly for things that the IRS counts as her support. The possibilities include outlays for food, clothing, medical and dental care (remember to include premiums for health insurance), charitable contributions, recreation, transportation and similar necessities.

HELP FROM THE IRS. Authoritative information on federal income tax rules for dependency exemptions, giving greater detail than the instructions you receive with Form 1040, is contained in IRS Publication 501, *Exemptions*, *Standard Deduction and Filing Information.* It is available at the agency's Web site, htpp://www.irs.gov, or call 800-TAX-FORM. While you are at it, order Publication 910, *Guide to Free Tax Services.* It lists all of the IRS booklets.

December 14, 2009

THE TAX ADVISER

BUNCHING MISCELLANEOUS DEDUCTIONS AND RESCUING WRITE-OFFS

Miscellaneous itemized deductions on Schedule A of Form 1040 include job-search expenses, unreimbursed employee business expenses like union and professional dues and fees for tax and investment advice. They are allowable only to the extent that their total exceeds two percent of adjusted gross income (AGI). Anything below the two-percent threshold is nondeductible. An AGI of $100,000 and $5,000 of expenses means no deduction for the first $2,000. More of them become allowable when you incur the expenditures during a year in which AGI decreases. Don't even think about deducting any of them if you are snagged by the alternative minimum tax.

If you are close to, or already surpass the two-percent barrier for 2009, now is the time to pay for miscellaneous expenses that push you beyond two percent and then entitle you to claim

write-offs. Another way to increase those miscellaneous deductions is to decrease AGI by accelerating other kinds of deductions from 2010 into 2009 or by postponing the receipt of income until after 2009 — strategies that must be completed by Dec. 31.

Some of the ways to shrink AGI: boost deductible contributions to retirement plans; if you are self-employed, pay business expenses no later than Dec. 31 or delay the receipt of income by mailing bills to clients after Dec. 31; in the case of stocks and bonds whose prices have declined, sell losers by Dec. 31, and use the investment losses to offset already-registered gains and, when losses exceed gains, use up to $3,000 of losses to offset income from sources like salaries and business profits.

Strategies that lower AGI could qualify you for many other deductions and credits that are linked to AGI — for instance, recently introduced incentives like the credit for first-time home buyers or the deduction for buyers of cars and other motor vehicles.

Closing by Dec. 31 on a mortgage refinancing can be a tax trimmer. The tax rules are helpful when you must pay points for refinancing an existing mortgage and use the loan proceeds to improve your home. They allow you to include the full amount of the points with other itemized deductions for 2009.

But restrictive rules apply when you refinance just to take advantage of lower interest rates. They allow you to claim points only in dribs and drabs over the loan's full term — divide what you paid for points by the number of monthly payments you will make over the life of the loan.

Borrowers who refinance for second or third times often overlook sizable write-offs. Serial refinancers can immediately deduct what remains of the points from previous refinancings undertaken only to benefit from lower interest rates

But borrowers fail to recall those points because they don't show up on the closing papers of new refinancings. Typically, several thousand dollars fall right through the cracks. For refinancers who fall into a 30 percent federal and state bracket, every $1,000 they write off lowers taxes by $300 — more than enough to pay for a pleasant night on the town.

December 21, 2009

THE TAX ADVISER

DEDUCTIONS FOR MOVING EXPENSES

Pay for a job-related move by Dec. 31 and gain some write-offs. There is help at filing time for people who lose jobs and find new ones that require them to relocate. If the new employers do not pay for the relocation costs or reimburse them, employees can deduct many of the expenses incurred in the shift. To qualify, employees must meet distance and time tests, requirements that also apply to self-employed individuals.

As long as you shell out for moving expenses by Dec. 31, they are deductible on 2009's 1040. You don't need to land the job before you move or start work by Dec. 31, provided you satisfy the time test. Another plus is that you don't even need to satisfy it by the return's due date. What if you eventually flunk the test? Either amend 2009's return or report the amount previously

deducted for expenses on your 2009 return as income on the return for the year you flunk the test.

The new job has to be at least 50 miles farther from your old home than your previous job location was. Suppose the distance between your old home and your old job is 20 miles. Then the distance between your old home and your new job has to be at least 70 miles.

You have to work full-time in your new location for specified periods — as an employee, at least 39 weeks in the 12-month period after the move; as a self-employed individual, at least 78 weeks in the 24-month period after the move, including at least 39 weeks during the first 12 months. There is no requirement that the weeks be consecutive or that you work for the same employer. If you switch from employee to self-employed before meeting the 39-week test, you still qualify if you meet the 78-week test.

The IRS relaxes the rules for joint filers. Either spouse can meet the full-time work test. But you cannot add the weeks your spouse works to those you work to satisfy that requirement.

Deductible outlays include unreimbursed costs of transporting your family members, pets and belongings to your new home. It is not necessary that you, household members, and Lassie travel together or at the same time. If you use your car for the move, deduct the actual cost of gas and oil or a standard mileage rate — for 2009, 24 cents per mile, plus parking fees and tolls.

You don't have to itemize to deduct claim moving expenses. Claim this write-off on the front of the 1040 form — the same way write-offs are claimed for, among other things, alimony payments and money moved into retirement plans.

Closing by Dec. 31 on the purchase of a new home can lower your taxes. The inducement for meeting that deadline: an itemized deduction for 2009 if you must pay points (each point equals one percent of the loan amount) to obtain a mortgage from a lending institution. Take an immediate deduction in full for up-front interest payments incurred to obtain a loan to buy, build or improve your main home (as when you add or remodel a room), as opposed to, say, a second home that you use as a vacation retreat, or property for which you charge rent.

December 28, 2009

THE TAX ADVISER

TAX PLANNING AFTER 2009

There are going to be many changes in the tax rules for 2010 and later years. But the fundamentals of good planning will continue to apply.
Harsh economic times require President Obama and Congress to cut deals on tax rates for ordinary income, capital gains and dividends. Mr. Obama has proposed, and Congress is expected to enact, legislation to increase 2010's two top income tax brackets — 33 percent for taxable income above $209,250 for joint filers and $171,850 for singles and 35 percent for taxable income above $373,650 for joints and singles. The two top rates would move up to 36 percent and 39.6 percent for 2011 and later years, which is what they were before 2001. The other four rates would continue to be 28, 25, 15 and 10 percent.

The tax rates apply to taxable income, which means adjusted gross income (the amount on the last line of the front page of the 1040 form) minus dependency exemptions and itemized deductions like charitable contributions and medical expenses on Schedule A of the 1040 form or the standard deduction for individuals who do not itemize.

Mr. Obama also wants to boost the top rate for dividends and for long-term capital gains from sales of stocks and other securities owned more than 12 months. The top rate for dividends and long-term gains would increase from 15 to 20 percent for individuals in the two top income tax brackets. But for 2011 and later years, investors in the bottom two income tax brackets of 10 percent and 15 percent would still be taxed at a rate of zero percent on long-term gains and dividends.

Whatever happens to taxes after 2009, many time-honored techniques will still work well for most people. One is a standard admonition to maximize deferral possibilities. Whenever possible, investors should avail themselves of traditional IRAs and other tax-deferred retirement plans to hold taxable bond funds, real estate investment trusts or high-turnover stock funds that incur short-term gains (for 2009 and 2010, top tax rate of 35 percent for interest and short-term gains). And they should use taxable accounts to hold shares of mutual funds that generate long-term gains and dividends — assuming dividends continue to be taxed at the top rate of 15 percent for long-term gains. All of that noted, it remains essential for investors to run the numbers. Moving too much money into tax-deferred plans can cause them to get hit with more overall taxes when they take money out. In any case, their decisions on which investments are best held inside or outside such plans must jibe with their individual risk tolerance and investment aspirations.

WORTHLESS SECURITIES. The IRS allows 2009 deductions for worthless securities only if they became *entirely* worthless by Dec. 31. It matters not that the securities are no longer traded on a market and are *practically* worthless for all intents and purposes. If you are uncertain about the year of worthlessness, claim the deduction for the first year in which they became entirely worthless. The paperwork isn't bad. Just report the loss on Schedule D as if you sold the securities for $0 on Dec. 31. That date also determines if your loss is short- or long-term.

To reap a 2009 deduction for securities that have not become totally worthless, sell them by Dec. 31. Some brokerage firms will buy almost-worthless securities for nominal amounts to enable clients to establish their losses for 2009.

Monday, January 4, 2010

THE TAX ADVISER

ESTIMATED TAXES: ANOTHER DEADLINE COMING UP

Make sure to stay on top of the deadlines for filing federal tax returns and the due dates for making payments. Miss just one, and the IRS might exact a sizable, nondeductible penalty.

Friday, Jan. 15, 2010, is a key date for many taxpayers to remember. For individuals whose estimated income tax exceeds $1,000, that's the due date for the final quarterly installment of estimated income tax for 2009 — including any self-employment tax and alternative minimum

tax. But it’s okay to skip this final payment, provided they submit their 2008 returns and pay their tax in full by Monday, Feb. 1.

Who needs to make estimated payments? Individuals with income from sources not subject to withholding of taxes. This category mostly comprises self-employed individuals who operate businesses or professions as sole proprietorships, in partnerships with others, or as independent contractors, and investors who receive sizable amounts of interest, dividends and profits from sales of assets.

To avoid unnecessary payments, remember to take account of withholding during 2009 on what you or your spouse receive from salaries, wages and other types of compensation. Ditto for an overpayment of taxes in 2008 that you elect to apply to your 2009 bill.

The IRS can exact penalties for failing to pay sufficient tax during the year through withholding or quarterly payments, as well as for failure to pay required installments on time as they become due. It matters not that your final estimated payments are sufficient to erase any balance due when you submit your 2009 1040 form in 2010.

However, there are “safe harbors” or exceptions that excuse you from any penalties for underpayments of more than $1,000 for withheld or estimated taxes. For relief from these penalties, you must satisfy a two-step requirement:

First, make payments by the quarterly due dates — for 2009, by April 15, June 16, Sept. 15, and Jan. 15.

Second, those payments must at least equal *any* of the following three amounts:

(1) 90 percent of the total tax for 2009 (reduced to 66 2/3 percent for qualifying farmers and fishermen).

(2) 100 percent of the total tax for 2008. This is the amount on line 61 of the 2008 1040 form.

The exception based on the prior year’s tax is available even if the amount due was zero, provided the return covered 12 months, as it ordinarily would.

As the prior-year exception uses a fixed number, it’s the easiest way for most individuals to figure their payments and avoid penalties. To illustrate, your tax payments total $12,000 for 2008 and $15,000 through estimates or withholding in 2009. With those kinds of numbers, you’re home free, no matter how much extra you owe when you file for 2009.

There’s a restriction on use of this exception when adjusted gross income for 2008 (the amount on the last line of page one of Form 1040) exceeds $150,000 — declining to $75,000 for married couples who file separate returns. To take advantage of the 100-percent escape hatch, payments must equal 90 percent of the total tax for 2009 or 110 percent of the total tax for 2008 — whichever is *less*.

Small business owners qualify for a break if their 2008 AGI was less than $500,000 ($250,000 if married and filing separately) and more than half of their gross income was from a firm with less than 500 workers. They can base payments on the lesser of 90 percent of 2008’s tax, rather than the 100 or 110 percent benchmarks.

(3) 90 percent of the total tax for 2009, figured by "annualizing" income actually received by the end of the quarter in question.

The annualizing exception helps those whose incomes unexpectedly increase or fluctuate throughout the year, such as Roth IRA converters who move money out of traditional IRAs and into Roth accounts at year's end, or investors who receive higher than anticipated distributions of dividends and capital gains from their taxable accounts with mutual funds. But be warned: this calculation is complicated.

Monday, January 11, 2010

THE TAX ADVISER

GOING GREEN TRIMS TAXES

Installing energy-efficient home improvements like windows and doors in your principal residence will qualify you for a tax credit. The credit equals 30 percent of the cost, capped at a maximum of $1,500. There's another credit of 30 percent of the cost of installing renewable-energy improvements like solar water heaters and solar panels. This credit isn't capped, and the residence doesn't have to be your principal residence. For detailed information on the laundry list of items that qualify for the two credits, go to www.energytaxincentives.org.

BUY A HOME AND LOWER TAXES. New rules that took effect on Nov. 7, 2009, extend and liberalize tax credits for homebuyers. Now there are two kinds of credits for homes costing under $800,000. One is a credit of up to $8,000 for first-time buyers of a principal residence who didn't own another principal residence during the three-year period ending on the date they purchase the new place. The other is up to $6,500 for buyers who owned a principal residence for any five consecutive years during the eight-year period that ends on the purchase date. Both credits allow buyers with higher incomes to qualify and require them to sign a binding contract by April 30, 2010, and complete the deal by June 30, 2010.

CREDITS VERSUS DEDUCTIONS. Most taxpayers do not understand the difference between credits and deductions. Credits lower a person's taxes dollar for dollar, making them more valuable than deductions, which merely reduce the amount of income on which taxes are figured. The distinction is critical. A deduction of $1,000 saves $350 in taxes for someone in the highest bracket of 35 percent, but only $100 for someone in the lowest bracket of 10 percent. A credit of $1,000 reduces taxes by that amount, whatever someone's bracket is.

Another difference is that credits come in two flavors, nonrefundable and refundable. Nonrefundable means credits cannot be refunded to the extent that they exceed your income tax. Put another way, credits like the one for child care provide no help after your income tax becomes zero. Refundable means credits like the recently revised one for first-time homebuyers can be refunded to the extent that they exceed your income tax. So even buyers who have no income-tax liability could receive as much as $8,000 from the IRS.

NAIL DOWN BAD DEBT DEDUCTIONS FOR LOANS TO FRIENDS AND FAMILY. These being the troublesome times they are, friends or relatives who are strapped for funds may try to tap their lines of credit at the Bank of You. Before doling out dollars, do the paperwork necessary to establish that the transactions actually are loans. Be sure to have debtors sign agreements or notes stipulating amounts advanced and repayment provisions as well as when

they must make interest payments. Charge a realistic rate of interest — say, whatever your money would earn in a savings account if it were not out on loan.

At Form 1040 time, you will be rewarded for your foresight: Loans that later become worthless are deductible under the rules for short-term capital losses. What if you just shake their hands and skip the paperwork? Expect skeptical tax collectors to throw out write-offs for “loans” that really were nondeductible gifts.

Monday, January 18, 2010

THE TAX ADVISER

HEALTH INSURANCE DEDUCTIONS FOR SELF-EMPLOYED INDIVIDUALS

Medical expenses are deductible only if they satisfy two requirements. They can be claimed only by individuals who itemize on Schedule A of Form 1040 and don’t use the standard deduction. The big hurdle is that medical expenses not covered by insurance are allowable only to the extent that they exceed 7.5 percent of adjusted gross income.

But there’s a special break for freelancers, consultants and other self-employed individuals. People who are their own bosses can deduct 100 percent of their payments for medical insurance for themselves, their spouses and dependents. They aren’t subject to the 7.5 percent nondeductible floor. And they don’t even have to itemize to deduct insurance. Their insurance write-off goes on the front of the 1040 form — the same as write-offs for, among other things, money stashed in tax-deferred retirement plans and moving expenses.

This break benefits self-employed individuals who now incur hefty payments, because they were laid off by companies providing employer-sponsored insurance plans.

A curtailment kicks in when premiums are high and business income low. No deduction for medical insurance payments that exceed the business’s net earnings (receipts minus expenses).

There’s no special treatment for newly minted self-employeds who buy COBRA coverage through their former employers’ group plans. COBRA payments and other medical expenses are subject to the 7.5 percent threshold. But those who are unemployed are earning less, so their insurance and other medical costs may well exceed the threshold.

SMALL BUSINESSES GET FASTER WRITE-OFFS WITH FIRST-YEAR EXPENSING DEDUCTIONS. There are two ways for small businesses to write off their outlays for equipment purchases such as computers and file cabinets. One is to use the "standard" route to recover the cost through depreciation deductions over a period of years. The other is the often-overlooked tactic of "expensing" authorized by Internal Revenue Code Section 179. It allows them to deduct the entire cost of the equipment in the year of purchase. The immediate write-off and resulting tax trimming benefits businesses battered by the recession.

Let’s say equipment purchases include $10,000 for computers, copiers and the like. Instead of depreciating that equipment over five years, they can be immediately expensed. A $10,000 write-off lowers taxes by $3,000 for individuals in a top federal and state bracket of 30%.

PROFIT FROM PAYING YOUR KIDS. Do your children help out with your business? *Could* they? A savvy way to take care of their allowances at the expense of the IRS is to pay them wages for work they do. Hiring them keeps income in the family but shifts some out of your higher bracket and into their lower one.

Of course, deductions for their wages stand up under IRS scrutiny only if you treat them as real employees performing real work and receiving reasonable wages — not more than the going rate for unrelated employees performing comparable chores like clerical work or deliveries.

The children are liable for income taxes on their wages. But children's earnings are offset by their standard deduction — for 2010, $5,700, a figure that's scheduled to increase in later years.

There's an additional carrot. Code Section 3121(b)(3)(A) allows you to sidestep Social Security and Medicare taxes on wages paid to under-age-18 sons or daughters, provided you do business as (1) a sole proprietorship (IRS lingo for the lone owner of a full-time or part-time business that's not formed as a corporation or partnership) or (2) a husband-wife partnership. To put it another way: This exemption *doesn't* apply to a family business that's incorporated or a partnership with a partner other than a spouse.

Write-offs for wages enable self-employeds to save more than just income taxes. They also reduce self-employment taxes owed for 2010 on the first $106,800 of net (receipts minus expenses) earnings.

Monday, January 25, 2010

THE TAX ADVISER

TAKE THE STANDARD DEDUCTION OR ITEMIZE?

Many of you who are about to file returns for 2009 want advice on whether to claim the standard deduction or to itemize outlays like mortgage interest and charitable contributions. Itemizing pays off only when total itemized deductions surpass the standard deduction.

The normal standard deduction amounts are $11,400 for joint filers, $8,350 for heads of household, and $5,700 for married persons filing separately and singles. Couples who file separate returns must handle their deductions the same way; if one spouse itemizes, so must the other.

The deduction of $11,400 for joint filers also is available to a "surviving spouse" — a widow or widower who has a dependent child living with him or her and is entitled to use joint-return rates for two years after the death of a spouse in 2007 or 2008.

The deductions for individuals who have reached age 65 by the end of 2009 increase by $1,100 for a married person and $1,400 for someone whose filing status is single or head of household. Persons considered to be blind are entitled to those additional amounts or double those amounts if they are both 65 and blind.

So the standard deduction rises from $5,700 to $7,100 for a single person who is age 65 or older. It goes from $5,700 to $8,500 for a single person who is at least 65 and blind. On a joint return, depending on whether one or both spouses are at least 65, it increases from $11,400 to $12,500 or $13,600 (with additional $1,100 amounts available for blindness).

The standard deduction *decreases* for individuals (children and elderly parents, mostly) who can be claimed as dependents on the returns of other persons. For 2009, the standard deduction can be as little as $950.

There are some add-ons to the standard deduction. But they come with plenty of stipulations.

Homeowners who do not itemize can claim an additional standard deduction for state and local real estate taxes. The extra deduction is capped at $1,000 for joint filers or $500 for other returns (or actual taxes paid, if that is less).

Another change helps nonitemizers whose homes and other properties were damaged or destroyed in places declared to be federal disaster areas eligible for assistance. They can boost their standard deduction by the amount of uninsured losses attributable to natural disasters like hurricanes and landslides. Disaster losses are deductible without being subject to the usual requirement that casualty and theft write-offs are allowable only to the extent they exceed 10 percent of AGI, adjusted gross income.

Another add-on is for individuals who buy new motor vehicles between Feb. 17, 2009 and Dec. 31, 2009. Buyers boost their standard deduction by what they pay for state and local sales taxes and excise taxes on up to $49,500 of the purchase price of *each* qualifying vehicle. Vehicles passing muster include new cars, sport-utility vehicles, light trucks, motorcycles (must weigh under 8,500 pounds), and mobile homes, but not used-vehicle purchases or leases.

As with lots of other incentives, this add-on is unavailable to high-income buyers. It starts to vanish when modified AGI (same as AGI for most buyers) exceeds specified amounts — between $125,000 and $135,000 for individual filers and $250,000 and $260,000 for joint filers.