CHAPTER 1

New Rules for Income and Exclusions

Income can come from many sources: your job, a business, investments, bank interest, and alimony, to name a few. In most cases, all of your income is included in the “Income” section on your tax return.

Sometimes, however, a special tax rule allows you *not* to report some or all of an item of income. There may be breaks if your income is low. For example, Social Security retirement or disability benefits are not taxed if your income is below set amounts; if not fully tax free, then the benefits are included in income at 50 percent or 80 percent, again depending on your other income.

The tax law may have an *exclusion* or *exemption* for certain types of income. Without a specific exclusion or exemption, the income is taxable; with it, the income becomes tax free. The exclusion may be for some or all of the income item. Eligibility for an exclusion may depend on your adjusted gross income (AGI), which is your income minus adjustments to gross income, or your modified adjusted gross income (MAGI), which is usually AGI without regard to certain foreign income exclusions.

This chapter covers the new rules affecting income and exclusions in 2009 and 2010. It also covers some important rules that are set to expire soon, so you can act now to take advantage of them. And the chapter provides planning strategies for income that you can use to save money on your return for 2009 and for years to come.

COMPENSATION AND OTHER JOB-RELATED BENEFITS

There are an estimated 140 million U.S. workers on company payrolls. They are paid wages and may also receive various fringe benefits. The benefits may be cash, in the form of bonuses, vacation pay, sick days, and personal leave. The benefits may also be tax-free fringe benefits where the employer pays for certain items on which the employee is not taxed, such as health insurance and employer contributions to retirement plans. If you are among those who are employed today, here are some changes of note related to your compensation package.

In this tough economy, not everyone has been able to keep their job. In July 2009, the national unemployment rate was 9.4 percent. Also included in this section is information that may relate to you or a family member who has lost a job.

Elective Deferrals

If you are employed and participate in a 401(k) plan, a 403(b) annuity, a 457 government plan, a salary reduction simplified employee pension (SARSEP) established before 1997, or a savings incentive match plan for employees (SIMPLE), you can opt to have part of your wages added to the plan. The wages you add to the plan are called elective deferrals or salary reduction contributions. You do not get a tax deduction for your contribution (although you may be eligible for a tax credit related to your contribution, as explained in Chapter 5). Instead, the contribution is not included in your income for the year, so you don't pay tax now on your contribution to the plan.

Note: You still pay Social Security and Medicare (FICA) taxes on elective deferrals even though you don't pay income tax on them.

Contribution Limits for Plans Other Than SIMPLEs

For 2009, the tax law increased the elective deferral limit to $16,500 (up from $15,500 in 2008). This is called the "basic" elective deferral limit.

If you are at least age 50 by December 31, 2009, you can add an additional elective deferral amount, called a "catch-up contribution" for 2009. The catch-up amount for 2009 is $5,500 (up from $5,000 in 2008).

Example

A salaried person age 52 can add $22,000 ($16,500 + $5,500) to a 401(k) plan in 2009 as long as wages are at least $22,000 and the pan allows the full limit.

Typically, the elective deferral is spread out over the year, with an allocated portion subtracted from each paycheck (or from one paycheck each month for those with a twice-a-month paycheck schedule).

For 2010 and later years, the basic and catch-up contribution amounts can be adjusted upward for inflation. These amounts usually are announced late in the year so plan participants can agree to their contributions for the coming year.

PLANNING

If you will celebrate your 50th birthday *during* the year, you can make the catch-up contribution *throughout* the year. You don't have to wait until your birthday passes to start making catch-up contributions.

Elective deferrals can be as great as 100 percent of compensation, up to the dollar limit for basic and catch-up contributions for the year. However, most plan participants contribute only a small percentage of their wages. It is highly advisable to contribute at least the minimum amount needed to obtain employer matching contributions. Usually, employer matching contributions are based on up to 6 percent of compensation. However, in these tough economic times, some employers have reduced or eliminated matching contributions, so check with your employer before committing to next year's elective deferral amount.

If you are enrolled in an automatic enrollment plan (one in which your employer enrolls you but you have the ability to opt out or reduce the automatic elective deferral amounts), review your contribution amounts for the coming year. The elective deferral percentage under an automatic enrollment plan can and usually does increase each year. You can choose to increase or decrease this percentage amount. If you have any questions about elective deferrals, ask your plan administrator.

Starting in 2010, small employers (those with 500 or fewer employees) can offer a hybrid retirement plan that combines a defined benefit (pension) plan with a 401(k) plan. This type of plan is called a DB(k). If your employer adopts this type of plan, ask the plan administrator to explain elective deferral limits and other rules.

Contribution Limits for SIMPLEs

Savings incentive match plans for employees (SIMPLEs) are plans offered by some small employers. From an employee's perspective, they look and act much like a 401(k) plan, although the dollar limits on elective deferrals are lower. For 2009, the elective deferral to a SIMPLE plan is $11,500 (up from $10,500 in 2008).

If you are at least age 50 by December 31, 2009, you can also make a catch-up contribution for 2009. The catch-up amount for 2009 is unchanged at $2,500.

Example

A salaried person age 52 can add $14,000 ($11,500 + $2,500) to a SIMPLE plan in 2009 as long as compensation for the year is at least $14,000 and the plan allows the full limit.

PLANNING

Decide on your elective deferral contribution for next year. You can add up to 100 percent of your wages, up to the dollar limit for the basic and catch-up contributions for the year. If your employer makes a *nonelective* contribution (usually 3 percent of your compensation), you receive the benefit of this contribution only if you, too, contribute to the plan for the year.

For 2010 and later years, the basic and catch-up contribution amounts can be adjusted upward for inflation. These amounts usually are announced late in the year so plan participants can decide on their contributions for the coming year.

Transportation Fringe Benefits

Usually, your out-of-pocket costs for commuting to and from work each day are not deductible; they are considered nondeductible personal expenses. There are, however, ways around this rule. Your employer can pay for certain transportation fringe benefits up to set limits and you are *not* taxed on the payments made on your behalf. The monthly benefits include:

- *Free parking*—parking spaces for employees on or near the employer's business premises or at or near a location from which the employees commute to work by mass transit, car pooling, or van pooling, such as a train or bus station.
- *Monthly transit passes*—payments for mass transit travel to and from work.
- *Van pooling*—a program that the employer sets up for transporting employees to and from work in a company-owned "commuter highway vehicle" that seats at least six adults (not counting the driver) and for which at least 80 percent of the mileage is used to transport the employees to and from work.

For 2009, the dollar limit on the exclusion for free parking for all of the year is $230 per month. For March through December 2009, the exclusion for monthly transit passes and van pooling is $230 per month; for January and February 2009 it is $120 for these transportation fringe benefits. In 2008, free parking was limited to $220 per month and transit passes and van pooling were limited to $115 per month.

For 2010, the dollar limit on these three transportation fringe benefits could have been increased for inflation but there will be no adjustment. Free parking, monthly transit passes, and van pooling will remain in parity so that there is the same monthly limit for each type of commuting fringe benefit.

For 2009, there is a new transportation fringe benefit for bicycle commuting. An employee can receive from an employer $20 per month tax free to cover the cost of buying, storing, and maintaining a bicycle used to get to and from work. The $20 per month benefit will not be indexed for inflation and will remain at $20 per month in 2010. To receive this fringe benefit, an employee cannot receive free parking, commuter passes, or van pooling.

PLANNING

Your employer may allow you to pay for monthly transit passes on a pretax basis. Like contributions to 401(k) plans, the amount of your wages that you opt to apply toward the purchase of monthly transit passes is not treated as taxable wages (the amount is subtracted from your wages). The elective deferral that reduces your wages cannot exceed the dollar limit for transit passes for the year.

You can enjoy *both* free parking and monthly transit passes or van pooling, for a maximum monthly exclusion in 2009 of $460 each month for most of the year. For example, if your employer pays for parking at the train station and transit passes for the train, you can exclude the cost of each up to $230 a month for parking and $230 a month for the train travel for March through December ($120 for January and February).

Foreign Earned Income Exclusion

If you work abroad, you may still owe U.S. income taxes. The tax law generally requires U.S. citizens and residents to file U.S. income tax returns and pay U.S. income taxes on their worldwide income. However, the law allows you to exclude income earned outside of the United States from income on a U.S. tax return up to a set limit. For 2009, the limit is $91,400; in 2008 it was $87,600.

To qualify for this exclusion, you must meet one of two tests:

- A foreign residence test—you are a U.S. citizen and you reside abroad.
- A foreign physical presence test of 330 days—you are a U.S. citizen or resident living in a foreign country for an uninterrupted period that includes one full year.

Only compensation paid by a private employer or self-employment income earned in a foreign country qualifies for the exclusion. U.S. government pay does not qualify for the exclusion, regardless of the fact that you live abroad. The exclusion does not apply to those who work in locations that are not foreign countries:

- Antarctica
- International airspace
- International waters

PLANNING

The exclusion amount can be adjusted annually for inflation. See Appendix B for details.

Foreign income taxes paid on foreign wages or self-employment income can be claimed as a tax deduction or credit on a U.S. income tax return.

Housing Expenses

If you are living abroad and qualify for the foreign earned income exclusion, you can also exclude housing expenses over a set amount. For 2009, the base housing amount has increased to $40.07 a day, or $14,624 for the entire year; expenses over this amount are excludable. However, the excludable amount cannot exceed 30 percent of the foreign earned income exclusion of $91,400, or $27,420 in 2009. Higher dollar limits apply in certain so-called high-cost areas.

PLANNING

The exclusion amount can be adjusted annually for inflation. See Appendix B for details.

Combat Pay

Payments to noncommissioned U.S. military personnel and part of the pay to commissioned officers serving in a combat zone or while hospitalized as a result of combat-related wounds or disease are excludable from gross income. The exclusion does not extend any further. The Internal Revenue Service (IRS) has made it clear, however, that this exclusion does not apply to civilian employees of the armed forces or for supplemental compensation paid by private businesses to members of the U.S. armed forces.

PLANNING

Civilian employees cannot use the combat pay exclusion but may qualify for the regular foreign earned income exclusion discussed earlier.

Military personnel eligible to exclude combat pay from gross income may opt to include it in order to claim certain tax benefits, such as the earned income credit and a deduction for individual retirement account (IRA) contributions.

Unemployment Benefits

Generally, unemployment benefits paid by states to individuals who are terminated from their jobs are all included in income. However, for 2009 only (unless Congress extends this break), a recipient can exclude up to $2,400 of such benefits from income. This exclusion applies without regard to your overall income for the year.

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PLANNING

Recipients of unemployment benefits can opt to have income taxes withheld from their benefits by filing Form W-4V, *Voluntary Withholding*. If this is done, withholding is taken at the rate of 10 percent. For certain individuals, voluntary withholding can avoid the need to pay estimated taxes.

COBRA Subsidy

COBRA (an acronym for the Consolidated Omnibus Budget Reconciliation Act) is a federal law requiring employers that regularly employ at least 20 workers and that offer health coverage to allow workers who leave the job to continue in the group plan for 18 months. Usually, the employee pays the full cost of COBRA coverage, plus an administrative fee of up to 2 percent of premiums.

Under a special rule, certain terminated workers can receive federal assistance for COBRA premiums. An assistance-eligible individual pays only 35 percent of COBRA premiums for nine months; the federal government pays the other 65 percent of premiums for this period (the employer pays this portion and receives reimbursement from the government via a reduction of employment taxes).

To qualify for the COBRA subsidy, you must have been involuntarily terminated from employment on or after September 1, 2008, and before January 1, 2010. You don't get the subsidy if you left the job for your own reasons. Once involuntarily terminated, you must make a timely election for COBRA coverage. (Under a special rule, those who were terminated before February 17, 2009, were given an additional 60 days to elect COBRA coverage and receive the federal subsidy.)

You receive the subsidy regardless of the amount of your income for the year. However, the subsidy is tax free to you only if your modified adjusted gross income (MAGI) does not exceed a set amount ($125,000 for singles or $250,000 for joint filers). If your MAGI exceeds the limit, then the federal subsidy is included in gross income. A worksheet for figuring recapture of COBRA premium assistance is in Appendix C.

PLANNING

If you are eligible for this COBRA subsidy, decide whether it is less costly than obtaining health coverage elsewhere. For example, it may be less costly to seek

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individual coverage to obtain the type of benefits you need and not pay for those you don't (which may be part of the price of the employer's coverage).

Note that the federal subsidy runs for only nine months but you can continue federal COBRA for another nine months (18 months in total). If your employer pays for some months of COBRA, this reduces the period of the federal subsidy. For instance, if your employer lays you off and agrees to pay all of your COBRA costs for three months, you can then obtain the federal subsidy for only six months (not the usual nine months).

Even if you work for an employer who is not subject to federal COBRA (there are fewer than 20 workers on the payroll), a state law, called mini-COBRA, may apply. The nine-month federal subsidy can be used to the extent of your state's COBRA coverage period.

INTEREST AND DIVIDENDS

Build America Bonds

Build America Bonds (BABs), created by the American Recovery and Reinvestment Act, are *taxable* municipal bonds issued by states and municipalities for schools and infrastructure. What sets them apart from other bonds is the fact that the federal government effectively pays 35 percent of the bond interest. Typically, the issuer retains this federal subsidy and offers a higher rate of interest on the bond. The issuer is allowed to pass the 35 percent interest credit on to the investor; if the credit cannot be fully utilized by the investor in one year, it can be carried over to the next. These bonds can be issued only in 2009 and 2010.

From your perspective as an investor, these bonds offer a relatively high yield and safety (the bonds are AAA-rated). However, the bonds are *not* guaranteed by the federal government even though there is the interest subsidy, so an investor still needs to exercise caution in buying a BAB.

PLANNING

Because BAB interest is taxable, the bonds are probably best held in an IRA so that the interest becomes tax deferred.

Interest on Savings Bonds

If you own U.S. savings bonds—series EE and I—you can opt to report interest annually, but this is rarely done. Typically, bondholders wait to report the interest until they redeem the bonds or the bonds mature. At that time, a part of what you receive represents principal (what you paid for the bonds) and the balance is interest. Savings bond interest usually is fully taxable for federal income tax purposes; it is always tax free for state income tax purposes. However, you may be able to exclude some or all of the interest from your federal tax return if you use the bonds to pay for college (see discussion under "Your Education" later in this chapter).

PLANNING

If you already own bonds and want to transfer them to a revocable **trust** (often referred to as a *living trust*), you can do so without triggering immediate taxation. Title to the bonds is transferred to the trust, and the interest continues to be taxable to you when and to the extent described as long as you are treated as the owner of the trust.

Interest on California Registered Warrants

Because of California's budget crisis in 2009, the state in June 2009 began to issue IOUs (technically called registered warrants) to individuals and businesses providing goods and services to the state, as well as to taxpayers owed income tax refunds and to owners of unclaimed property. The IOUs bore an interest rate of 3.75 percent and were redeemable on October 2, 2009 (or sooner if the state determined there were funds available for redemption).

According to the California controller's office, the interest on a warrant redeemed within one year of its maturity date is tax free for *both* federal and California income tax purposes. California also allowed holders of these warrants to use them to pay state income taxes; they cannot be used to pay federal income taxes.

Tax on Qualified Dividends

The same tax rules for qualified dividends that applied in 2008 continue to apply for 2009 and 2010, unless Congress changes the rules (as it has talked about doing). This means that qualified dividends are taxed at 15 percent for taxpayers in tax brackets above 15 percent (tax brackets are explained in Chapter 4). There is no tax on qualified dividends for taxpayers in the 10 percent or 15 percent tax bracket. For 2009, the 15 percent tax bracket covers taxable income up to

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$67,900 for joint filers, $45,500 for heads of households, and $33,950 for singles. (Taxable income is income after subtracting deductions and exemptions.)

How do you know whether the dividends you received qualify for this special tax treatment? On Form 1099-DIV, *Dividends and Distributions*, which you receive early in the year following the year of dividend payments, qualified dividends are identified in Box 1b.

YOUR INVESTMENTS

You may own stocks, bonds, mutual fund shares, antiques and collectibles, realty, or other investments that can produce income (or losses) for you in the form of capital gains and losses. The tax law looks favorably on gains but often restricts your ability to deduct your losses.

General Capital Gains Rates

During the stock market downturn, people have been focused more on their losses than on their gains. However, some people have continued to enjoy capital gains on the sale of stocks, bonds, mutual fund shares, and other capital gain property. The tax law continues to provide favorable treatment for capital gains. Technically a capital gain for this purpose means a net long-term capital gain in excess of any net short-term capital losses. Long-term capital gains and losses result from sales or exchanges after holding the assets for more than one year. Capital gain distributions from mutual funds are taxed like long-term capital gains.

The maximum tax rate on most capital gains continues for 2009 and 2010 to be 15 percent. For taxpayers in the 10 percent or 15 percent tax brackets, there is *no* tax on capital gains. The taxable income limit for the 15 percent tax bracket is listed in the preceding section, "Tax on Qualified Dividends."

The extent of capital gains representing depreciation recapture is taxed at 25 percent for taxpayers in tax brackets of 25 percent or higher. Capital gains on the sale or exchange of collectibles and certain small business stock (after an exclusion explained later in this Chapter) are taxed at 28 percent for taxpayers in tax brackets of 28 percent or higher.

PLANNING

Since taxpayers in the 10 percent or 15 percent tax bracket pay no tax on capital gains, it may be helpful to give appreciated securities to an elderly parent whom

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you are already helping to support. The parent can sell the securities and pay no capital gains, allowing more money to be retained within the family.

Example

You are helping to support your elderly mother and usually give her $750 a month in cash. You own 100 shares of XYZ stock now worth $9,000, which cost you $3,000 to acquire. If you sell the stock, you'll have only $8,100 after tax (your $6,000 gain [$9,000 – $3,000] incurs tax of $900 [$6,000 × 15%]). If you give your mother the shares and she sells them, she can use the entire proceeds, $9,000, in place of your monthly $750 for an entire year!

Small Business Stock

Usually, gain on the sale of stock held for more than one year is taxed at a capital gains rate of no more than 15 percent. However, there is a special rule for stock that is qualifying small business stock. Gain on the sale of qualifying small business stock (defined shortly) held for more than five years is not fully taxed. Instead, a portion of the gain can be excluded from income; the balance is subject to tax at a rate up to 28 percent.

For some time now the exclusion for gain on qualifying small business stock has been 50 percent. There has also been a 60 percent exclusion for small business stock in a business within an empowerment zone (an economically-disadvantaged area designated by the federal government) if the stock is acquired after December 31, 2000, and before January 1, 2014. Now a higher exclusion is possible. For stock issued by any small business after February 17, 2009, and before January 1, 2011, the exclusion is increased to 75 percent.

Qualified small business stock is stock in a C corporation (not an S corporation) acquired in the original issue for money or property other than stock, or as compensation for services other than underwriting the stock offering.

PLANNING

Obviously, because of the five-year holding period, the higher exclusion won't come into play for a number of years. However, action now can ensure that you acquire stock within the applicable time frame.

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If, after 2009, you sell small business stock that had been in an empowerment zone, you can disregard the end of the empowerment zone designation on December 31, 2009, so that you still qualify for the 60 percent exclusion.

Using the exclusion for small business stock sales for regular tax purposes requires an adjustment for alternative minimum tax purposes. This is explained in Chapter 6.

Mark-to-Market Reporting

Those who regularly trade in securities may make a tax election, called mark-to-market accounting, to treat all securities positions as having been sold at the end of the year for their fair market value, with all gains and losses deemed to be ordinary gains or losses. Thus, those who incur losses would be able to report them all as ordinary losses rather than as capital losses subject to limitations.

However, the time limit for making a mark-to-market election is limited. The election for a tax year must be made no later than the due date of the return for the prior tax year. For example, a mark-to-market election for 2010 has to be made by April 15, 2010 (the due date for the 2009 return). A timely election applies to the year for which it is made and all later years unless the IRS grants permission to revoke the election.

As recent court decisions have demonstrated, the election cannot be made retroactively and no extension can be granted to make a late election. Thus, the election cannot be made on an amended return (which, by definition, is filed after the due date of the return for the year in question).

Investment Losses in Ponzi Schemes

If you lost money in a Ponzi scheme, such as the Bernard Madoff debacle, you may be able to deduct your losses as casualty losses (not as capital losses). See Chapter 3.

Losses in Passive Activities

As a way to clamp down on so-called tax shelters, the tax law limits losses from activities treated as passive activities (all rental realty as well as other businesses in which you do not materially participate) to the amount of income from such activities for the year. If losses cannot be claimed currently under this rule, the excess can be carried forward and used to offset passive activity income in future years. If you dispose of an investment in a passive activity, you can then report all of the carried-over losses from such activity without regard to passive activity income that year. These are called the passive activity loss (PAL) rules.

If you are a limited partner in a business, you are automatically treated as owning an interest in a passive activity. However, courts recently have concluded (despite IRS objections) that investments in limited liability companies (LLCs) or limited liability partnerships (LLPs) are not *automatically* treated as passive activities. Even though owners in LLCs and LLPs have personal liability protection, they can participate in the operations of the business and may materially participate so as to avoid the passive activity loss limits.

YOUR RETIREMENT INCOME

You may receive various forms of income to support you in retirement. Common types of retirement income include Social Security benefits, distributions from qualified retirement plans, and withdrawals from IRAs. Some of this income may be fully taxable, while other income may be partially or fully tax free.

Required Minimum Distributions

If you have an IRA or a qualified retirement plan (such as a 401(k) plan), usually you are required to take annual distributions from the plan starting at age $70^1/_2$. However, because of the dramatic drop in the stock market in the fall of 2008, Congress suspended the required minimum distribution (RMD) rules for 2009. It is hoped that the stock market will recover so that account values will also recover.

The suspension of RMDs applies both to IRA owners and plan participants as well as to beneficiaries of IRAs and retirement plan benefits.

Usually, distributions by beneficiaries are figured using an IRS table for life expectancy (called the single life expectancy table) and commence by the end of the year following the year of the account owner's death (though no distributions are required for 2009). However, distributions can be based on a five-year rule. Under this rule, no distributions are required to be taken by the end of the year

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following the year of the account owner's death but rather are postponed until five years after death. Then the entire account (not just a partial distribution) is taken. Because of the suspension of the RMD rules, a beneficiary using the five-year rule does not include 2009 as one of those five years.

PLANNING

The suspension does not bar you from taking any or all of the money from your retirement accounts in 2009. However, by leaving the funds untouched, you may allow the value of your account to recover somewhat from the devastating losses so many people experienced in 2008.

If you take withdrawals from traditional IRAs and qualified retirement plans, you are taxed on the distributions. If you're under age $59^1/_2$ (or under 55 when you separate from service and take distributions from a plan), you are subject to a 10 percent early distribution penalty. There are a number of exceptions to this penalty. For example, if you withdraw funds from an IRA to pay for health insurance after being unemployed for 12 weeks, there is no penalty. However, the Tax Court has made it clear taking hardship withdrawals from IRAs or retirement plans is not one of the allowable exceptions to this penalty. Anyone under age $59^1/_2$ (or under age 55 as just described) who has taken distributions from an IRA or a qualified retirement plan because of a need for the money will owe *both* regular income tax on the distribution as well as the 10 percent early distribution penalty.

Roth IRA Conversions

A Roth IRA is a type of IRA that allows earnings to grow into tax-free income. You can create an IRA in two ways: by making annual contributions (explained in Chapter 2) and/or by converting a traditional IRA or qualified retirement plan account, such as a 401(k) plan, into a Roth IRA. When you make the conversion, the income that would have been taxed had you taken a distribution from the traditional IRA or qualified retirement plan account becomes fully taxable.

The rules for converting a traditional IRA or retirement plan account to a Roth IRA have not changed for 2009. To be eligible to make a conversion, your adjusted gross income (AGI) cannot be more than $100,000 (without regard to the income from the conversion), whether you are single or a joint filer. Married persons filing separately are ineligible in 2009 to make the conversion.

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Starting in 2010, however, the AGI limit as well as the bar to married persons filing separately disappears. Anyone will be eligible to convert some or all of their IRA accounts to a Roth IRA.

As mentioned earlier, the cost of conversion is reporting the income that would have been taxable if the funds had been distributed from the account rather than converted to a Roth IRA. For those with traditional (deductible) IRAs or a 401(k) plan, this means all of the funds that are converted are taxable.

There is a special rule for conversions made in 2010 only. Fifty percent of the resulting income is reported as income in 2011 and the other 50 percent in 2012. However, you can opt to report *all* of the conversion income in 2010 and not use the deferral option. Which way is better? It's difficult to answer this now, because the tax rates that will be in effect after 2010 have yet to be set by Congress. The rates could be higher after 2010, making it better to report all of the income in 2010. However, deferral means you only have to take half of the income into account in each of two years. This spread could lower the tax bracket you are in, depending of course on the amount of conversion income and your other income.

PLANNING

Conversion isn't an all-or-nothing decision; you can convert some or all of your IRA or IRAs. You can make conversions year after year if you want to.

In deciding whether to convert an IRA to a Roth IRA or how much to convert, take into account the impact that the conversion may have on the taxation of Social Security benefits. The income from the conversion can trigger or increase the amount of benefits subject to tax if you make the conversion when you are already receiving Social Security benefits. In deciding how much to convert, make sure you have the funds set aside to pay the taxes (don't use IRA funds for this purpose).

If you convert funds to a Roth IRA in 2009, later on you may wish to undo the action. Perhaps your income in 2010 will be lower than it was in 2009. Or maybe the value of the account has declined below its value at the time of conversion. Generally, you have until October 15 of the year following the year of conversion to recharacterize the transaction. This means retitling the Roth IRA as a traditional IRA in order to avoid having the account treated as a taxable distribution.

Example

In March 2009 when the stock market was still low, you thought it was wise to convert your traditional IRA to a Roth IRA. Now, in March 2010, you see that the value of the holdings in your account is even lower than in the previous year. You have until October 15, 2010, to recharacterize the transaction. If you filed your 2009 return before this date, you'll need to file an amended return to delete the conversion income.

IRA Rollovers

You can transfer funds from one IRA to another without any current tax cost. As long as you complete a rollover within 60 days of taking a distribution (you can do this only once a year) or you instruct the trustee or custodian of your current IRA account to transfer the funds directly to the trustee or custodian of a new IRA account (called a direct transfer), there is no current tax on the amount rolled over (you can do this as often as you like).

Rollovers are also allowed from qualified retirement plans to other qualified retirement plans or to IRAs. For example, if you leave your job, you may be able to roll over your 401(k) account to your IRA. If you die and your spouse inherits the benefits, he or she can roll them over to his or her own IRA. This is helpful for younger individuals because it allows spouses to delay starting required minimum distributions until they reach age $70^1/_2$. But what about benefits inherited by those who are not surviving spouses?

The tax law changed a couple of years ago to allow nonspouses who inherit benefits in qualified retirement plans to make a rollover rather than simply being taxed immediately on the benefits they inherited. There was, however, confusion about whether plans had to permit the rollover or whether it was discretionary. Under a new law, starting in 2010, plans *must* permit nonspouse beneficiaries to make a rollover of inherited benefits.

PLANNING

If you inherit qualified retirement plan benefits from a person who is not your spouse and you make an IRA rollover, be sure to note how the account must be titled. You must retain the deceased person's name in the title.

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Example

An IRA with inherited funds must be titled "Ann Smith, as beneficiary of Betty Smith, deceased" or "Betty Smith, deceased, IRA, for the benefit of daughter Ann Smith, beneficiary."

YOUR HOME

The housing market has been in a bad way for the past two years, with home prices declining and foreclosures rising. Still, the national home ownership rate for the second quarter of 2009 was 67.4 percent, only slightly lower than a year earlier (68.1 percent).

When you move out of your home because of a sale or a foreclosure, you may be eligible for special tax breaks. This section explains new developments as well as breaks that are set to expire soon.

Home Sale Exclusion

Even in this tough housing market, homes are selling and some homeowners are reaping a profit (especially those who have owned their residences for a number of years). A homeowner who sells his or her main residence can exclude from the gain income up to $250,000 ($500,000 on a joint return). To qualify for this exclusion, the homeowner must have owned and used the home as his or her principal residence for at least two of the five years before the date of sale (special rules apply for those in the military and foreign service).

In the past, it was possible for homeowners to convert vacation homes and rental property to or from a principal residence, satisfy the two-year ownership and use test, and then use the home sale exclusion for gain on the sale of the converted property. This is no longer possible, because Congress has closed this loophole. Effective for homes sold in 2009 and later years, the exclusion can no longer be used for any gain related to nonqualified use of the home after 2008. *Nonqualified use* means use of the home as a vacation home or rental property.

Nonqualified use does *not* include absences due to the following:

- Military service (up to 10 years).

- Temporary absences (up to two years) due to a change in employment, health conditions, or other unforeseen circumstances.
- Leaving the home vacant while waiting to sell it after you relocate to a new principal residence.

PLANNING

In this tough real estate market where there is a glut of inventory and depressed housing prices, sellers may wish to take a wait-and-see approach. It may become financially necessary or desirable to rent a home out until the housing market improves. In making the decision to rent the home, be sure to factor in the impact it can have on the home sale exclusion.

Cancellation of Debt

If you have a mortgage on your home and some or all of the remaining balance on the loan is forgiven because of a foreclosure, a mortgage workout, or a short sale (which avoids the need for foreclosure), the amount forgiven usually is treated as taxable income. However, under a special rule for a principal residence, such debt forgiveness is not taxable.

To be tax free, the debt must have been used to buy, build, or substantially improve your main home and the debt must have been secured by the home (this is called "qualifying debt"). If the debt was refinanced, the amount qualifying for this break is limited to the mortgage principal immediately before the refinancing. The limit on qualifying debt cannot be more than $2 million ($1 million for a married person filing separately).

The lender will issue a Form 1099-C, *Cancellation of Debt*, reporting the mortgage forgiveness and the portion that is not taxable. Then you must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, to report the transaction on your income tax return for the year of the debt forgiveness (see Appendix C).

PLANNING

This break applies only to qualified debt forgiven on a main home in 2007 through 2012. The break does not apply to a mortgage on a second home, rental property, or business property.

Even though your home has been foreclosed upon, you may still have to recognize gain from the foreclosure sale if the amount realized (the fair market value of the home, as reported to you in Box 7 of Form 1099-C) is more than the basis in your home. This gain is *not* forgiven as is debt cancellation. If you have a loss on the foreclosure (the fair market value is less than your basis), you cannot deduct the loss, because it is a nondeductible personal loss.

Losses on the Sale of a Residence

In this tough real estate market, many sellers who have been able to find buyers for their homes may wind up losing money. It is a fact of tax law that you cannot deduct losses on the sale of a principal residence. This is considered a personal asset and no losses are allowed on the sale or exchange of personal assets.

There had been rumbling in Congress to reverse this result and allow homeowners to claim their losses on their tax returns. So far, there have been no positive developments on this front.

YOUR EDUCATION

Unless someone else is paying the bill—an employer, a school scholarship—the cost of higher education can be steep. Still, in the tough economy, children continue to attend college and many laid-off workers have gone back to school to retool their careers. The tax law provides various higher education incentives. Some breaks encourage savings, while others help to defray the cost of paying for tuition and other education expenses. An above-the-line deduction for tuition and fees discussed in Chapter 2. Tax credits for higher education are discussed in Chapter 5.

Savings Bond Interest

You can exclude from income the interest earned on series EE or I U.S. savings bonds that you redeem to pay for qualified higher education costs for yourself, your spouse, or a dependent. The exclusion applies only to interest on bonds purchased in your name after 1989; you must have been at least 24 years old at the time of purchase.

You can claim the exclusion only if your modified adjusted gross income (MAGI) is no more than a set limit. This limit is adjusted annually for inflation.

TABLE 1.1 Savings Bond Interest Phaseout Ranges

Filing Status	2009 MAGI	2008 MAGI
Single	$69,950 to $84,950	$67,100 to $82,100
Married filing jointly	$104,900 to $134,900	$100,650 to $130,650

Table 1.1 shows the MAGI limit for fully or partially excluding savings bond interest based on your filing status for 2009 compared with 2008. Find the MAGI limits for 2010 in Appendix B.

Example

You're a single parent and redeem bonds in 2009 to pay your child's college tuition. Interest on the redeemed bonds is $4,000 (all of which is used to pay qualified costs). If your MAGI is below $69,950, you may exclude all of the interest. If your MAGI is $77,450, you may exclude $2,000 of interest from your income. If your MAGI is over $84,950, you cannot exclude any interest.

PLANNING

Many people make gifts to babies and children in the form of savings bonds. Recognize that these gifts won't qualify for the interest exclusion even though they may be redeemed to pay for higher education costs. The reason: The bond owner (the child) isn't over age 24 and didn't purchase them him/herself. Instead, consider giving money to a child's 529 account if one has been set up for the child.

Section 529 Plans

Saving for college is challenging, especially in tough economic times when there are many demands on a family's budget. However, taking a long view for college savings can reduce the funds needed to be added each year. One of the best savings plans for college is the 529 plan (the name comes from the section in the Internal Revenue Code governing it).

There are two types of plans:

1. A prepaid tuition plan, which guarantees to cover some or all of tuition costs, depending on your contributions.
2. A savings plan, which provides funds based on investment performance of your contributions.

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With both types of plans, there is no federal income tax deduction for contributions (there may be state-level deductions or credits for making contributions). However, earnings grow tax deferred and withdrawals are completely tax free if used to pay qualified higher education expenses. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution (any college, university, vocational school, or postsecondary school eligible to participate in federal student loan programs). Room and board are also a qualified higher education expense if the student is at least a half-time student.

Computer Technology

For 2009 and 2010, qualified higher education expenses also include technology equipment. This means computers, Internet access fees, and software. However, it does not include software for games, sports, or hobbies unless the software is "predominantly educational in nature."

PLANNING

A computer that is paid for by funds from a 529 plan does not have to be used *exclusively* for educational purposes to qualify for the exclusion.

Changing Investments

The tax law usually lets you change your 529 plan investment selections once a year and whenever there is a change in the beneficiary. However, due to the state of the economy in 2008 and 2009, the IRS has said that *two* investment changes are permissible in 2009. Whether the IRS will extend this rule to 2010 depends on how the economy progresses.

OTHER INCOME AND EXCLUSIONS

There are many other types of income you can receive besides income related to a job, investments, retirement, your home, or education. Some of this other income may be fully taxed, while other items may be partially or fully tax free.

Cash for Clunkers Buying Incentive

The federal government's $1 billion cash for clunkers program, which was extended through an infusion of an additional $2 billion, began on July 24, 2009, as a way to spur the ailing auto market by allowing the more than 16,000 participating dealers to offer $4,500 to buyers trading in vehicles that meet certain requirements (so-called clunkers) so consumers would purchase or lease more fuel-efficient vehicles. A smaller incentive of $3,500 was available for less fuel-efficient models.

Individuals who were able to receive the incentives also get favorable income tax treatment; the incentives are tax free to buyers. The incentives could not be converted to cash; they could only be applied toward the purchase or lease of a new vehicle.

Cancellation of Debt (Other Than Home Mortgages)

Generally, when a lender forgives some or all of the amount owed on a loan, the forgiven amount is cancellation of debt income or discharge of indebtedness income. This income is taxable unless you are insolvent or bankrupt at the time of the debt forgiveness.

For example, in a recent Tax Court case, a car was repossessed and the finance company forgave the remaining installments of the loan. Because the borrower was not insolvent at the time, the cancellation of this debt was taxable income.

The lender will report this income to the borrower on Form 1099-C, *Cancellation of Debt.*

Damages

Generally, all damages received are fully taxable *except* for compensatory damages for physical injury or sickness. It is often problematic to decide when emotional distress, and the compensation for it, is excludable as payment for a physical injury or taxable as a nonphysical injury. The Tax Court has reiterated that in discrimination actions that do not involve physical injury or sickness, the exclusion covers damages for emotional distress only to the extent the amounts are expended for medical care attributable to emotional distress. The fact that there is an allegation of physical injury is not sufficient; the settlement or award allocated to emotional distress must clearly connect the emotional distress to a physical injury.

Selling or Surrendering Life Insurance Policies

When you no longer need a life insurance policy, you may be able to pocket some money by selling it or simply surrendering it to collect the cash surrender value. The following three examples show the extent to which the cash received is taxable and whether the resulting income is ordinary income or capital gain.

Example 1

A person who bought a whole life insurance policy on his life eight years ago, with the proceeds payable to a family member, retained the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. He chose to surrender the policy for its $78,000 cash surrender value (after a $10,000 reduction for charges collected by the insurer). His premiums totaled $64,000, so he has to recognize $14,000 of income. The Tax Code does not specify whether income recognized upon the surrender of a life insurance contract is treated as ordinary income or as capital gain. Since this was a surrender and not a sale, the income is ordinary income and not capital gain. In effect, the IRS has restated a 1964 ruling that says that the proceeds received by an insured upon the surrender of a life insurance policy constitute ordinary income to the extent such proceeds exceed the cost of the policy.

Example 2

Same as Example 1 except that the insured sold the contract for $80,000 to an unrelated person. The cost of insurance was $10,000. In this situation, there is $26,000 of income ($80,000 sale proceeds minus $64,000 premiums and $10,000 cost of insurance). Part of the income is ordinary income and part is capital gain. Under the "substitute for ordinary income" doctrine, income that has been earned but not yet recognized by a taxpayer cannot be converted into capital gain by a sale or an exchange (e.g., a lottery winner who sells the right to receive future installments of lottery winnings still has ordinary income, not capital gain). For the sale of a life insurance policy, the portion of the gain that would have been ordinary income if the policy had been surrendered (i.e., the inside buildup under the contract) is ordinary income. However, any income over that amount can qualify for capital gains treatment. In this example, $14,000 of the $26,000 gain is ordinary income representing the inside buildup under the contract. The remaining $12,000 of income is long-term capital gain.

Example 3

Same as Example 1 except the policy is not a whole life policy but rather a 15-year level-premium term policy with no cash surrender value. Total premiums paid were $45,000 when the policy was sold to an unrelated party for $20,000. In this case, the adjusted basis of the term life contract for purposes of determining gain or loss is the total premiums paid minus charges for the provision of insurance before the sale. The cost of insurance in this case amounted to $44,750, so the insured's adjusted basis is $250 ($45,000 total premiums minus the $44,750 cost of life insurance protection). Because the policy has no cash surrender value, the $19,750 of income ($20,000 sale proceeds minus $250 basis) is *all* long-term capital gain.

PLANNING

If the insured is terminally ill, funds can be withdrawn tax free from the policy under an accelerated death benefit clause, as explained shortly.

Exclusion for Benefits Paid from Long-Term Care Policies

The costs of long-term care for a chronic illness or simply for the frailties of old age are not covered by Medicare or other standard health insurance policies. Some people carry a long-term care policy to pay for in-home assistance or nursing home care. If you have a long-term care insurance policy and require long-term care, some or all of the benefits paid under the policy are tax free.

Payments made from a long-term care policy to cover long-term care costs are fully tax free.

If, under the terms of the policy, you receive a daily dollar benefit without regard to your long-term care costs, you can exclude up to $280 a day in 2009 (up from $270 a day in 2008). The 2010 daily limit is in Appendix B.

Exclusion for Accelerated Death Benefits

Life insurance is designed to pay benefits to a named beneficiary when the insured dies; all of the proceeds of a life insurance policy paid at death are tax free. However, some life insurance policies may allow payments to be made to the insured during his or her lifetime because of health conditions. If you have a life insurance policy that permits benefits to be paid for long-term care, the benefits used for this purpose may be partially or fully tax free.

Accelerated death benefits made from a life insurance policy to an insured who is terminally ill are tax free under an accelerated death benefit clause. A person is terminally ill if he or she has a noncorrectable illness or condition that is expected to result in death within 24 months of a physician's statement of this fact.

Accelerated death benefits made from a life insurance policy to an insured who is chronically ill are excludable up to $280 a day (up from $270 a day in 2008). (The 2010 per day limit is in Appendix B). A chronically ill person is someone who has been certified by a licensed health-care practitioner within the preceding 12 months as being unable to perform for a period of at least 90 days at least two of the following activities without assistance: eating, toileting, dressing, bathing, continence, or transferring (getting in and out of bed).

Reimbursements to Parents of Disabled Children

Under the Individuals with Disabilities Education Improvement Act of 2004, a board of education may be required to pay for nonpublic education services obtained by parents for their disabled children if: (1) the services offered by the board are inadequate or inappropriate, (2) the services obtained by the parents are appropriate, and (3) there are equitable considerations to support the parents' claim. The IRS has said that these payments are not taxable to the parents or the children and can be excluded from gross income. There is no dollar limit on the amount that can be excluded from gross income.

Gambling Winnings and Losses

For casual gamblers (nonprofessionals), wagering gains are taxable while wagering losses are deductible only as a miscellaneous itemized deduction and only to the extent of reported gains. The itemized deduction is *not* subject to the 2-percent-of-AGI floor applicable to most other miscellaneous itemized deductions.

According to the IRS, for those who play slot machines, gains result only when a gambler can establish winning above the amounts played. If the gambler uses tokens, then the winnings are the tokens redeemed minus the initial tokens played. In effect, gain is determined at the end of slot machine play. Day-by-day results are netted to determine gain (or loss) for the year.

Example

A casual gambler starts out with $100 in tokens and at the end of the day redeems tokens for $300. The gambler has a $200 gain ($300 winnings minus $100 original tokens played). This is so even though the gambler may have had winnings on a spin of $1,000, $800, or other amount that he subsequently lost during the day. If the gambler loses the $100 he started out with and walks away, he has a $100 loss for the day, even if he also had winnings on a spin or $1,000, $800, or other amount during the day.

PLANNING

Keep good records of gambling activities throughout the year to support your claims of losses and prove the limit of reportable gains.

TAX STRATEGIES FOR INCOME

Many of the tax rules for reporting income and relying on exclusions have not changed. For example, the tax rate for net capital gains and qualified dividends remains highly favorable and unchanged from 2008. Taxpayers who are in a tax bracket of 25 percent or higher pay just 15 percent on net capital gains and qualified dividends (information about determining your tax bracket can be found in Chapter 4). Taxpayers in the 10 percent or 15 percent tax bracket pay *no* tax on this income in 2009. The same rule is set to apply in 2010, but Congress could change it; there has been talk about raising the tax rate on this type of income. Here are some strategies to consider now in light of current rules and uncertainty about the future.

Year-End Strategies for Capital Gains and Losses

Markets go up; markets go down. To some extent, however, you have the ability to control your gains and losses and, consequently, the taxes you pay each year. As the year comes to a close, review your holdings in your taxable—non-IRA/non-401(k)—accounts. Look at the gains and losses you've already taken for the year as well as your paper gains and losses (the potential results if you sell now). The following are some basic strategies to minimize your tax results. Of course, be sure to adapt them to your personal financial situation and consult with your financial adviser. Above all, do not let tax results override investment objectives.

Take Capital Gains

This year may be the final opportunity to enjoy historically low capital gains rates of 15 percent (or zero for those in the 10 percent or 15 percent tax bracket). These capital gains rates are scheduled to expire at the end of 2010, allowing the single rate of 20 percent to apply; Congress could raise the rate even sooner.

For 2009, the 15 percent tax bracket covers *taxable income* (income after deductions and exemptions) up to $33,950 for singles and $67,900 for joint filers. After the sale of securities, shares can be repurchased to maintain the same investment position, although you'll have to pay commissions for selling and buying.

Take Capital Losses

Capital losses can be used to offset all of your capital gains. If losses exceed your gains, the excess can be used to offset up to $3,000 of ordinary income ($1,500 for married persons filing separately). (There have been proposals to increase the $3,000 limit, the dollar limit in effect since 1978, but nothing has been enacted thus far.) If you still have excess losses after offsetting ordinary income, the excess can be carried forward and used in future years; there is no time limit on the carryforward.

Beware, however, of the wash sale rule that bars you from recognizing losses on the sale of securities if you acquire substantially identical securities within

30 days before or after the date of sale. The loss disallowance rule applies even though the 61-day period starts this year but ends next year.

Remember that losses in your IRA or 401(k) plan cannot be used to offset gains from your other investments. Losses in these accounts can only be recognized for tax purposes in very limited circumstances. Also, the wash sale rule applies if you take the loss in a taxable account and then cause your IRA or 401(k) plan to acquire substantially identical securities within the wash sale period.

Determine Worthless Securities

If you're holding securities that have become completely worthless, you can write them off this year as if they had been sold on the last day of the year. There must be no hope of recovery; the fact that the company has filed for bankruptcy is not enough to show worthlessness.

There are two ways around the rule that requires you to show there is no hope of recovery. You can abandon the securities, which means giving up any rights without receiving any compensation. Alternatively, you can sell them for a nominal amount. Some brokerage firms make accommodation sales for pennies to help their customers write off nearly worthless securities.

Installment Sales

If you sell property and receive at least one payment after the year of the sale, you are treated has having transacted an installment sale. Gain on the sale generally is reported over the term of the sale. However, you can opt to report all of the gain in the year of the sale, even though you have not yet received all of the proceeds from the sale. There is no special election form to file; just report all of the gain on the return for the year of the sale.

This may be a good year to opt out of installment reporting if you have an installment sale. This will ensure that the gain is taxed at current low capital gains rates. If, instead, you report your gain over a number of years, some of that gain may be taxed at rates higher than the rates in effect today. While no one has a crystal ball to predict tax rates in the future, it's likely that capital gains rates will rise (see the earlier discussion, "Take Capital Gains"). If you don't opt out in the year of the sale and later wish you had, usually the IRS won't let you change your mind.

Section 1244 Stock

If you've invested in a privately held corporation that has gone under this year, you may be able to write off your loss as an ordinary loss under Section 1244 in the Internal Revenue Code rather than as a capital loss subject to limitations discussed earlier in this chapter. Under a special rule for losses in stock in a corporation (whether it is a C or an S corporation), you can deduct up to $50,000 of the losses as an ordinary loss ($100,000 on a joint return). Section 1244 losses in excess of these dollar limits are treated as capital losses.

Losses on Section 1244 stock do not require any special forms or other schedules; just make sure that the stock meets the definition of Section 1244 stock. Generally, this means the corporation's equity cannot exceed $1 million, you acquired your stock by purchase (not as a gift or inheritance), and the corporation is an operating corporation (not a holding company).