TAX GUIDE

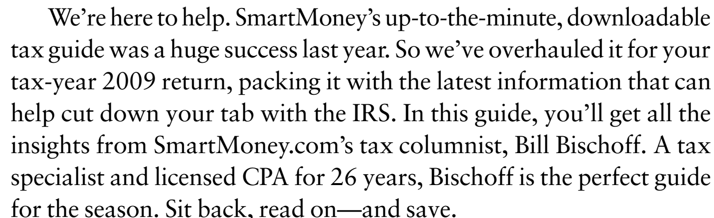
SmartMoney

2010

Foreward

BY THOMAS E. WEBER | SMARTMONEY.COM EDITOR

If you're feeling overwhelmed by the prospect of tax time, you've got good reason. The changes that can save or cost you money this year are significant—with many reflecting the scramble in Washington to break the back of the recession. From the home-buyer tax credit to deductions for new car buyers, there's a thicket of new rules to be aware of.



We're here to help. SmartMoney's up-to-the-minute, downloadable tax guide was a huge success last year. So we've overhauled it for your tax-year 2009 return, packing it with the latest information that can help cut down your tab with the IRS. In this guide, you'll get all the insights from SmartMoney.com's tax columnist, Bill Bischoff. A tax specialist and licensed CPA for 26 years, Bischoff is the perfect guide for the season. Sit back, read on—and save.

Introduction

BY BILL BISCHOFF

As you probably know, keeping up with tax changes has become a big challenge - in large part because they've been coming so fast and furious. From December 2007 to January 2010, we saw 13 new laws passed that included significant tax changes. I expect more of the same as politicians continue to look for solutions to the current economic mess. One thing you don't want to do during tough times is pay more taxes than you need to. I hope you'll find this information helpful in dealing with your 2009 income tax return and in planning ahead to lower your taxes and increase your cash flow for this year and beyond - without running afoul of the IRS, of course.

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I. BREAKING NEWS

TAX CHANGES THAT MIGHT IMPACT YOUR 2009 RETURN

THE AMERICAN RECOVERY and Reinvestment Act of 2009 (better known as the Stimulus Act) and the Worker, Homeowner and Business Assistance Act of 2009 made changes that will impact many taxpayers. Here's a quick rundown of the changes we think will affect the most folks as they prepare their 2009 returns. (We cover most of these changes in more detail later on.)

NEW "MAKING WORK PAY" CREDIT

MANY WORKING INDIVIDUALS can claim this credit on their 2009 returns. The credit amount is 6.2% of 2009 earned income, up to a maximum credit amount of $400 for an unmarried person or $800 for a joint-filing married couple. The credit is refundable, which means it can reduce your federal income tax bill to zero. Then, you can collect any leftover credit amount in cash.

NEW CREDIT FOR GOVERNMENT RETIREES

THE STIMULUS ACT also granted a $250 free-money goodie to certain government retirees. It comes in the form of a one-time 2009 refundable tax credit of $250 for each eligible individual or $500 for a joint-filing married couple when both spouses are eligible.

MORE GENEROUS CREDITS FOR HOMEBUYERS

THE STIMULUS ACT extended and liberalized the credit for qualified home purchases between Jan. 1, 2009 and Nov. 6, 2009. Then, the Worker, Homeowner and Business Assistance Act of 2009 went even further for qualified purchases through the rest of 2009 and into 2010. As a result, for the 2009 tax year, one set of rules applies to purchases that closed between Jan. 1, 2009 and Nov. 6, 2009, and another more generous set of rules applies to purchases that closed between Nov. 7, 2009 and Dec. 31, 2009. In addition, a credit for a 2010 purchase can be claimed on a 2009 return. However, for a 2010 purchase, the home must be under contract by no later than April 30, and the deal must be closed by no later than June 30.

NEW AMERICAN OPPORTUNITY CREDIT FOR COLLEGE COSTS

THE STIMULUS ACT replaced the familiar Hope Scholarship credit for higher education expenses with the new (and more generous) American Opportunity credit. The new credit can save filers as much as $2,500 per student; it can cover up to four years of undergraduate education costs; and it is available to taxpayers with higher incomes.

MORE GENEROUS CREDITS FOR ENERGY-EFFICIENT HOME IMPROVEMENTS

FOR THE 2009 TAX YEAR, two separate credits are available, and the rules are significantly more generous than in previous years. The credits are equal to 30% of qualifying home energy-efficiency improvement expenditures. The first credit is capped at $1,500, but the second credit is generally uncapped and can amount to big savings.

MORE GENEROUS REFUNDABLE CHILD CREDIT

THE CHILD CREDIT equals up to $1,000 for each qualifying child under 17. For those who owe only a modest amount of federal income tax or no tax at all, part of the child credit is refundable. After the refundable part of the credit has been used to reduce your federal income tax bill to zero, you may collect any leftover refundable amount in cash. For the 2009 tax year, the rules for the refundable part of the credit have been liberalized to make it available to individuals with less earned income. To find out if you are eligible for the refundable part of the credit, fill out Form 8812 (Additional Child Tax Credit). Enter the refundable credit amount on line 65 of Form 1040.

MORE GENEROUS EARNED INCOME CREDIT

IF YOU HAVE THREE or more qualifying children, you may be eligible for a more generous earned income credit (EIC) than in previous years. Also, the income restrictions on the EIC have been eased to make more taxpayers eligible. The EIC is also a refundable credit. Any credit amount left over after your federal income tax bill has been reduced to zero is refunded to you in cash. To find out if you are eligible for the EIC under the liberalized rules that apply for 2009, fill out Schedule EIC in your Form 1040 instruction package. Enter the EIC amount on line 64a of Form 1040.

NEW VEHICLE SALES TAX DEDUCTION

THE STIMULUS ACT created a new deduction for state and local sales and excise taxes paid on new (but not used) vehicles that were purchased (not leased) between Feb. 17, 2009 and Dec. 31, 2009. The write-off is limited to the amount of taxes on the first $49,500 of a vehicle's purchase price. You can claim this break whether you itemize or not.

FIRST $2,400 OF UNEMPLOYMENT COMPENSATION IS TAX-FREE

THE GENERAL RULE SAYS unemployment compensation benefits count as taxable income. However, the Stimulus Act granted a one-year exemption for the first $2,400 of unemployment compensation received in 2009. Any unemployment benefits in excess of the $2,400 tax-free limit must be reported as income on line 19 of your 2009 Form 1040.

MORE GENEROUS IRA CONTRIBUTION RULES

FOR THE 2009 TAX YEAR, more individuals are eligible to make deductible contributions to traditional IRAs and contributions to Roth IRAs because the income restrictions on both types of contributions have been eased. If you have not already contributed for the 2009 tax year, you have until April 15, 2010 to do so.

NEW $500 FLOOR ON PERSONAL CASUALTY AND THEFT LOSSES

IF YOU HAD A PERSONAL casualty or theft loss in 2009, you generally must subtract $500 from the loss amount. Then, you can generally deduct the remaining loss amount (if any) to the extent it exceeds 10% of your adjusted gross income. Before 2009, the casualty and theft loss floor was only $100. To see if you can deduct a casualty or theft loss, fill out Form 4684. Enter the deductible amount as an itemized deduction on line 20 of Schedule A.

2009 BUSINESS LOSSES CAN BE CARRIED BACK UP TO FIVE YEARS

DID YOUR BUSINESS run up a tax loss for 2009? If so, you may benefit from a temporary provision that allows so-called net operating losses (NOLs) to be carried back for up to five tax years to recover federal income taxes paid in those years. This favorable change was made by the Worker, Homeowner and Business Assistance Act of 2009. (Under the rules that normally apply, most NOLs can be carried back only two years.)

II. PERSONAL CREDITS AND DEDUCTIONS FOR 2009

NEW FOR 2009

"MAKING WORK PAY" CREDIT

MANY WORKING INDIVIDUALS can claim this credit on their 2009 returns. The credit amount equals 6.2% of annual earned income, up to a maximum of $400 for an unmarried person or $800 for a joint-filing married couple. The credit is also refundable, which means it can be used to offset your entire federal-income tax bill, including any alternative minimum tax (AMT), and that you may collect any leftover credit amount in cash after your tax bill has been reduced to zero. Unfortunately, phase-out rules reduce or completely eliminate the credit privilege over the following adjusted gross income (AGI) ranges:

- $75,000 to $95,000 for singles and married folks who file separately.
- $150,000 to $190,000 for joint-filing married couples.

If you are an employee, you have probably already collected all the credit you are entitled to though reduced federal income tax withholding on your 2009 wages. In fact, you may have collected more than you are entitled to. To find out, you'll have to fill out the new Schedule M form (Making Work Pay and Government Retiree Credits) and attach it to your Form 1040. Report your rightful credit amount (if any) on line 63 of Form 1040.

WARNING: If you collected the so-called economic recovery payment of $250 for beneficiaries of certain government programs (including Social Security and veterans, disability and pension benefits) or the separate $250 tax credit for government retirees, you must reduce your Making Work Pay credit accordingly. The necessary subtractions are made on Schedule M.

NEW FOR 2009

CREDIT FOR GOVERNMENT RETIREES

THE STIMULUS ACT granted a $250 free-money goodie for certain government retirees. This payment comes in the form of a one-time 2009 refundable tax credit of $250 for each eligible individual or $500 for a joint-filing married couple when both spouses are eligible. You have to meet both of the

following requirements to be eligible.

1. During 2009, you must have received retirement benefits for past service as an employee of the U.S. or other government entity based on earnings that were not subject to Social Security tax withholding at the time.
2. You must be ineligible for the $250 economic recovery payment granted to recipients of certain government programs (such as Social Security).

If you meet these guidelines, fill out new Schedule M form (Making Work Pay and Government Retiree Credits) and attach it to your Form 1040. Report the credit amount on line 63 of Form 1040.

WARNING: If you're eligible for this $250 credit, it must be subtracted from any Making Work Pay credit that you would otherwise be entitled to collect.

NEW FOR 2009

TWELVE THINGS TO KNOW ABOUT THE HOMEBUYER CREDIT

ON NOV. 6, the president signed the Worker, Homeownership and Business Assistance Act of 2009 into law. The centerpiece of this legislation is the extension and liberalization of the first-time homebuyer credit (which is now a misnomer). Here are the 12 most important things to know about claiming the revamped credit on your 2009 return.

1. New Purchase Deadline Extends Well into 2010: The homebuyer credit was previously scheduled to expire on Nov. 30, 2009. The new law extends the deal to cover purchases of U.S. principal residences that close by April 30, 2010. However, if a home is under contract on that date, the deadline for the closing is extended to June 30, 2010.
2. Existing Homeowners Can Now Qualify: The new law allows a reduced credit for existing homeowners who buy a replacement U.S. principal residence after Nov. 6, 2009. The credit is equal to the lesser of: (1) $6,500, (2) 10% of the price of the replacement home, or (3) $3,250 for a buyer who uses married filing separate status. To reiterate, the new existing homeowner credit is available only for purchases that close after Nov. 6, 2009. To qualify, the buyer must have owned and used the same home as a principal residence for at least five consecutive years during the eight-year period ending on the purchase date for the replacement principal residence. If the filer is married, his or her spouse must pass this test, too (whether or not they file jointly).
3. Larger Credits Still Allowed for First-Time Buyers: Before the new law, the homebuyer credit was available only to so-called first-time homebuyers. These are people who had not owned a U.S. principal residence during the three-year period prior to and ending on the purchase date for a home that will serve as their new principal residence. If you're married, both you and your spouse must pass the three-year test (whether or not you file jointly). These first-time homebuyer rules still apply for purposes of claiming a larger credit of up to $8,000. Specifically, the credit for a first-time buyer still equals the lesser of: (1) $8,000, (2) 10% of the home purchase price, or (3) $4,000, if you use married filing separate status.
4. Higher-Income Buyers May Now Qualify: The homebuyer credit is reduced or completely eliminated as income goes up. However, the new law significantly raises the phase-out ranges, so many more higher-income buyers will now qualify.

NOTE: For purchases after Nov. 6, 2009, the phase-out range for unmarried individuals and married folks who file separately is between modified adjusted gross income (MAGI) of $125,000 and $145,000 (way up from the old law's range of $75,000 to $95,000, which applies to purchases before Nov. 7, 2009).

NOTE: The phase-out range for married joint filers is now between MAGI of $225,000 and $245,000 (way up from the old law's range of $150,000 to $170,000, which applies to purchases before Nov. 7, 2009).

5. Credit is Refundable: Since the homebuyer credit is refundable, it can be used to offset your entire federal-income tax bill, including any alternative minimum tax (AMT), and you may collect any leftover credit amount in cash after your tax bill has been reduced to zero. However, the credit is reduced or eliminated if your MAGI is too high, as explained above.
6. New $800,000 Purchase Price Limit: For purchases after Nov. 6, 2009, the credit can be claimed only for a principal residence that costs $800,000 or less. So if your

new home costs $800,001, the credit is completely off limits.

7. No More Credits for Kids or Dependents: For purchases after Nov. 6, 2009, the homebuyer must be at least 18 years old on the purchase date to qualify for the credit. Also, no credit is allowed for a buyer who can be claimed as a dependent on someone else's Form 1040 for the year of the purchase. These new rules are intended to shut down the practice of claiming the credit for youngish buyers who really don't even have incomes of their own (like college students who use money from their parents to buy a pad near the campus).
8. New Anti-Fraud Rules: A recent government report said the IRS has already identified over 100,000 returns with potentially fraudulent homebuyer credits. This is not surprising when up to $8,000 in free money is available to anyone who files a return, even when that person reports no income. Until now, no documentation had been required to claim the credit. Now, for credits claimed on 2009 and 2010 returns, buyers must attach a properly executed real estate settlement sheet (typically on a HUD-1 form) to the return along with some other documentation in certain cases. Also, the IRS can now simply disallow credits in fishy circumstances (like when it appears the $8,000 credit is being claimed by someone who already owns a home).
9. Credits Can Still Be Claimed on Prior-Year Returns: Under the revamped rules, you can still claim the credit for a 2009 purchase on your 2008 return (although you would now generally have to file an amended return to do so). You can also claim the credit for a 2010 purchase on your 2009 Form 1040. This allows you to cash in on the credit sooner rather than later, and it may also allow you to claim a larger credit if your income in the year of purchase is too high.
10. Credits Must Still Be Repaid in Some Cases: Under old rules for homes purchased between April 9, 2008 and Dec. 31, 2008, buyers are generally required to repay the credit over 15 years. However, this repayment rule is generally eliminated for purchases after 2008. That said, you might still have to repay the credit if you sell your home within three years of the purchase date or stop using it as your principal residence during that period.
11. Better Rules for Military Service Members. For military service members on extended duty outside the U.S., the new law lengthens the deadline for closing on home purchases for an extra year, to April 30, 2011 (or June 30, 2011 for homes under contract on April 30, 2011). The new law also waives the credit repayment rules for service members who are forced to move because of new orders.
12. Fill Out New Form 5405 to Claim Credit on Your 2009 Return. Be sure to use the updated (and much longer) version of Form 5405 (First-Time Homebuyer Credit) to claim the homebuyer credit on your 2009 Form 1040. The updated version is dated December 2009. Claim the credit on line 67 of Form 1040.

NEW FOR 2009

AMERICAN OPPORTUNITY CREDIT CAN COVER UP TO $2,500 OF COLLEGE COSTS

FOR 2009, the Stimulus Act replaced the well-known Hope Scholarship tax credit with the new American Opportunity credit. The new credit equals 100% of the first $2,000 of qualified post-secondary education expenses plus 25% of the next $2,000. So the maximum credit annual credit is $2,500, assuming the income phase-out rule (explained later) doesn't affect you.

ELIGIBILITY RULES AND QUALIFIED EXPENSES

A STUDENT'S EXPENSES ARE ineligible for the American Opportunity credit if he or she has already completed fours years worth of college work as of the beginning of the tax year in question. This is a big improvement over the old Hope credit which only covered expenses for the first two years worth of college credit. Therefore, many taxpayers who would have been ineligible for the old Hope credit will be eligible for the American Opportunity credit.

You can claim the credit for expenses to educate your dependent children as well as expenses to educate yourself or your spouse. For example, if you have two eligible students in your family, you could potentially claim $5,000 worth of American Opportunity credits, and you could potentially do this for several years running. Sweet!

However, you are completely ineligible if you are married and don't file a joint Form 1040 with your spouse.

Qualified expenses include tuition, mandatory enrollment fees and course materials including books. However, optional

fees for things like student activities, athletics, and health insurance don't count. Neither do room and board costs. Fair enough.

Here's the first big catch: the student must attend an eligible institution. Fortunately, virtually all accredited public, nonprofit, and for-profit postsecondary schools meet this definition, and many vocational schools do too. The two main criteria are that the school must offer programs that lead to an associates degree, bachelors degree, or some other recognized credential; and the school must qualify to participate in federal student aid programs. An eligible school will have a Federal School Code, which you should be able to verify online at www.fafsa.gov.

The second big catch is that the American Opportunity credit is only allowed for a year during which the student carries at least half of a full-time load — in a program that would ultimately result in an associates degree, bachelors degree or some other recognized credential — for at least one academic period beginning in that year. So although you have to be a fairly serious student, you don't actually have to intend to complete a degree or credential program.

PHASE-OUT RULE

THE THIRD BIG CATCH is the biggest one for some folks. The American Opportunity credit is phased out (reduced or completely eliminated) if your modified adjusted gross income (MAGI) is too high.

- The phase-out range for unmarried individuals is between MAGI of $80,000 and $90,000.
- The range for married joint filers is between MAGI of $160,000 and $180,000.

MAGI means "regular AGI" from the first line on page 2 of your Form 1040 increased by certain tax-exempt income from outside the U.S.

NOTE: While the phase-out rule for the American Opportunity credit is still bad news for some taxpayers, the phase-out ranges are at much higher income levels than the ranges for the old Hope credit. Therefore, many taxpayers who would have been ineligible for the old Hope credit will be eligible for the American Opportunity credit.

CREDIT IS PARTIALLY REFUNDABLE

THE AMERICAN OPPORTUNITY credit can be used to offset your regular federal income tax bill and any alternative minimum tax (AMT) that you may owe. For full-fledged adult taxpayers like you, up to 40% of the credit can be refundable. That means you can collect in cash some or all of any credit that is left over after your federal income tax bill has been reduced to zero. However, this partial refundability privilege is not allowed for taxpayers who fall under the Kiddie Tax rules (those rules can potentially affect young-adult students who are up to 23 years old).

LIFETIME LEARNING CREDIT CAN COVER UP TO $2,000 FOR GRAD SCHOOL AND OTHER TRAINING

FOR 2009, the rules for the Lifetime Learning credit are unchanged from previous years. The credit equals 20% of up to $10,000 of qualified education expenses, for a maximum annual credit of $2,000 (assuming the income phase-out rule explained later doesn't affect you). Unlike the American Opportunity credit, there is no limit on the number of years you can claim the Lifetime Learning credit, nor is there any course load requirement. So you can use this credit to help offset costs for undergraduate study that drags on for more than four years or costs for years when the student carries a light course load. You can also claim the Lifetime Learning credit for graduate school expenses, courses to maintain or improve your job skills, or courses taken for just about any reason.

ELIGIBILITY RULES AND QUALIFIED EXPENSES

YOU'RE INELIGIBLE FOR the Lifetime credit if you're married and don't file a joint Form 1040 with your spouse. Also, the maximum amount of annual expenses for which the credit can be claimed is limited to $10,000, regardless of how many students you have in your family. Finally, you can't claim both the American Opportunity credit and the Lifetime Learning credit for the same student for the same year. However, you can potentially claim the American Opportunity credit for one or more students in the family while also claiming the Lifetime Learning credit for expenses paid for one or more different students in the family.

Qualified expenses only include tuition, mandatory enrollment fees. Course supplies and materials (including books) are eligible expenses only if they are required to be purchased directly from the school itself. Other expenses, including optional fees and room and board, are off limits.

Finally, the school must be an eligible institution (using the same definition as for the American Opportunity credit).

PHASE-OUT RULE

LIKE THE AMERICAN OPPORTUNITY credit, the Lifetime Learning credit is phased out if your modified adjusted gross income (MAGI) is too high. However, the phase-out ranges for the Lifetime Learning credit are much lower income levels.

- The 2009 phase-out range for unmarried individuals is between MAGI of $50,000 and $60,000.
- The 2009 range for married joint filers is between MAGI of $100,000 and $120,000.

CREDIT IS NOT REFUNDABLE

THERE IS NO PARTIAL refundability feature for the Lifetime Learning credit. However, it can be used to reduce both your regular federal income tax bill and any AMT for 2009 (I expect Congress will extend this courtesy to 2010).

HOW TO CLAIM THESE CREDITS

TO CLAIM EITHER the new American Opportunity credit or the familiar Lifetime Learning credit, you must complete Form 8863 (Education Credits) and then transfer the credit amounts from that form to the applicable lines on page 2 of your Form 1040.

NEW FOR 2009

TWO SEPARATE TAX CREDITS FOR MAKING YOUR HOME MORE ENERGY-EFFICIENT

IF YOU WANT TO go green or just lower your utility bills, Uncle Sam is willing to help with two tax credits for energy-saving home improvements and equipment. The rules for these credits are tricky, and things have changed a lot since 2008.

THE FIRST CREDIT IS FOR GARDEN VARIETY ENERGY-SAVING IMPROVEMENTS AND EQUIPMENT

THE FIRST CREDIT IS for 30% of qualifying home improvement and equipment expenditures in 2009 and 2010 (the credit could not be claimed in 2008). The maximum credit over 2009 and 2010 is $1,500 for any and all eligible expenditures. For example, if you claim a $1,000 credit for 2009, you can claim up to another $500 in 2010. Although the $1,500 limit is pretty modest, the credit covers a broad range of energy-saving expenditures for your principal U.S. residence (vacation homes and foreign residences don't count). There are no income limits on the credit, and you can use it to offset your regular federal income bill and any alternative minimum tax (AMT) that you owe for 2009 (and potentially 2010, depending on what happens in Congress).

CREDIT FOR IMPROVEMENTS

FOR THE FOLLOWING home improvement items, the credit equals 30% of qualifying expenditures (excluding costs for site preparation, assembly, and installation).

- Exterior windows including skylights and storm windows.
- Exterior doors including storm doors.
- Insulation systems designed to reduce heat loss or gain.
- Metal and asphalt roofs with heat-reduction components.

CREDIT FOR EQUIPMENT

FOR THE FOLLOWING equipment, the credit equals 30% of qualifying expenditures (including costs for site preparation, assembly, and installation).

- High-efficiency central air conditioners.
- Furnaces, water heaters, and water boilers that run on natural gas, propane, or oil.
- Electric heat pumps and electric heat pump water heaters.
- Circulating fans used in natural gas, propane, and oil furnaces.
- Biomass fuel stoves used for heating or hot water.

MAKE SURE YOU BUY CERTIFIED PRODUCTS

YOU MUST OBTAIN a manufacturer's certification that the product qualifies for the credit (after May 31, 2009, windows and skylights with the Energy Star label don't automatically qualify). The certification may be on the product packaging, or you may be able to print it out from the manufacturer's web site. Keep the certification with your tax records. You don't need to attach the certification to your return, but you do need to file Form 5695 (Residential Energy Credits) with your Form 1040 to claim your credit at tax return time. Enter the credit amount on line 52 of Form 1040.

THE SECOND CREDIT IS FOR MORE EXOTIC (AND EXPENSIVE) ENERGY-SAVING EQUIPMENT

THERE'S ANOTHER COMPLETELY separate personal credit for 30% of expenditures to buy and install more exotic and expensive energy-saving equipment for your home in 2009 through 2016. There are generally no dollar limits on this credit,

so big credits can be claimed for big expenditures (however, there is a dollar limit on fuel cell equipment, which is explained below). There are no income limits on the credit, and you can use it to offset your regular federal income bill and any alternative minimum tax (AMT) that you may owe. If your credit is so big that you can't use it all on your 2009 return, you can carry the excess forward to 2010.

QUALIFYING EXPENDITURES

The credit equals 30% of qualifying expenditures (including costs for site preparation, assembly, installation, piping, and wiring) for the following gear.

- Solar water-heating equipment for your U.S. (not foreign) residence (including a vacation home).
- Solar electricity-generating equipment for your U.S. residence (including a vacation home).
- Wind energy equipment for your U.S. residence (including a vacation home).
- Geothermal heat pump equipment for your U.S. residence (including a vacation home).
- Fuel cell electricity-generating equipment for your U.S. principal residence (a vacation home doesn't count here). (Note that the maximum annual credit is limited to $500 for each 0.5 kilowatt hour of fuel cell capacity.)

You cannot claim the credit for equipment used to heat a swimming pool or hot tub. Special rules apply to expenditures for residential co-ops and condominium buildings.

MAKE SURE YOU BUY CERTIFIED GEAR

AS WITH THE FIRST CREDIT, you must obtain a manufacturer's certification that the energy-saving equipment qualifies for this credit. The certification may be on the packaging, or you may be able to print it out from the manufacturer's web site, or the contractor that installs the equipment may give you a written statement from the manufacturer. Keep the certification with your tax records (but don't attach it to your return). Also, be sure to keep proof of how much you spend, including any extra amounts for site preparation, assembly, and installation. To claim the credit, file Form 5695 with your Form 1040. Enter the credit amount on line 52 of Form 1040.

ADDITIONAL BENEFITS MAY BE AVAILABLE

YOU MIGHT ALSO BE eligible for state and local tax benefits; subsidized state and local financing deals; and state and local government and utility company rebates.

NEW FOR 2009

DEDUCTION FOR SALES AND EXCISE TAXES ON NEW VEHICLE PURCHASES

THE STIMULUS ACT created a new but fleeting federal income tax deduction for state and local sales and excise taxes paid on new (not used) vehicles that were purchased (not leased) between Feb. 17, 2009 and Dec. 31, 2009. However, the new write-off is limited to the amount of taxes on the first $49,500 of purchase price. You can claim the break whether you itemize or not, and it's allowed even if you owe the alternative minimum tax (AMT). The IRS has confirmed that you can claim the deduction on as many vehicles as you happened to buy within the designated timeframe.

QUALIFYING VEHICLES

THE NEW WRITE-OFF is available for any of the following:

- New (not used) passenger autos and light trucks with gross vehicle weight ratings of 8,500 pounds or less (this definition includes almost all SUVs and conventional pickups).
- New (not used) motorcycles with gross vehicle weight ratings of 8,500 pounds or less.
- New (not used) motor homes.

BEWARE OF HIGH-INCOME PHASE-OUT RULE

UNFORTUNATELY, THE NEW vehicle sales and excise tax deduction is reduced or completely eliminated if your adjusted gross income (AGI) is too high. The phase-out range for unmarried individuals and married individuals who file separately is between AGI of $125,000 and $135,000. The range for married joint filers is between $250,000 and $260,000.

HOW TO CLAIM THE WRITE-OFF IF YOU DON'T ITEMIZE

IF YOU DON'T itemize deductions, claim the new vehicle sales and excise tax write-off as an additional itemized deduction amount on line 40a of Form 1040. You must also check the box on line 40b and attach the new Schedule L form (Standard Deduction for Certain Filers) to your return.

HOW TO CLAIM THE WRITE-OFF IF YOU DO ITEMIZE

IF YOU DO ITEMIZED deductions, claim the new vehicle sales and excise tax write-off as an additional itemized deduction on line 7 of Schedule A. Note that you cannot claim the new vehicle sales and excise tax break if you choose to deduct general state and local sales taxes on the Schedule A form instead of deducting

state and local income taxes. However, if you make the choice to deduct general state and local sales taxes, you can include any such taxes on a vehicle purchase, and it doesn't matter if the vehicle is new or used.

NEW FOR 2009

MORE-GENEROUS IRA CONTRIBUTION RULES

FOR THE 2009 tax year, more individuals are eligible to make deductible contributions to traditional IRAs and contributions to Roth IRAs because the income restrictions on both types of contributions have been loosened. If you have not already contributed for the 2009 tax year, you have until April 15, 2010 to do so.

TRADITIONAL IRAS

FOR THE 2009 tax year, you can contribute up to $5,000 to a traditional IRA. If you were age 50 or older on Dec. 31, 2009, the contribution maximum is $6,000. If you're married, the same contribution limits apply to your spouse if he or she wants to fund a separate IRA. The deadline for contributions for the 2009 tax year is April 15, 2010.

Here are the other traditional IRA contribution ground rules.

- Once you turn 701/2, you can no longer contribute to a traditional IRA. However, Roth IRAs are still fair game.
- You (or, if you're married, you and your spouse), must have had 2009 earned income from salary or self-employment that at least equals the amount you contribute to IRAs for 2009. Note: Any alimony payments you received also count as earned income.

For those who were covered by retirement plans in 2009, the AGI restrictions on deductible contributions are considerably looser than they were just a few years ago. In each of the cases below, these AGI restrictions only affect your ability to make deductible contributions to traditional IRAs. (You can make nondeductible contributions to traditional IRAs no matter how high your income.) Here's the breakdown.

- If you're unmarried, your eligibility to make a deductible 2009 contribution to a traditional IRA is phased out between AGI of $55,000 and $65,000.
- If you're married and you and your spouse were covered by retirement plans in 2009, your right to make deductible 2009 contributions to traditional IRAs is phased out between joint AGI of $89,000 and $109,000.
- If you're married and only one spouse was covered by a retirement plan in 2009, the covered spouse's eligibility to make a deductible 2009 contribution to a traditional IRA is phased out between joint AGI of $89,000 and $109,000. The noncovered spouse's deductible contribution privilege is phased out between joint AGI of $166,000 and $176,000.

ROTH IRAS

THE DOLLAR LIMITS on contributions to Roth IRAs are the same as the limits for traditional IRAs. After that, there are some important differences in the rules.

- If you've turned age 701/2, you can no longer contribute to a traditional IRA, but you can still contribute to a Roth, as long as you (or you and your spouse, if you're married) had earned income at least equal to what you contribute.
- The ability to make Roth contributions for the 2009 tax year is phased out between AGI of $105,000 and $120,000 for unmarried taxpayers. For joint filers, the range is between $166,000 and $176,000. These ranges are considerably higher than they were just a few years ago.
- Being covered by a retirement plan has no impact on your eligibility to make Roth contributions.

THE BOTTOM LINE

ONLY A FEW YEARS AGO, IRA contributions were limited to a measly $2,000. Plus, strict income limits had prevented many folks from being able to contribute to deductible or Roth IRAs at all. Favorable changes have eased these limitations considerably. So if you haven't considered the IRA as a retirement savings tool, this year represents a good opportunity to change your thinking.

BREAKS FOR HIGH-INCOME TAX BREAKS

IF YOU'RE A high-income earner, you're probably aware that many tax breaks are reduced or eliminated as your adjusted gross income, or AGI, increases. That's the price of success, right? Well, not necessarily. Some tax breaks are available to just about anybody - regardless of their income. Here are six.

RETIREMENT PLANS FOR THE SELF-EMPLOYED

IF YOU'RE SELF-EMPLOYED, you may be able to contribute and deduct up to $49,000 for 2009 (same for 2010) by setting up a SEP (simplified employee pension). Contributing to a SEP could dramatically reduce your taxable income and save you a lot. If you don't already have a retirement plan in place, you can still set up a SEP and make a deductible contribution to your account for 2009. That can be done as late as Oct. 15, 2010 if you extend your return for the automatic six-month period.

CREDIT FOR OVERPAID SOCIAL SECURITY TAXES

DID YOU HAVE TWO JOBS last year and earn more than $106,800? Then you probably had too much withheld for Social Security tax. Your credit will be for the withheld amount in excess of $6,621.60, which represents the 6.2% Social Security tax on a maximum salary of $106,800. Getting the money back is easy - just report the overpaid amount (you can tell what that is by looking at your W-2s) on Form 1040, line 69.

DEDUCTING ALIMONY PAYMENTS TO YOUR EX

IF YOU MADE ALIMONY payments last year, they're probably deductible. It all depends on the terms of your divorce agreement. Assuming you qualify, you can claim the write-off on page 1 of your Form 1040 (use line 31a).

WRITING OFF GAMBLING LOSSES

IF YOU ITEMIZE deductions, you can deduct gambling losses up to the amount you won during the year on the Schedule A form, line 28. (Your winnings are taxed as regular income and should be reported on line 21 of Form 1040.) But beware: If you claim this deduction, you should have written evidence of your losses, just in case you get audited. So try to dig up some evidence (betting tickets, etc.). In the future, keeping a journal of your daily wins and losses should do the trick.

WRITING OFF INVESTMENT INTEREST

DID YOU BORROW on margin last year? As long as you itemize deductions on your return, you can probably deduct the interest you paid on the account. The deduction for the interest paid to carry taxable investments (so-called investment interest expense) is unaffected by the phase-out rules that apply to most other itemized deductions listed on Schedule A. There's only one small catch: Your investment interest expense deduction generally can't exceed your taxable income from interest, annuities, royalties and short-term capital gains. That said, any excess investment interest expense can be carried over to the following tax year. See IRS Form 4952 (Investment Interest Expense Deduction) for details (including a special election to treat long-term capital gains and dividends as investment income taxed at regular rates).

DEPENDENT CARE CREDIT

THIS TAX BREAK IS technically subject to some AGI phase-out rules, but nearly everybody who claims this credit is partially phased out. What's left still represents a substantial tax break. If you worked last year and paid someone to take care of your child under 13, you could be eligible for this credit. Keep in mind, if you're married, both spouses must work, unless one is a student. Additionally, neither of you could have contributed to a child-care flexible spending account (through your employer) to cover the same expenses last year. If your income (married or single) exceeds $43,000 then you can take a credit equal to 20% of your child-care expenses. However, the credit limit is $600 if you have one child, or $1,200 if you have two or more. (If you earned less than $43,000, you may be entitled to a larger credit.) The definition of "child care" can cover anything from summer day camp to a babysitter. See Form 2441 for details. Claim your credit on line 48 of Form 1040.

REFUNDABLE AMT CREDIT COULD MEAN CASH IN YOUR POCKET

IF YOU'VE BEEN socked with a big alternative minimum tax (AMT) bill in the past, you may be in luck. Thanks to a little-known provision, you could get a refund.

Typically, taxpayers are hit with a big AMT bill because they exercised some lucrative incentive stock options (ISOs). Unlike the regular tax rules, the AMT rules tax you on the "bargain element" when you exercise an ISO. The bargain element is the difference between the fair market value of the ISO shares on the date you exercise the option and the exercise price. The regular tax rules don't tax the bargain element until you actually sell your ISO shares. So your AMT bill can be bigger than your regular tax bill in a year when you exercise in-the-money ISOs. The IRS insists that you pay the larger AMT amount.

A few years ago, when the stock market was on fire, many folks exercised in-the-money ISOs and wound up paying huge AMT bills for the privilege. If you were one of them, you can get some of that AMT money back. Here's how:

REGULAR AMT CREDITS

ONE WAY AMT VICTIMS are allowed to offset some of their liability is through the AMT credit. The amount of AMT triggered by exercising ISOs generally yields a credit you can use to lower your tax bills in future years. Any unused AMT credit can be carried forward indefinitely.

However, under the general rules, you can only use as much of the credit as it takes to reduce your regular tax liability to the point at which it equals the AMT. So even if you have a big AMT credit, it does no good in years when you owe the AMT, and it does only a minor amount of good in years when your regular tax bill is just a little larger than your AMT bill (the typical situation). Therefore, under the general rules, you might die before you ever get a substantial break from your AMT credit.

TAPPING INTO LITTLE-KNOWN REFUNDABLE AMT CREDITS

FORTUNATELY, THERE'S A huge favorable exception to the general AMT credit rules. Under this exception, unused AMT credits that are more than three years old become refundable, which means you can use them to reduce your regular federal income tax bill and your AMT bill and then collect any leftover credit amount in cash. You can take advantage of the refundable AMT credit rules when you file your 2009 Form 1040.

The refundable AMT credit amount for a particular tax year includes only unused AMT credits that were generated more than three years earlier. These are also referred to as long-term unused AMT credits. So for the 2009 tax year, you can only have a refundable AMT credit if you have unused AMT credits that were generated more than three years earlier (in this case, in years prior to 2006). (For newer AMT credits, you're stuck with the less-favorable general rules.)

The refundable AMT credit amount for the current year is limited to the greater of:

- 50% of the long-term unused AMT credit amount carried into that year (for 2009, this means the amount of credits generated in pre-2006 years), or
- The amount of refundable AMT credit for the preceding year (for 2009, this means the refundable AMT credit amount, if any, from your 2008 Form 1040).

However, the refundable AMT credit for the current year cannot exceed the long-term unused AMT credit carried into that year. The following example should clarify how the limitation rule works. Under this scenario, the entire long-term unused AMT credit was generated in the same year.

EXAMPLE: Say you generated a $150,000 AMT credit in 2005 when you exercised some profitable ISOs. For 2009, the entire $150,000 amount counts as a long-term unused AMT credit because the whole amount was generated before 2006. For 2008, you had no refundable AMT credit-because your credit was not yet old enough.

Your 2009 refundable AMT credit amount figured under the annual limitation rule is $75,000 (0.50 x $150,000). You can collect the entire $75,000 by filing out a Form 8801 (Credit for Prior-Year Minimum Tax) and including it with your 2009 Form 1040. By "collect," I mean you can use the $75,000 credit to reduce your 2009 federal income tax bill (including any AMT) to as low as zero. Any leftover credit amount will be sent to you in cash.

For 2010, your long-term unused AMT credit amount is the $75,000 left over from 2009. Under the annual limitation rule, the entire $75,000 is refundable because it equals the 2009 refundable credit amount. So you can collect the entire $75,000 by filing your 2010 Form 1040. When all is said and done, you can collect the whole $150,000 over two years.

NOTE: Things get more complicated when you have credits that were generated in several different years. However, once the credit from any particular year is over three years old, you can always collect it over a two-year period (if not sooner) under the refundable AMT credit rules.

MY ADVICE: Take advantage of this credit if it's available to you. And if you have significant money at stake, consider hiring a tax pro to get the numbers right.

THREE OFTEN OVERLOOKED TAX SAVERS

AS UNPLEASANT AS filing one's taxes may be, don't let the desire to simply get your taxes done keep you from making sure you get every tax break to which you're entitled. Here are three commonly overlooked ways to save:

SELLER-PAID MORTGAGE POINTS

DID YOU BUY a home in 2009? Then be sure to review your paperwork to see if the seller paid some (or all) of your points

when you took out a mortgage to finance the deal. If so, you're entitled to deduct those seller-paid points even though someone else paid the tab.

Claim your deduction on line 12 of your Schedule A (or on line 10 if the seller-paid points were reported to you on Form 1098). You must then lower the tax basis of your home by the amount of your deduction. This will slightly increase your gain when you eventually sell the home, but chances are good that it won't matter: given the relatively generous home-sale-gain exclusion privilege (up to $250,000 for singles and up to $500,000 for joint filers), it's quite possible you won't owe any federal capital-gains tax when you sell.

SELLING GRANDMA'S STUFF

IF YOU SOLD something last year that you inherited, understand that your tax basis for gain or loss purposes generally has nothing to do with what your benefactor paid for the asset. And that's probably going to save you a bundle in taxes. With items inherited before 2010, your tax basis is usually the asset's fair-market value as of your benefactor's date of death. In other words, your tax basis is adjusted to that value, which is usually a taxpayer-friendly outcome for assets owned for a long time, like a house or stocks. (The tax basis rules for items inherited from someone who dies in 2010 are still being decided.)

Suppose your grandmother died on April 5, 2008, and you inherited shares of General Electric, which you subsequently sold in 2009. To figure out your tax gain or loss on those shares, do you have to go back and figure out what Grandma paid for her original shares back in, say, 1947? No. You simply have to figure out what the stock was trading for on April 5, 2008, and calculate the gain or loss from there.

Occasionally, the estate executor will choose to value the estate's assets as of the "alternate valuation date." In that case, your basis is equal to the asset's fair-market value on the date you received it, or six months after the date of death, whichever came first. One other thing: Gains from inherited capital assets automatically qualify for favorable long-term-gain treatment, regardless of the length of time they were actually owned by you or the person who left them to you.

ADOPTING A CHILD

IF YOU ADOPTED a child younger than 18 last year, you can generally claim a tax credit for up to $12,150 of adoption-related expenses (such as adoption fees, legal fees, court costs, travel expenses, etc.). The credit reduces your tax bill, dollar for dollar. The only downside is that this deal is phased out for a parent (or parents) with adjusted gross income starting at $182,180 and ending at $222,180. Also, if you're married, you generally must file a joint return to claim the credit. To take the credit, fill out Form 8839 (Qualified Adoption Expenses) and file it with your 1040. Then enter the adoption-credit amount on Line 52 of your 1040.

GIVE YOUR COLLEGE KID A TAX BREAK

IF YOU EARN A healthy income, you may not qualify for the higher-education tax credits intended to help pay college-tuition bills. However, your college-age child just might.

The American Opportunity credit (maximum $2,500) and the Lifetime Learning credit (maximum $2,000) can help soften the cost of postsecondary education. The American Opportunity credit is available only for the first four years of college. The Lifetime Learning credit can be used at any time and doesn't require you to be in a degree program or carry any particular course load.

Unfortunately, you can't take both credits for the same student in the same year, and some parents earn too much to be eligible for either one. That's because in tax year 2009, the American Opportunity credit is phased out starting at an adjusted gross income, or AGI, of $160,000 for joint filers and $80,000 for singles. At AGI levels of $180,000 and $90,000, respectively, you're completely ineligible. The Lifetime Learning credit is phased out at much lower income levels, starting at AGI of $100,000 for joint filers and $50,000 for singles. At AGI levels of $120,000 and $60,000, respectively, you're completely ineligible.

As you might imagine, plenty of parents fall into the ineligible category. But even if you're among them, these valuable credits may not have to go to waste.

Here's how to take advantage: Arrange for your college-age child to claim one of these credits instead of you. To implement this strategy, you must forgo the dependency exemption deduction for your child ($3,650 for the 2009 tax year). Then, the education tax credit becomes the property of your child, whose income is presumably well below the phase-out range.

The education credit can cut your college-age child's tax bill by quite a bit. However, the credit is worthless to your child unless he or she has enough taxable income to actually owe the IRS. This income could be from summer jobs, work-study

at school or income and gains from investments held in your child's name.

Also, keep in mind that this strategy makes the most sense when your AGI is quite high. Your dependency write-off for your college kid is itself partially phased out for 2009 between an AGI of $250,200 and $372,700 for joint filers and between $208,500 and $331,000 for heads of households. So giving up that dependency deduction on your 2009 tax return may not cost as much as you might think. (This strategy does not permit your child to claim an exemption on his or her return; the exemption belongs to you whether you choose to use it or not.)

III. TAX TRAPS

WHY OUR #$*! TAX CODE IS SO CONFUSING (AND HOW TO FIX IT)

OUR TAX SYSTEM IS falling apart because it's become way too complicated. Tax breaks are not as helpful as advertised because many taxpayers can't figure out how to use them. Tax increases don't raise the expected revenue because many taxpayers are unwilling to spend extra time and money to comply only to get a bigger tax bill for their trouble.

If you doubt that tax complexity is a huge problem, consider the fact that my personal copy of the Internal Revenue Code takes up over 4,000 pages of very tiny print. Then there are many thousands of pages of regulations and other guidance put out by the IRS in efforts to explain how the tax law provisions are supposed to work. Then there are many more thousands of pages of court decisions dealing with disputes about how they are supposed to work. I can't keep up with all this stuff, even though it's my profession. The average individual or small-business owner has little hope.

And it's getting worse. From December 2007 to January 2010, Congress passed 13 significant new tax laws. Every one of them added more complexity, and there will be more new laws before the end of the year.

When guys like me who make a living from dealing with tax complications start ranting about too much complexity, it's time for you ordinary citizens out there to demand an end to the nonsense. Here's what you should be howling about to your Congresspersons:

BE HONEST ABOUT TAX RATES

MUCH OF OUR TAX SYSTEM'S complexity is caused by stealthy provisions intended to penalize certain categories of taxpayers without explicitly raising anybody's tax rates. That way the politicians can advertise low rates for all while keeping their hands in your pocket. For example:

The alternative minimum tax (AMT) hits many middle-income folks by disallowing deductions for dependents and state and local income and property taxes.

Tricky rules can cause you to pay federal income tax on up to 85% of your Social Security benefits - even though you already paid income tax on Social Security taxes when they were taken out of your salary or self-employment earnings.

Some phase-out rules reduce or eliminate the chance for middle-income folks to claim the child tax credit and education tax credits.

I could go on and on, but you get the idea. It's time to tell the politicians to be straight with you by raising or lowering your taxes with easy-to-understand rate changes. The current practice of granting well-advertised tax goodies and then sneakily taking them away from less-favored folks has got to stop.

STOP TRYING TO MICROMANAGE THE ECONOMY WITH TAX POLICY

IN GENERAL, lower taxes tend to encourage legitimate economic activity, and higher taxes tend to do the opposite. But many politicians want to micromanage.

For example, after the devastating Gulf Coast hurricanes in 2005, Congress enacted a bunch of exceedingly complicated special tax breaks intended to help individuals and businesses rebuild. This was on top of many billions worth of direct relief from the Feds and many billions more from charitable donations. In my opinion, the tax breaks were unnecessary overkill, and they added a lot more complexity. The beleaguered IRS is still trying to catch up on issuing guidance about how all the special breaks are supposed to work.

LOWER THE CORPORATE TAX RATE AND ELIMINATE CORPORATE WELFARE

LARGE U.S. CORPORATIONS face a 35% federal income tax rate on their domestic profits. This is one of the highest rates in the industrialized world. As a result, big companies pay untold amounts to lobby Congress for unadvertised tax breaks (better known as corporate welfare) and to devise tax-avoidance strategies (some legit and some not). The high U.S. tax rate also

encourages companies to move operations overseas and keep the resulting profits over there. Why? Because they generally don't have to pay U.S. taxes on offshore profits until they bring them home. So they don't. As a result, the amount of federal income taxes that big corporations actually pay is often laughably low. Although I can't prove it, I'm sure that a major reduction in the corporate tax rate combined with an end to corporate welfare would benefit our economy. Plus, we could cut a few hundred pages out of the Internal Revenue Code. This isn't micromanagement. This is a big idea.

PUT "FAIRNESS" IN THE PROPER PERSPECTIVE

A FEW YEARS AGO, the politicians became aware that lots of grandparents and aunts and uncles are raising children of their relatives. In the name of "fairness," Congress changed the rules to allow these grandparents and aunts and uncles to claim tax breaks, like dependency exemption deductions and child tax credits, for the kids they are selflessly supporting. The unfortunate result was rules that are so hideously complicated that I can barely understand them. Ordinary taxpayers have not a prayer. So now you have many cases in which divorced moms and dads, along with grandparents and aunts and uncles, are all claiming the same tax breaks for the same kids. This is against the law, but it's up to the beleaguered IRS to issue audit notices and try to sort out the mess.

I can cite other examples of attempts to inject "fairness" into the tax law. Such attempts often result in rules that are too complicated to be effective - which isn't fair to anybody.

THE LAST WORD

THE PURPOSE OF OUR federal tax system should be to raise revenue in a reasonably predictable, efficient and fair manner. The current system doesn't do any of these things - mainly because it's too complicated to work right. The problem has reached scary proportions, but don't fault the IRS. The blame lies with the politicians. Now is a great time to tell them you want a simpler tax system if they want to keep their jobs.

TAX-WISE, DEBT FORGIVENESS ISN'T SO DIVINE

BELIEVE IT OR NOT, some lenders are still willing to forgive the debts of beleaguered consumers. While debt forgiveness can help you survive financially, it might also increase your tax bill. Here's what you need to know.

What is cancellation of debt income and how is it taxed?

When a lender forgives part or all of a debt, it results in so-called cancellation of debt (COD) income. As a general rule, COD income is taxable, and the lender is supposed to report the amount to you, and to the IRS, on Form 1099-C (Cancellation of Debt) for the year when the COD income occurs.

Thankfully, there are some favorable exceptions to the general rule that COD income is taxable. Here are the taxpayer-friendly exceptions that are most likely to help you out.

BANKRUPTCY EXCEPTION

IF THE COD INCOME occurs while the borrower is in Title 11 bankruptcy proceedings, the income is completely exempt from federal taxation. Title 11 encompasses bankruptcy filings under Chapter 7 (liquidations), Chapter 11 (reorganizations), Chapter 12 (for farmers and fishermen), and Chapter 13 (wage earner filings). Legislation passed in 2005 made it more difficult to file for Chapter 7 bankruptcy protection, thereby making it harder to be completely exonerated from unsecured debts such as credit-card balances. However, COD income can still occur in Chapter 7 cases (just not as often), and it still occurs in some Chapter 11, 12 and 13 cases, as well.

INSOLVENCY EXCEPTION

WHEN A BORROWER IS insolvent (meaning their debts exceed their assets) but not in bankruptcy immediately before COD income occurs, the COD income is completely exempt from federal income taxation to the extent of the borrower's insolvency. However, when the COD effectively makes a person solvent (because assets now exceed debts), the COD income is taxable to the extent of that solvency. Any remaining COD income will be exempt from taxation under the insolvency exception.

HOME MORTGAGE EXCEPTION

LEGISLATION ENACTED IN 2007 and 2008 created an exception for qualifying cancellations of home mortgage debt during the years 2007 through 2012. Taxpayers don't need to be bankrupt or insolvent to take advantage of this provision, which allows an individual to have up to $2 million of federal-income-tax-free COD income from forgiven qualified principal residence debt. This only includes debt that was used to acquire, build or improve a main residence and that is secured by that residence. Refinanced debt can also qualify for this exception to the extent it replaces debt that was used to acquire, build or

improve a principal residence. You must reduce the tax basis of your residence (but not below zero) by the amount of COD income that you're allowed to treat as tax-free under this exception.

DEDUCTIBLE INTEREST EXCEPTION

IF COD INCOME includes unpaid interest that was added to a loan's principal and then forgiven, you may be in luck. Any forgiven interest that you could have deducted (had you paid it) is free from federal income taxation. This exception often comes into play with forgiven principal residence mortgage interest, vacation home mortgage interest, and rental property mortgage interest.

SELLER-FINANCED DEBT EXCEPTION

WHEN COD INCOME is from forgiven seller-financed debt (meaning mortgage debt that you owe to the previous owner of a property), it is exempt from federal income taxation. However, your basis in the property must be reduced by the amount that you're allowed to treat as tax-free under this provision.

THE BOTTOM LINE

THERE ARE SOME OTHER more arcane exceptions to the general rule that COD income is taxable, but they are fairly unlikely to apply to most people. One last thing to know is that the tax code extracts a price for allowing those who are in bankruptcy or insolvent to exempt their COD income from taxation. So-called tax attributes that these taxpayers have, such as capital loss carryovers, tax credit carryovers, and the tax basis of certain assets (used to calculate tax gains and losses and depreciation deductions) may have to be reduced. See IRS Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness), which must be filed with your federal return. You must also file Form 982 if you take advantage of the home mortgage exception. The good news is the exceptions explained here can prevent a major tax hit on COD income, which would really be adding insult to injury.

IV. TAXES AND YOUR RETIREMENT SAVINGS

HOW TO DEDUCT IRA LOSSES

IF YOUR IRA IS still hurting badly from the 2008 stock market meltdown, there is a chance you can claim a tax deduction to help ease the pain. With traditional IRAs, getting a write-off is possible but not terribly likely. Roth IRA owners, on the other hand, will have a much easier time. Here's what you need to know.

DEDUCTING TRADITIONAL IRA LOSSES

ACCORDING TO THE IRS, you have a tax loss from your traditional IRAs when the following conditions are met:

- You liquidate all the traditional IRAs set up in your name.
- Your total tax basis in the accounts-which equals the sum of your nondeductible contributions (if any)-exceeds the liquidation proceeds. Since you only get tax basis from nondeductible contributions, it's fairly unlikely that you'll have a tax loss even if you've lost your shirt. However, it can happen (as example 1 below illustrates).

Let's say you do have a tax loss. The IRS says it's classified as a miscellaneous itemized deduction. As such, it gets thrown into the pot with other miscellaneous deductions-such as investment expenses and fees for tax advice. Only the excess of total miscellaneous deductions over 2% of adjusted gross income (AGI) can be claimed as a write-off.

Even if you clear that hurdle, you're still not out of the woods. You could lose part of the write-off due to an unfavorable phase-out rule for high-income individuals. Finally, the write-off is completely disallowed for alternative minimum tax (AMT) purposes. So if you're hit with the AMT, some or all of the hoped-for tax savings will vaporize.

EXAMPLE 1: You own one traditional IRA that has plummeted in value. Unusually enough, you funded the account with $11,000 in nondeductible contributions, so it has a tax basis of $11,000. When you liquidate the account, you receive just $6,000. At this point, you have a potentially deductible tax loss of $5,000 ($11,000 - $6,000).

The IRS says that $5,000 loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $100,000,

the AGI threshold is $2,000 ($100,000 x .02). Say you have $1,500 in other miscellaneous deductions, for a total of $6,500 ($5,000 + $1,500). You can claim a $4,500 deduction on your Form 1040 ($6,500 - $2,000). However, if you're a victim of the AMT, the deduction is disallowed in the AMT calculation. Your actual tax savings may be little or nothing.

Let's say you aren't getting hit with the AMT. Liquidating the IRA triggers a $4,500 deduction, which reduces your taxable income by that amount. If you're in the 25% federal income tax bracket, the deduction saves you $1,125 (.25 x $4,500). You may reap a state-income-tax savings too. Plus, you've got $6,000 in cash.

The downside is you've caused a permanent reduction in a tax-favored account balance. Are the current tax savings and cash in hand worth it? That's what you need to decide.

DEDUCTING ROTH IRA LOSSES

ROTH IRAS MUST BE treated separately from traditional IRAs. To have a tax loss from your Roth IRA, the following conditions need to be met (regardless of what's going on with any of your traditional IRAs):

- You liquidate all the Roth IRAs set up in your name.
- Your total tax basis in the accounts exceeds the liquidation proceeds. With Roth IRAs, all contributions generate tax basis because all contributions are nondeductible. For this reason, you're much more likely to have a tax loss with a Roth IRA than with traditional IRA. Unfortunately, all the other hurdles mentioned earlier for traditional IRA losses also apply to Roth IRA losses.

EXAMPLE 2: You own one ill-fated Roth IRA. It was funded with $20,000 of annual contributions, so it has a $20,000 tax basis. You receive only $9,000 when you liquidate the account. Now you have a potentially deductible loss of $11,000 ($20,000 - $9,000).

As explained earlier, the loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $100,000, the threshold is $2,000. Say you have $1,500 of other miscellaneous deductions for a total of $12,500 ($11,000 + $1,500). You can claim a $10,500 deduction ($12,500 - $2,000). If you're an AMT victim, the deduction is disallowed in the AMT calculation.

Again, let's say you aren't getting hit with the AMT. Liquidating the Roth IRA triggers a $10,500 deduction. If you're in the 25% federal income tax bracket, you save $2,625 (.25 x $10,500). You may get a state income tax benefit, too. Plus you've got the $9,000 in hand. However, you've also caused a permanent reduction in the balance of the most taxpayer-friendly type of account known to humankind. Is it worth it? That's for you to decide.

WARNING: If you liquidate a Roth IRA that was funded with a conversion contribution (from converting a traditional IRA into a Roth account), you generally must pay a 10% penalty tax if: (1) the liquidation occurs within five years of the contribution (the five-year period is deemed to start on Jan. 1 of the year you made the conversion contribution) and (2) you're under age 591/2. So if you're 50 years old and funded your Roth IRA with a conversion contribution on June 1, 2006, the five-year period is deemed to start on January 1, 2006. Therefore, you'll generally owe the 10% penalty if you liquidate the account before Jan. 1, 2011. If you get hit with the penalty tax, it can wipe out some or all of the tax savings from a deductible Roth IRA loss. So be very careful.

THE FINAL WORD

THE SEEMINGLY SIMPLE question of whether you can deduct IRA losses really isn't so simple after all. Please consult your adviser before closing loser accounts in the hopes of gaining some tax savings. All in all, it may be a poor idea unless you desperately need the cash.

TAPPING YOUR IRA PENALTY-FREE

ALTHOUGH 59½ IS generally the magic age for being able to take IRA withdrawals without getting hit with the 10% premature withdrawal penalty tax (whether you continue to work or not), there are some exceptions that allow you to take money out sooner without paying the penalty. Here's a rundown:

ANNUITIZE YOUR IRA

ONE WAY TO TAKE money from your traditional IRA without incurring the 10% penalty is to "annuitize" your account. The way this works is that for five years, or until you turn age 591/2 (whichever is longer), you take annual cash withdrawals based on your life expectancy, as predicted by the IRS. To see how much time the IRS thinks you have left, visit the IRS web site.

Here's an example. If the IRS actuarial tables predict you will live for another 20 years, then you can withdraw about

1/20th of the balance in your account the first year. Then about 1/19th of your new balance the second year. And so on. During the payout period, your distribution schedule cannot change or you will be hit with the 10% penalty. Once the payout period has ended, you can modify the schedule, take a lump payment or stop taking distributions altogether. If you do decide to take early withdrawals, consult a tax expert who has some experience in planning for penalty-free IRA distributions.

WITHDRAW ROTH CONTRIBUTIONS

THE ROTH IRA ALLOWS penalty and tax-free withdrawals of contributions for any reason. But remember, once you've taken out that money, you don't have the option of replacing it. For 2010, your Roth IRA contribution is limited to $5,000 or $6,000 if you will be age 50 or older at the end of the year (less if your adjusted gross income exceeds $167,000 if you file jointly; $105,000 if you are single).

SPECIAL PENALTY-FREE WITHDRAWAL SITUATIONS

- First-time home purchase: Up to $10,000.
- Qualified education expenses: For you, your spouse, your kids or even your grandkids. Approved expenses include post-secondary education, tuition, books, supplies and, if the student is enrolled at least half-time, room and board.
- Disability: To qualify for a disability exemption, you must prove that you are incapable of working.
- Unreimbursed medical expenses: Expenses must exceed 7.5% of your adjusted gross income.
- Health insurance for the unemployed: Only after 12 consecutive weeks of collecting unemployment benefits.

A FINAL NOTE: Before you start dipping into your retirement stash, you should explore other options including a standard commercial loan. Only tap into your tax-sheltered retirement accounts as a last resort.

TIPS CAN HELP YOU WEATHER ECONOMIC STORMS

WHEN IT COMES TO retirement savings, preserving principal has always been a key concern. But these days, with unprecedented market swings tearing into investors' savings, it's even more important.

One way to protect your nest egg from the ravages of both inflation and deflation is to invest a portion of your portfolio in U.S. Treasury Inflation Protected Securities (TIPS). TIPS are typically sold with terms to maturity of five, 10, and 20 years. They pay cash interest twice a year at fixed rates. For example:

- The five-year TIPS maturing on April 15, 2014 pay interest at the stated annual rate of 1.25% and are currently trading at a premium in the secondary market to yield about 0.2%.
- The 10-year TIPS maturing on Jan. 15, 2020 pay interest at the stated annual rate of 1.375% and are currently trading at a premium to yield about 1.3%.

TIPS IN AN INFLATIONARY ENVIRONMENT

IN TIMES OF INFLATION, TIPS principal balances are adjusted upwards twice a year based on changes in the Consumer Price Index. You receive the higher inflation-adjusted principal balance at maturity so inflation won't hurt you. That wouldn't be the case if you follow the knee-jerk conservative investment strategy of buying regular U.S. Treasury notes or bonds. Buy them and bad inflation could hurt you badly.

With TIPS, you receive cash interest payments twice a year. Each payment equals half the stated annual interest rate times the inflation-adjusted principal balance at the time of the payment. So your interest payments go up with inflation, too.

TIPS IN A DEFLATIONARY ENVIRONMENT

IF YOU BUY TIPS with care and hold them to maturity, your investment will do OK even if there's significant deflation. During these times, TIPS principal balances are adjusted downward twice a year. Interest payments are also adjusted downward because they are based on declining adjusted principal balances. (The stated interest rate itself doesn't change.) However, even if there's severe deflation, the results from owning TIPS won't be too bad-you'll still get interest payments and you'll still get full face value at maturity.

EXAMPLE: Say you buy at face value $50,000 of 10-year TIPS that pay 1.5% stated interest. If you hold to maturity and inflation runs at an average of 7% during your ownership, the annual return will be about 8.5% (1.5% interest + 7% inflation adjustment). If instead you buy at face value $50,000 of regular 10-year Treasury notes that pay 4% interest, your annual return will be 4%. If there's deflation, the return on TIPS will still be positive, but it will be

less than 1.5% (because the interest payments will go down as the adjusted principal balance deflates). With regular Treasurys, deflation does you no harm. You'll get your 4% no matter what.

Bottom Line: TIPS have a relatively big advantage over regular Treasurys if there's significant inflation and a relatively small disadvantage if there's significant deflation.

BUYING NEWLY ISSUED TIPS VERSUS OLDER ONES

When you buy newly issued TIPS directly from the government, nothing bad can happen to the principal-assuming you buy at face value (or below) and hold onto them until maturity. At maturity, you'll receive full face value even if there's heavy deflation.

But if you buy older TIPS in the secondary market, you'll have to pay for the accrued inflation adjustment to the principal balance. The problem is that amount can vaporize with deflation. The way to avoid this risk is to buy TIPS when they are issued or shortly thereafter (assuming you can buy them at face value or below). That way the accrued inflation adjustment will be little or nothing, and you'll have less to lose in the event of deflation.

TAX IMPLICATIONS

WHEN YOU HOLD TIPS in a taxable account, you must pay current federal income taxes on both the cash interest payments and the inflation adjustments (if any) to the principal balance. Paying current taxes on the inflation adjustments isn't a great way to go. You won't actually collect those inflation adjustments in cash until the TIPS mature or you sell them in the secondary market. To avoid this problem, hold your TIPS in a tax-advantaged retirement account, such as a traditional or Roth IRA, 401(k) or SEP.

HOW TO BUY TIPS

THE MINIMUM FACE VALUE for TIPS is $1,000. Larger denominations are available in $1,000 increments. TIPS are marketable securities, so they can be easily bought and sold in the secondary market through a brokerage firm. Just be aware that you'll have to pay a commission. However, these fees tend to be reasonable. Original issue TIPS can be purchased from the government through the online Treasury Direct program. However, the Treasury Direct option is only available for TIPS purchased for taxable accounts, which is generally inadvisable.

One thing to keep in mind with TIPS is that market prices fluctuate due to changes in prevailing interest rates, supply and demand, and other factors. If you don't intend to hold TIPS to maturity, you must understand that market prices can and do change on a daily basis, and there's no certainty about how much you'll be able to sell TIPS for in the secondary market.

V. TAXES AND YOUR INVESTMENTS

MAKING THE MOST OF CAPITAL GAINS

IF YOU'RE A STOCK OR mutual-fund investor, then you probably know that investments held for more than a year and sold for a profit are subject to lower long-term capital gain tax rates. Generally speaking, if you're in the 25% tax bracket or higher, you will owe no more than 15% of your profits to the Internal Revenue Service.

But what you might not realize is that more than just stock and mutual-fund shares are eligible for favorable capital-gains tax treatment. If you sold, say, your vacation time share or your country-club membership, then you just might be pleasantly surprised to discover you'll owe no more than 15% on the gain (assuming that you held the asset for more than a year).

Here's a list of some of the most common types of assets potentially subject to these lower rates:

1. Securities options (as in puts and calls) held as personal investments.
2. Stock of closely held corporations.
3. Collectibles held as personal investments, like baseball cards, stamps, rare coins, art, etc. In this case, a 28% (not 15%) maximum federal tax rate applies.
4. Personal residences (including vacation homes). In this case, the 15% maximum rate generally applies to gains beyond what you can exclude (not pay tax on) under the $250,000/$500,000 home-sale gain exclusion privilege. However, a 25% maximum rate applies to gains triggered by certain depreciation deductions claimed against your property.
5. Vacation time-share interests.
6. Country-club memberships.
7. Personal autos (that aren't collectibles). Keep in mind, this means that you've sold your car at a profit, which is unlikely.

8. Personal-property items (that aren't collectibles) in general-such as jewelry, furniture, a lawn mower and so on.
9. Rental real estate owned by an individual, partnership, limited-liability company (LLC) or S corporation. (The standard 15% maximum rate applies, but gain from depreciating a property may be taxed at up to 25%.)
10. Land held as an investment by an individual, partnership, LLC or S corporation.
11. Your ownership interest in a partnership or LLC. In this case, the 15% maximum rate usually applies, although depending on the assets of the partnership or LLC, part of your gain may be taxed at higher rates of up to 35%.
12. Land used in a business owned by an individual, partnership, LLC or S corporation. This could be the actual land that your small business is located on, or it could be land held by your small business, such as an apple orchard.
13. Options to buy investment land when the option is owned by an individual, partnership, LLC or S corporation. This is the option to buy land at a certain price over a set period of time. It could be, for example, that you've purchased the option to buy a plot of land that you think is going to appreciate because of future development in the area.
14. The right to receive money for release of a restrictive covenant in a land deed when the deed is owned by an individual, partnership, LLC or S corporation.
15. The right to a condemnation award when the right is owned by an individual, partnership, LLC or S corporation. This would apply if, say, your property were condemned by the city so that it could take over the land and build a civic building.
16. The right of a tenant to receive a lease-cancellation payment when the tenant is an individual, partnership, LLC or S corporation. This would apply if you were renting property and your landlord cancelled your lease.
17. Contract rights owned by an individual, partnership, LLC or S corporation. For example, you might own a license giving you the right to use a software program. If you can sell that license to someone else for a gain, it will be taxed at no more than 15%.
18. Most other intangible business assets (such as intellectual property, trade secrets, goodwill and so on) owned by an individual, partnership, LLC or S corporation. In these cases, the 15% maximum rate generally applies. However, if the business intangible was amortized, gains attributable to the amortization deductions are taxed at your regular rate (up to 35%).
19. A stock-exchange membership owned by an individual, partnership, LLC or S corporation. Obviously, there aren't too many of these, but this does apply to regional exchanges as well.
20. Depreciable or amortizable assets used in business-provided the asset is owned by an individual, partnership, LLC or S corporation. Gains attributable to depreciation or amortization deductions are generally taxed at your regular rate (up to 35%). The 15% maximum rate generally applies to the balance of the gain.

MUTUAL FUND TAX BREAKS

PART OF BEING A smart mutual-fund investor is making sure you walk away with as much profit in your pocket as possible. This means avoiding load funds (usually, anyway) and funds with ridiculously high expense ratios. Now, most readers of SmartMoney.com are already aware of these pitfalls, but one area where many wise fund investors still stumble is with taxes. For starters, many investors don't pay close enough attention to a fund's tax efficiency. And that isn't the only common mistake. Here are a couple more often-overlooked ways to reduce the tax hit to your fund shares:

ARE YOU INVESTED IN FOREIGN STOCKS OR MUTUAL FUNDS?

IF YOU'VE WORKED in a foreign country or have substantial income from outside the U.S., you probably know all about the foreign tax credit. It's intended to keep you from being taxed on the same income by two different countries. But if you simply invested in some international mutual funds, you may also be able to claim this valuable tax break, since it's quite likely you paid foreign taxes last year (even though you probably didn't know it).

To find out, take a close look at your fund summary statements for 2009. You'll probably have to make some calculations to figure the exact amount of foreign taxes that came out of your account. Fortunately, your fund family should provide you with the information you need to do the math. Usually they'll give

you a figure by which you'll multiply the number of shares you own. The payoff is that you're allowed a dollar-for-dollar credit against your U.S. income-tax bill. So while this might seem like a hassle, the extra work is definitely worth the trouble.

If you have direct holdings in foreign stocks or bonds, any foreign taxes should show up on your Forms 1099-DIV and 1099-INT. Assuming that 1) all your foreign taxes were on interest and dividends (including those earned via mutual funds), and 2) the foreign taxes amounted to $300 or less ($600 if you file jointly), things are simple. Just claim your credit by entering the foreign tax amount on Form 1040, line 47.

In all other cases, you must file Form 1116 (Foreign Tax Credit) to claim your rightful credit. Consider yourself warned: This form is pretty nasty, so you may want to get professional assistance if your foreign tax hit was substantial.

DID YOU SELL FUND SHARES LAST YEAR?

IF YOU'VE INVESTED in a mutual fund, chances are you agreed to reinvest all of your dividends in the fund. It's a pretty painless way to practice dollar-cost averaging. But if you sold some shares last year, don't forget to claim the additional basis from the reinvested dividends in calculating your gain or loss on Schedule D. In other words, because you paid tax on those dividends (even though the cash never actually passed through your hands), the reinvested amounts represent after-tax dollars in the form of additional share basis.

For example, say several years ago you invested an initial $2,000 to buy 100 shares in Fund XYZ. During your ownership period, you received a total of $500 in dividends, which were automatically reinvested to buy 20 more shares of the fund. Then last year, you sold all of your shares. In figuring your gain or loss, the correct tax-basis figure for your 120 shares is $2,500 (your $2,000 initial investment plus the $500 reinvested to acquire additional shares). If you screw up and claim only $2,000 of basis, you'll overstate your gain or understate your loss by $500. The IRS gets more than it should, and you lose out.

Now, your fund company should have provided you with your average basis for all the shares you own, including those acquired by reinvesting dividends. But many investors still overlook this information and use their own (incorrect) figures. So do yourself a favor and take a close look at the year-end statement from your fund family.

THE TRICKY ART OF DEDUCTING 529 LOSSES

IF YOU'VE BEEN TRYING to save for a son or daughter's college years by investing in a 529 savings plan, you may have suffered major losses during the stock market meltdown. If you decide to bail out, the losses may be tax deductible. But be careful: The IRS rules on this are a little hazy.

In Publication 970 (Tax Benefits for Education), the IRS says you can trigger a potential tax-deductible loss when you shut down a loser 529 account. Unfortunately, there's no other official or unofficial guidance. Here's my take:

The loss is potentially deductible when both of the following conditions are met:

- You liquidate all of the holdings in the 529 account(s) that you own under a particular state's plan for a particular beneficiary (college-bound child). Since you own the account(s), the liquidation proceeds go to you rather than the beneficiary.
- The total proceeds from liquidating the account(s) is less than your total basis in the account(s). Your basis in an account equals the amount of money you've contributed to it-assuming you've made no withdrawals. So if you only have one account and have never taken anything out of it, you have a potentially deductible loss if the amount you receive from closing the account is less than what you put in.

It gets even trickier from here. There are additional hurdles to clear before you can collect any actual tax savings.

MISCELLANEOUS ITEMIZED DEDUCTION TREATMENT

ACCORDING TO THE IRS, your 529 account loss is a miscellaneous itemized deduction. As such, it gets thrown into the pot with other miscellaneous deductions (such as investment expenses and fees for tax advice and return preparation). Only total miscellaneous deduction amounts that exceed 2% of your adjusted gross income (AGI) can be written off.

If you clear the 2%-of-AGI hurdle, you're still not home free. You may lose part of your write-off due to a phase-out rule for high-income individuals. And your deduction is completely disallowed under the alternative minimum tax (AMT) rules. So if you're an AMT victim, some or all of the hoped-for tax savings will go up in smoke.

EXAMPLE: Say you've put $50,000 into your one and only 529 account. Even though you've never taken money out of it, the account is now worth just $30,000. You're thinking

about liquidating the darn thing and hoping for a tax deduction to ease your pain.

Liquidation Results: Since you haven't taken any withdrawals, your basis in the account is $50,000. Closing it would mean a $20,000 loss ($50,000 basis - $30,000 proceeds).

Deductible Loss Calculation: As mentioned, the IRS says your loss is a miscellaneous deduction subject to the 2%-of-AGI threshold. If your AGI is $150,000, the threshold is $3,000 ($150,000 x 0.02). Say you also have $1,000 of other miscellaneous deductions, for a total of $21,000 (529 plan loss of $20,000 + $1,000). You can deduct $18,000 ($21,000 - $3,000). However, if you're an AMT victim, that write-off is disallowed, and your actual tax savings may be whittled down or eliminated.

Bottom Line: For our purposes, let's assume you're not an AMT victim. In your situation, closing the 529 account triggers an $18,000 write-off. If you're in the 28% federal tax bracket, you save $5,040 (0.28 x $18,000). Plus you get back what's left of your money.

OTHER TAX CONSIDERATIONS

YOU MAY HAVE TO REPAY STATE INCOME TAX BENEFITS

IF YOU COLLECTED a state income tax write-off or credit when you invested in your state's 529 plan, then closing the account could mean you'll have to report a previously-claimed deduction in income on your state tax return or repay a previously-claimed credit.

YOU MAY BE GIVING UP A TAX-FREE RECOVERY

SAY YOUR LOSER 529 account recovers and becomes worth what you've contributed and more. Assuming that you eventually end up draining the account to pay for qualified college costs, you won't owe any federal income tax on the difference between what the account is worth now and the higher value after it recovers.

DON'T REINVEST TOO QUICKLY

IF YOU LIQUIDATE a loser 529 account to reap some tax savings, don't reinvest in another 529 within 61 days after liquidating the first one. If you do, the IRS may deem it as simply rolling over proceeds from one 529 to another-and some or all of your loss deduction might go out the window.

BEWARE OF GIFT TAX IMPLICATIONS IF YOU REINVEST

SAY YOU MADE A lump-sum 529 plan contribution a couple years ago and spread it out over five years for gift tax purposes. If you liquidate the account, you may have to wait until the five-year period is over before making another significant contribution to a new account that is set up for the same beneficiary. Otherwise, you could face adverse gift-tax consequences. (The rules are unclear here.)

THE LAST WORD

WHILE CLOSING A LOSER 529 account may cut your tax bill, the benefit may be less than you hoped. Plus, there are all of the other issues to overcome. All things considered, the clearest argument for liquidating is when you simply want (or need) your money back and the tax benefit (if any) is just a bonus.

VI. YOUR HOME/REAL ESTATE

TAX BENEFITS OF REFINANCING

MANY PEOPLE REFINANCED their mortgages in 2009, despite the bad economy and stricter lenders. If you fall into this category, here's how to make sure you claim all your rightful deductions on your 2009 return.

DEDUCTING MORTGAGE INTEREST

SAY YOUR ORIGINAL mortgage was $200,000. On July 1, 2009, you took out a new 30-year, $300,000 mortgage and paid 11/2 points, or $4,500, for the privilege. (Each point represents 1% of your total loan amount.) You then used the extra $100,000 from the new mortgage to eliminate some high-interest credit-card bills, pay off your car loans and cover various other expenses.

Assuming your home was worth at least $300,000 when you refinanced, you have, in effect, two new mortgages as far as the Internal Revenue Service is concerned. The first $200,000 of your new loan (the balance on your old mortgage when you paid it off) is treated as "home-acquisition debt." And the interest on this qualifies as an itemized deduction on line 10 of your Schedule A. (Don't forget, however, that if your adjusted gross income in 2009 was greater than $166,800, or $83,400 if you use married filing separate status, this deduction is subject to

the partial phase-out rule for itemized deductions.)

The remaining $100,000 of your new loan is treated as home-equity debt. The interest on this should also qualify as an itemized deduction on line 10 of your Schedule A. But keep one thing in mind: The IRS only recognizes home-equity loans up to $100,000; you can't deduct the interest paid on principal above that figure.

Also, if the home-acquisition debt plus the home-equity debt exceeded the fair-market value of your home, you generally can't deduct the interest on the excess debt. Say your home was worth $240,000 when you took out that new $300,000 loan. You can deduct the interest on the $200,000 of acquisition debt. However, for the home-equity debt, you can only deduct the interest on $40,000. So you can deduct 80% ($240,000/$300,000) of the total mortgage interest on line 10 of your Schedule A. (The interest on the remaining $60,000 of debt is generally considered a nondeductible personal expense, though there are a couple of exceptions, like if you used the loan proceeds to finance your small business.)

TALKING POINTS

YOU CAN ALSO AMORTIZE the points related to the home-acquisition-debt part of the new loan ($3,000 in our example) over the life of the loan. Say it's a 30-year loan (360 months). Your amortization deduction would be $8.33 a month ($3,000 divided by 360), for a grand total of $99.96 a year.

What about the points related to the home-equity debt ($1,500 in our example)? You can amortize those in the same proportion as the interest, provided that the home-equity debt is $100,000 or less, and the home's value isn't less than the home-equity debt plus the acquisition debt. Claim the amortization write-off for your home-mortgage points on line 10 or 12 of Schedule A.

This brings us to our last potential deduction. If you previously refinanced your mortgage and paid points, you probably have a good-sized unamortized (or not-yet-deducted) balance for those points. You can generally deduct that entire unamortized amount when you refinance again. For example, say the mortgage you refinanced last year was taken out in a previous refinancing deal done six years earlier, back in 2003. At that time you paid $2,000 in points for your 30-year loan. You should have $1,600 worth of unamortized points left over from the 2003 loan (80% of the original $2,000 amount). On your 2009 return, don't forget to deduct the $1,600 of unamortized points. Claim your write-off on line 12 of Schedule A.

TAX ANGLES WHEN YOU CONVERT YOUR HOME INTO A RENTAL PROPERTY

IN THIS ECONOMY it can difficult, if not impossible, to sell your home for a price you can swallow. So you might be thinking about converting it into a rental property until the local market improves — especially if you've already bought another home and are now paying two mortgages, two property tax bills, and so forth. However, converting a former personal residence into a rental has some tricky tax implications. Here's the story.

BASIS FOR LOSS AND DEPRECIATION PURPOSES DEPENDS ON MARKET VALUE

YOU MAY ALREADY KNOW you can't claim a tax loss when you sell a personal residence for less than tax basis. In most cases, basis equals the original purchase price plus the cost of any improvements (not counting normal repairs and maintenance) minus any depreciation deductions (say, from a deductible office in the home). The privilege of claiming tax losses is reserved for sales of property used for business or investment purposes.

But if you convert your home into a rental and eventually sell for less than tax basis, you cannot necessarily deduct the loss. A special basis rule is intended to curtail that taxpayer-friendly outcome.

The special rule says when you convert a former residence into a rental, your initial tax basis for calculating any later loss on sale equals the lesser of: (1)the property's basis on the conversion date under the normal rule or (2) the property's fair market value (FMV) on the conversion date.

In effect, the special rule disallows the loss from a decline in value that occurs before the conversion date. But a post-conversion decline will result in an allowable tax loss to the extent it's not offset by depreciation write-offs. (Because depreciation lowers the property's tax basis for loss purposes, it makes it harder to have a loss.)

You have to use the same unfavorable special basis rule to figure your initial tax basis for calculating depreciation deductions on the converted property. (You can depreciate basis allocable to the building—not the land—over 27.5 years.)

TAX BASIS FOR GAIN PURPOSES IS DIFFERENT

SAY THE VALUE OF the converted property recovers, and you sell for a profit down the road. The property's tax basis for gain purposes is determined under the normal basis rule,

which usually equals the purchase price plus the cost of improvements minus depreciation (including depreciation while the property is rented out).

DIFFERENT BASIS NUMBERS CAN CREATE UNEXPECTED RESULTS

BECAUSE THE SPECIAL basis rule for tax loss purposes is different than the normal basis rule for tax gain purposes, you could wind up in no man's land where you have neither a tax gain nor a tax loss. That will happen if the sale price falls between the two basis numbers. To clarify, here are some examples to illustrate the tax results that will occur with differing conversion date FMVs and differing sale prices.

SCENARIO 1: TAX LOSS ON SALE

1. Basis on conversion date under normal rule $300,000
2. FMV on conversion date 235,000
3. Post-conversion depreciation deductions 13,000
4. Basis for tax loss (line 2 - line 3) 222,000
5. Basis for tax gain (line 1 - line 3) 287,000
6. Net sale price (after selling expenses) 205,000
7. Tax loss (excess of line 4 over line 6) 17,000
8. Tax gain (excess of line 6 over line 5) N/A

NOTE: There's an allowable tax loss because the sale price is considerably lower than the conversion-date value.

SCENARIO 2: TAX GAIN ON SALE

1. Basis on conversion date under normal rule $300,000
2. FMV on conversion date 285,000
3. Post-conversion depreciation deductions 16,000
4. Basis for tax loss (line 2 - line 3) 269,000
5. Basis for tax gain (line 1 - line 3) 284,000
6. Net sale price 295,000
7. Tax loss (excess of line 4 over line 6) N/A
8. Tax gain (excess of line 6 over line 5) 11,000

NOTE: The tax gain is caused by the post-conversion depreciation deductions.

SCENARIO 3: NO TAX GAIN OR LOSS

1. Basis on conversion date under normal rule $300,000
2. FMV on conversion date 235,000
3. Post-conversion depreciation deductions 13,000
4. Basis for tax loss (line 2 - line 3) 222,000
5. Basis for tax gain (line 1 - line 3) 287,000
6. Net sale price 260,000
7. Tax loss (excess of line 4 over line 6) N/A
8. Tax gain (excess of line 6 over line 5) N/A

NOTE: There's no tax gain or loss because the sale price falls between the two basis numbers.

THE BOTTOM LINE

CONVERTING A PERSONAL residence into a rental property triggers some tricky tax rules. It's important to remember that the property's FMV on the conversion date is often the most important factor in determining the tax results from a later sale. So make sure you have some evidence of the FMV, like a market evaluation from a local realtor. Keep it with your tax records.

TAX RULES FOR RENTAL REAL ESTATE LOSSES

IF YOU OWN rental real estate, the down economy makes running up rental tax losses more likely than ever. However, your ability to actually deduct those losses may or may not be postponed. Here's the story.

THE DREADED PASSIVE ACTIVITY LOSS RULES

AS A GENERAL RULE, tax losses from owning rental real estate are treated as passive activity losses, or PALs. That's not a good thing because you can only deduct PALs to the extent you have passive income from other sources (such as income from other healthier rental properties or gains from selling rental properties). Unfortunately, many owners have little or no passive income, so most or all of their PALs are suspended and carried over to future years. You can deduct suspended PALs when you have passive income or when you sell the properties that generated the PALs, but that might be years from now.

Thankfully, there are two favorable exceptions to the general rule. So don't give up hope.

EXCEPTION 1: FOR ACTIVE INVESTORS

THE MOST WIDELY-AVAILABLE exception says you can deduct up to $25,000 of rental property PALs if: (1) your modified adjusted gross income (MAGI) is no more than $100,000 and

(2) you actively participate in the property. Active participation means owning at least a 10% stake and being making management decisions like approving tenants, signing leases, authorizing repairs, and so forth. You don't have to mow lawns or snake out drains. But if you use a management company to handle all the details, you'll fail the active participation test, and this exception will be off limits.

If your MAGI falls between $100,000 and $150,000, this exception is phased out pro-rata. For example, if your MAGI is $125,000, you can deduct up to $12,500 of PALs from rental properties in which you actively participate (half the $25,000 maximum). Once your MAGI hits $150,000, however, this exception is completely disallowed, and you fall back under the general anti-taxpayer PAL rule explained at the beginning.

EXCEPTION 2: FOR REAL ESTATE PROS

THIS SECOND EXCEPTION is only available to folks who I call real estate professionals. To be eligible, you must spend over 750 hours during the year on real estate activities in which you materially participate (not counting your spouse's time if you're married). And those 750 hours must be over half the time you spend working. If you clear these hurdles, losses from rental properties in which you materially participate are not PALs, and you can generally deduct them in the year they are incurred.

Passing the material participation test is harder than passing the Exception 1 active participation test. The three most-likely ways to pass are by:

1. Making sure the time you spend on your rental property during the year constitutes substantially all the time spent by all individuals.
2. Spending more than 100 hours on your property and making sure no other individual spends more time than you.
3. Spending over than 500 hours on the property.

You only have to meet one of these three requirements to pass the material participation test. If you're married, you can combine your hours with your spouse's. If you own multiple rental properties, you can choose to treat them all as one activity, and then count the combined hours spent on them all to meet any of the three requirements. (That said, check with your tax advisor before combining properties, because doing so can have a negative side effect if you later sell properties with suspended PALs.)

SPECIAL RULE FOR PROPERTIES IN RESORT AREAS

IF YOUR RENTAL PROPERTY is in a resort area, the average rental period may be seven days or less. In this seven-day-rental scenario, the IRS says you're running a hotel-like business as opposed to innocently renting out your property. That makes you ineligible for both Exception 1 and Exception 2. However, if you materially participate in the property, your tax losses are not PALs, and you can generally deduct them in the year they are incurred. Once again, the three most-likely ways to pass the material participation test are by:

1. Making sure the time you spend on your property during the year constitutes substantially all the time spent by all individuals.
2. Spending more than 100 hours on your property and making sure no other individual spends more time than you.
3. Spending over than 500 hours on the property.

Once again, meeting any one of these requirements is enough to pass the material participation test. And if you're married, you can combine your hours with your spouse's. However, if you fail the material participation test, your losses will be PALs, and they will fall under the general anti-taxpayer rule explained at the beginning. Once again, that rule says your PALs will be suspended unless you have passive income from other sources. Suspended PALs can be deducted in the future when you have passive income or when you sell the property.

FOR MORE INFORMATION

THE TAX RULES FOR rental property losses are tricky, and I've left out some details to keep this from section turning into a book of its own. For more information, I recommend checking out IRS Publication 527 (Residential Rental Property) at www.irs.gov.

LOSSES FROM SELLING INVESTMENT REAL ESTATE ARE TAX-FAVORED

IN THIS TOUGH ECONOMY, you may own a piece of rental real estate that you now need to sell — maybe for a loss. While loss sales were pretty unusual a few years ago, they happen all the time now. The good news is losses from unloading investment properties receive very favorable treatment under the Internal Revenue Code. The tax savings can be a real help. Here's what you need to know.

FIRST THINGS FIRST: DO YOU ACTUALLY HAVE A TAX LOSS?

YOU WILL HAVE A TAX LOSS if you sell your property for less than its tax basis—which generally equals the price you originally paid plus the cost of improvements over the years (not including repairs you deducted along the way) minus all the depreciation write-offs claimed during your ownership. So if you've owned the property for a long time, its basis may be a lot lower than you think due to the depreciation factor. If so, you might trigger a tax gain if you sell even though it "feels" like a loss—because the value has declined. Sadly, the IRS doesn't care about your feelings!

One more thing: your tax basis in the property you now want to sell might also be a lot lower than you think if you acquired it in exchange for another property in a tax-deferred "Section 1031" swap (also called a like-kind exchange). In this case, your initial tax basis in the property was reduced by the amount of gain that you deferred in the Section 1031 exchange. So if you deferred a big gain, the basis reduction was a big number, and selling the property could actually trigger a tax gain instead of the tax loss you were hoping for.

Bottom Line: Make sure you know what your property's tax basis really is before concluding that a sale would trigger a tax loss. You don't want to be mistaken and trigger a tax gain without knowing about it ahead of time.

TAX-SAVING RESULTS IF YOU DO HAVE A LOSS

Assuming you do have a tax loss and have owned the property for over a year, the loss will be a "Section 1231" loss. This is the very best kind of loss you can have because you can deduct it against any and all types of income (salary, interest, dividends, capital gains, alimony received, self-employment income, whatever). If your Section 1231 loss is big enough that it exceeds your 2009 taxable income (calculated before the loss), it may create a net operating loss (NOL). An NOL would be very handy because you can carry it back to previous tax years and recover some or all of the taxes you paid. Alternatively, you can choose to carry the NOL forward for up to 20 years, to 2010 and beyond, and use it to offset income that might be taxed at higher rates (possibly much higher rates) in those years.

YOU MIGHT BE ABLE TO DEDUCT SUSPENDED PASSIVE LOSSES TOO

AS A REAL ESTATE OWNER, you're probably aware of the passive loss rules. If they applied to you in previous years, some or all of your rental real estate losses may have been deferred (suspended) for tax purposes. When that happens, you generally cannot deduct the suspended losses until you either have positive taxable income from rental real estate activities or until you sell the property (or properties) that generated the losses in the first place. So if you now sell a property that generated suspended passive losses, those losses might suddenly become deductible on your 2009 Form 1040. And if those suddenly deductible losses are big enough, you might create or increase a 2009 NOL that you can then carry back to prior years or forward to future years with tax-saving results.

The rules for suspended passive losses can be tricky if you own multiple rental properties. If you do, consult your tax adviser about whether selling the property in question will allow you to deduct some suspended passive losses.

THE LAST WORD

IT'S NEVER FUN TO SELL what you hoped would be an appreciating asset for a loss, but doing so could generate some significant tax savings that could make you feel a bit better about the transaction.

VII. FOR BUSINESS OWNERS

NEW FOR 2009

EXPANDED LOSS CARRYBACK RULE

THE WORKER, Homeownership and Business Assistance Act of 2009 granted an important break to businesses that incur tax losses, which are called net operating losses, or NOLs, in tax lingo. Under the general rule, an NOL can be carried back for two years and deducted against taxable income in those years. Depending on the size of the NOL, you'll then get a refund for some or all of the taxes paid for those years. Obviously, when cash is tight, these refunds can be a lifesaver. But it would be even better if you could carry back an NOL to recover taxes paid three, four or five years ago. Thankfully, the new law allows you to do that, with a twist for the fifth year. Here's what you need to know.

HOW THE EXPANDED CARRYBACK RULE WORKS FOR SMALL BUSINESSES LOSSES

THE NEW LAW'S expanded NOL carryback deal is allowed for large and small businesses alike. However for smaller outfits, the new break is layered on top of a similar break that was included in the Stimulus Act. Under the Stimulus Act provision, you could carry back a 2008 NOL for three, four or five years (instead of the normal two years), but only if that NOL was from a business with average annual gross receipts of no more than $15 million. So if your small business had a 2008 NOL, you could choose to carry it back as far as 2003 and recover some or all of the federal income taxes paid for that year. If you still had some NOL left, you could deduct the remaining amount against your 2004 income, then against your 2005 income, and so on until the NOL was all used up. And if you still had some 2008 NOL left after all these carrybacks, you could carry that amount forward for 20 years to offset taxable income in 2009 and beyond.

Under the new law, you can choose to carry back a 2008 or 2009 NOL for three, four or five years. So if you already took advantage of the Stimulus Act break to carry back a 2008 NOL for more than two years, the new law allows you to do the same thing for a 2009 NOL. However, under the new deal, a NOL carried back to the fifth preceding year can't be used to offset more than 50% of that year's income. Here are some examples.

EXAMPLE 1: Say your business generated a $100,000 NOL in 2008 which you chose to carry all the way back to 2003 (the fifth year before 2008). You used up the entire NOL to offset 2003 income and got a big tax refund. Then your business ran up another $100,000 NOL in 2009. Under the new law, you can choose to carry the 2009 NOL back as far as 2004 (the fifth year before 2009). Say your 2004 taxable income was $80,000. Under the 50% limitation, you can use the NOL carryback to wipe out $40,000 of 2004 income (50% of $80,000). You can then use the remaining $60,000 of NOL to offset income from 2005-2008 (there's no 50% limitation for carrybacks to those years).

EXAMPLE 2: Say your business got through 2008 without running up a loss, but you had a $100,000 NOL in 2009. Under the new law, you can choose to carry that NOL as far back as 2004 (the fifth year before 2009). Say your 2004 taxable income was $120,000. Under the 50% limitation, you can use the NOL carryback to wipe out $60,000 of 2004 income (50% of $120,000). You can then use the remaining $40,000 of NOL to offset income from 2005-2008 (there's no 50% limitation for carrybacks to those years).

YOU HAVE OPTIONS

ALTHOUGH THE NEW LAW allows you to carry back a 2009 NOL for up to five years, you don't have to go that far back. As I said earlier, you can also choose to carry back a 2009 NOL for four years or three years. Or you can follow the standard rule and carry it back for two years. Or you can choose to carry the entire 2009 NOL forward for 20 years. All things being equal, you want to use the NOL to offset income in years when you pay the highest tax rates. However, cash flow considerations may dictate carrying back the NOL as far as you can to get a refund of taxes you've already paid.

Bottom Line: If you have a significant 2009 NOL to play with, huddle up with your tax pro before deciding what to do. If you choose to take advantage of the new law's expanded NOL carryback option, the deadline for making that choice is the due date (including any extension) of the return for the tax year that began in 2009. If you make do that choice, it's irrevocable, so don't make it lightly.

DEDUCT YOUR COMMUTING COSTS

FOR MOST OF US the cost of commuting between home and work isn't a deductible expense. But some lucky folks are indeed able to do this. Are you self-employed with a home office? Then you just might be able to write off the cost for traveling between your residence and any other location where you conducted work-related business last year.

To take advantage of this tax break on your 2009 return, you must have a home office that qualifies for write-offs because it was your "principal place of business." This means that your home office was used regularly and exclusively as the scene for most of your income-earning activities last year. Alternatively, it would also qualify as your principal place of business if it was used regularly and exclusively for management and administrative functions-provided you didn't make substantial use of any other fixed location for such activities last year. Administrative and management activities are things like preparing client proposals and invoices, strategic planning, market research, keeping up with professional literature and so forth.

For example, say your home office was used regularly and exclusively for administrative and management functions main-

ly during evening hours. During the day, you also had a "regular office" downtown, which you used for client meetings and as your base for daily operations (but, again, not for administrative chores). Because your home office qualifies as your principal place of business, you can deduct all the costs of commuting between there and your downtown office.

Regardless of whether you had another permanent office location (like the downtown office in our example), you can also always deduct the cost of commuting between your home office and any temporary work locations. These temporary work locations can include the post office, the office-supply store, the bank where you keep your business accounts, client sites and so on.

If you commuted between your home office and work locations by car, you can write off the actual expenses (including depreciation) or claim the standard business mileage allowance (55 cents per mile for 2009). And if you commuted by cab or public transportation, those costs are deductible, too.

Your commuting-expense deductions belong on Schedule C (if you're a sole proprietor or single-member LLC owner) or on Schedule E (if you're a partner or member of a multimember LLC). And keep in mind, write-offs claimed on those business tax schedules are double tax savers, because they reduce both your income and self-employment tax bills.

A TIP FOR SMALL-BUSINESS OWNERS

ATTENTION SMALL-BUSINESS owners: As you prepare your business tax forms and schedules, don't forget to take advantage of the ultra-generous first-year depreciation write-off for assets bought and put to use during 2009. Here's how it works:

Most small businesses are entitled to the privilege of immediately deducting up to $250,000 of new and used personal-property assets (meaning equipment, machinery, furniture, fixtures and software) under the "Section 179 deduction." Next, calculate your standard depreciation write-off using the cost remaining after subtracting the Section 179 deduction. You do all this by filling out Form 4562 (Depreciation and Amortization).

BEWARE OF REDUCED SECTION 179 BREAK FOR "HEAVY" SUVS

OUR BELOVED CONGRESS placed a reduced $25,000 limit on Section 179 deductions for "heavy" SUVs with gross vehicle weight ratings (GVWRs) between 6,001 and 14,000 pounds. The $25,000 limitation doesn't affect vehicles that are not considered to be SUVs under the tax law. For this purpose, "non-SUVs" are defined as vehicles that meet any of the following descriptions.

- Vehicles equipped with a cargo area that is not readily accessible directly from the passenger compartment and that is at least six feet in interior length. The cargo area can be open or designed to be open but enclosed by a cap. For example, many pickups with full-size cargo beds will qualify.
- Vehicles with: (1) an integral enclosure that fully encloses the driver's compartment and load carrying device, (2) no seating behind the driver's seat, and (3) no body section protruding more than 30 inches ahead of the leading edge of the windshield. For example, many delivery vans will qualify.
- Vehicles designed to seat more than nine passengers behind the driver's seat. For example, many hotel shuttle vans and minibuses will qualify.

In summary, vehicles with GVWRs above 6,000 pounds that meet any of the preceding descriptions are still eligible for the full Section 179 deduction of up to $250,000 for tax years beginning in 2009.

WHEN YOUR SPOUSE IS YOUR BUSINESS PARTNER

SOME HUSBAND/WIFE teams have committed to more than just loving each other forever-for richer or poorer. Some have chosen to also become business partners. Trust me, a little tax savvy could definitely help tip that scale toward "richer."

But before I titillate you with the gritty details, let me say upfront that this tip only applies to couples living in the nine community property states (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington or Wisconsin) who run their small business as a husband-wife partnership. If that's your situation, you've been filing Form 1065 (U.S. Return of Partnership Income) with the IRS each year to report your business income and expenses. These business tax items are then split between you and your spouse and shown on separate Schedules K-1 from the partnership (one for you and one for your spouse). Eventually, all the numbers from both of your Schedules K-1s are recombined and included on your joint Form

1040. (Anyone who's done this previously will tell you it's about as much fun as a root canal.)

But here's the good news: The IRS says you can start treating your husband-wife business as a sole proprietorship for federal-tax-filing purposes. This is thanks to little-known IRS Revenue Procedure 2002-69. The upshot is you can choose to report all your business income and expenses on simple-and-easy sole proprietorship Schedule C (Profit or Loss From Business) which you then include with your Form 1040. Then you can (mercifully) forget about that ultra-complicated Form 1065 and those nightmarish Schedules K-1.

And wait-there's more! Treating your husband-wife business as a sole proprietorship instead of a partnership could potentially save you thousands in self-employment (SE) taxes every year. Here's why.

With a husband-wife partnership, both you and your spouse must each file separate Schedules SE for your respective shares of partnership income. Then you must each pay 15.3% SE tax on the first $106,800 of your share of 2009 partnership SE income. If your share of SE income exceeds $106,800, the SE tax rate drops to 2.9%. So if you have a profitable husband-wife partnership, both you and your spouse can each get hit with the maximum 15.3% SE tax rate on up to $106,800 of SE income (total of $213,600). Remember: This is on top of your federal and state income taxes. Ouch.

In contrast, if you treat your husband-wife business as a sole proprietorship, you only have to file one Schedule SE-for the spouse considered to be the proprietor-with your joint return. That means no more than $106,800 of SE income gets hit with the maximum 15.3% rate (any remaining SE income gets taxed at the much-easier-to-swallow rate of only 2.9%).

So which would you prefer: up to $213,600 taxed at 15.3% or no more than $106,800 taxed at 15.3%? Assuming you prefer the latter, simply treat your husband-wife business as a sole proprietorship instead of a partnership-starting with your 2009 return. Do this by filing Schedule C with your 2009 Form 1040 and by ceasing to file a separate partnership tax return on Form 1065. This simple drill could save you thousands in SE tax for 2009 and similar amounts each year in the future.

However, don't make this move without checking with your tax adviser about the other tax implications-including the impact on your state-tax situation (if any). In most cases, however, there won't be any adverse side effects.

Who qualifies: The taxpayer-friendly rules in Revenue Procedure 2002-69 are limited to unincorporated businesses owned exclusively by husband and wife as community property under applicable state law (with no other owners in the picture). If your husband-wife business fits this description, you have the government's official blessing to follow the tax-saving advice in this article.

VIII. FILING, EXTENSIONS AND REFUNDS

SHOULD I PAY MY TAXES WITH PLASTIC?

WORRIED ABOUT HOW you're going to pay your tax bill? It might be tempting to slap it on plastic.

After all, you can charge your 2009 federal income taxes on a Visa, MasterCard, Discover Card or American Express. What if you want a filing extension? No problem. Just charge what you expect to owe the IRS. And if you owe estimated taxes for tax year 2010, you can charge those, too. In fact, in many states, you can put your state income-tax bill on plastic as well.

Clearly, charging your taxes is convenient. And with the right card, you can even rack up some extra frequent-flier miles or other goodies to boot. So what's the big issue?

The "convenience fee," that's what. It amounts to either 2.35% or 1.95% of the amount you charge. This is in lieu of the fee that merchants pay credit-card companies when you charge your purchases. Only in this case, the "merchant" is the Internal Revenue Service, and Uncle Sam isn't interested in turning any of his revenues over to the card companies. That means you foot the bill. Until now, you've probably been blissfully ignorant of merchant fees, but you'll become aware of them when they come directly out of your own pocket. The money is collected by one of the three vendors that facilitate these transactions: Official Payments Corp., Link2Gov Corp., and RBS WorldPay Inc. The first two charge 2.35% while RBS charges 1.95%.

Granted, paying $9.40 for the convenience of charging a $400 tax bill to your credit card isn't really a sin. But what about paying $117.50 on a $5,000 tax bill? And unless you pay off that bill within your credit-card issuer's grace period, you'll start getting charged interest (often at 13% or more annually).

Bottom line: you can probably find a better way to dig up the money to pay your tax bill. Perhaps your credit union, your parents or your rich brother-in-law. Also, don't overlook the IRS itself. You may qualify to set up an installment-payment

plan with the government. If so, this may be the cheapest way to go. You'll be charged a $52 setup fee (assuming you arrange for automatic payments out of your checking account) and then a monthly interest rate on the outstanding balance. Currently, that interest rate is 0.583% per month (which equates to 7% annually). However, the interest rate is subject to change every quarter. File IRS Form 9465 to get that ball rolling.

Of course, if you have a credit card with a low APR - say 5% or less - this could turn out to be the cheaper option. That is, provided you pay off your tab in a reasonable amount of time (i.e., before that introductory rate jumps up to something much higher). If so, visit officialpayments.com, pay1040.com (the Link2Gov site), or payUSAtax.com (the RBS site) to process your payment.

GETTING MORE TIME FROM THE TAX MAN

TICK, TOCK. Uncle Sam's deadline is looming, and you aren't nearly ready to file your taxes? Now could be the time to come up with a backup plan. Fortunately, the Internal Revenue Service has some sympathy for procrastinators: The paperwork for filing an extension is simple, and it will keep the Feds off your back all the way until Oct. 15, 2010. In other words, the IRS will give you an automatic six-month extension.

So what's the catch? In order to complete the paperwork, you have to come up with an estimate of your total tax liability for the 2009 tax year. You also need to know exactly how much you've already forked over to the tax man in the form of withholdings from paychecks, estimated tax payments and so on. And if it turns out that you owe money, you're going to have to ante up, based on your tax estimate. (See our previous tip for advice on what to do if you can't pay your bill.) Now, for some folks, once you've completed the exercise of coming up with an estimate, you might as well just go ahead and file your taxes. But if your taxes are complicated or if you're still waiting for information you need to complete your return, filing for an extension can be a major stress reducer.

Approval of your extension application is automatic, as long as the estimate of your 2009 tax bill is "reasonable." (You'll be OK if your estimate was accurate based on the information you had at the time.) Just keep in mind, you'll be charged interest (currently at a 4% annual rate) on any outstanding balance until you file your return and cough up the remaining part you owe. If your estimate is off, you'll also be charged a 0.5% a month "failure-to-pay" penalty.

If you're still interested in extending, you must notify the IRS that you want an extension by the April 15, 2010 deadline. You can do this by filling out Form 4868 (Application for Automatic Extension of Time To File U.S. Individual Income Tax Return), which you can download from the IRS web site.

BORROWING FROM UNCLE SAM

WORRIED THAT YOU don't have enough cash to pay your tax bill this year? Well, the worst thing you can do is miss the deadline while you try to scrounge up the money you need. Rest assured that if you fail to file on time, Uncle Sam will get very cranky and smack you with combined interest rates and penalties that are more what you'd expect from, say, Tony Soprano.

A better course of action? Get a loan. And remarkably, Uncle Sam himself may be your best source. Generally speaking, the interest rates charged by the Internal Revenue Service are comparatively low and most people who apply for an IRS loan are granted one.

As Tony might say, here's what you're gonna do. First off, you should still file your 2009 return by April 15. Be sure to include Form 9465 (Installment Agreement Request) with your return. On that form, you can suggest your own deferred payment plan to the IRS. Assuming you owe no more than $10,000, and are proposing to pay the total over 36 months or less, and have been current on your tax return filings and tax payments for the preceding five years, the IRS is required by law to accept your proposal. In fact, the IRS will generally accept deferred payment deals for up to $25,000 and repayment periods of up to 60 months (which goes well beyond what the law actually requires).

Of course, paying late is going to cost you something. When you receive an approval notice (which should happen within 30 days), you'll be charged a one-time $52 setup fee (assuming you agree to automatic payments from your checking account). You'll also be subject to interest charged on your deferred payments, which is currently 4% annually subject to quarterly adjustments, plus a "failure to pay" penalty of 0.25% a month. At the time this was written, those two charges together equate to a 7% annual interest rate on your unpaid tax balance.

That may sound like a lot, but it's probably less than what

you're paying on your credit cards. (Too many people look at that tax bill and figure they can just slap it on plastic.) Moreover, if you don't file at all, you'll face the outrageously expensive 5%-per-month "failure to file" penalty. It continues to accrue until it equals 25% of your unpaid tax balance. That's an awfully heavy price to pay when you could just apply for a loan.

Keep in mind, if you owe more than $25,000 with your 2009 return or will need more than 60 months to get caught up, the IRS will usually require you to fill out some financial disclosure forms. Still, the agency is generally pretty reasonable about agreeing to installment payment terms you can live with.

BORROWING FROM ESTIMATED TAXES

IF YOU ARE AMONG those who have to pay the tax man not once but four times a year, via estimated tax payments, you too can borrow from Uncle Sam. Estimated payments are the government's way of getting even when withholding from paychecks (if any) doesn't come close to keeping up with what is owed. More specifically, estimated tax payments are often required for people who are self-employed, who earn a fair amount or more from taxable investments, or who are taking withdrawals from tax-deferred retirement accounts. (Estimated tax payments for the 2010 tax year are due on April 15, June 15, Sept. 15 of 2010 and Jan. 17, 2011.)

So what happens if you can't pay or can only afford to make a partial payment for a 2010 estimated tax payment obligation? To be honest, not much. You're simply charged interest on the shortfall, and the current annual rate is only 4% (subject to quarterly adjustments). The only catch is that you must catch up on your estimated payment obligations by April 15, 2011. Otherwise, the IRS starts piling a 0.5%-per-month penalty on top of the interest charge.

With an interest rate this low, deferring some estimated taxes offers a reasonable source for a short-term loan. After all, the interest rate is certainly much lower than what many commercial lenders and credit-card companies charge.

DON'T LEND UNCLE SAM MONEY

DO YOU HAVE A juicy tax refund coming your way this year? Or were you once again blown away by how much you owe? It could be a sign that the amount your employer is withholding from your paycheck is out of whack. Ideally, you should owe Uncle Sam a small amount each year come tax time. If you're getting a large refund, you've given the Internal Revenue Service an interest-free loan of your money for the previous year-and we're sure you could have come up with a better use for that money than that. On the other hand, if you owe more than 10% of your total tax bill, you could owe an interest-charge penalty for failing to cough up enough in advance of filing your return. And clearly, that's not an ideal situation either. Here's what you need to do to make sure you don't get surprised again this time next year:

MY BILL IS TOO BIG!

IF YOU WORK FOR an employer (as opposed to being self-employed), correcting your withholding amount should be easy. Start by examining your paycheck to see how many exemptions you've claimed. (If it's not listed on your paycheck, someone in human resources should be able to help you.) If you claimed too many exemptions, your withholding won't be enough to cover this year's tax bill. (That is, assuming your tax situation is similar to last year's.) So you may want to re-file your W-4 with your employer, with fewer exemptions. This would translate into more withholding from each paycheck. You can get a new Form W-4 from your employer or print one out from the IRS web site.

Extra income from a self-employment activity, investments, or retirement account withdrawals could be another reason for your tax underpayment. If so, the fix is to start making estimated tax payments for this year or increase the estimated payments you already intended to make. For the 2010 tax year, estimated payments are due on April 15, June 15 and Sept. 15 of 2010, and Jan. 17 of 2011. You must file Form 1040-ES with each payment. You can download the form at the IRS web site.

MY REFUND WAS AWESOME!

WHILE TAX UNDERPAYMENTS can be a nasty surprise, you should be almost as distressed to discover you'll be getting a massive refund. What should you do to avoid giving the IRS another interest-free loan this year? Do the exact opposite of the advice given to folks who are in the underpayment scenario. In other words, you may need to increase the number of exemptions claimed on your Form W-4 or reduce your estimated tax payments. Or both. But don't get carried away

and create a big underpayment. Generally, your payments for the 2010 tax year (via withholding and/or estimated payments) should be enough to cover whichever of the following is the lower figure:

1. 90% of your ultimate 2010 tax bill, or
2. 100% of your 2009 tax bill if your 2009 adjusted gross income, or AGI, was $150,000 or less; 110% if AGI was over $150,000.

FILING YOUR TAX RETURN ONLINE FOR FREE

FILING A TAX RETURN is about as fun as a migraine headache, but now there's a pain reliever: Many U.S. taxpayers can file online, free of charge.

Why the gift? Online filing (which automatically does the math that many filers get wrong) significantly cuts down on errors, saving the IRS time and money. And for taxpayers, it has the added advantage of offering refunds within 10 days for those who use direct deposit. (With paper returns, that typically takes six to eight weeks.)

To qualify, the one overarching requirement is that you must have adjusted gross income of $54,000 or less. Beyond that, the 19 online-tax-software companies that have partnered with the IRS to offer this service may have added additional restrictions, such as age limits or state residency requirements.

So what's the catch? First, to use these services for free, taxpayers must access them through the IRS Free Filing web site. If you go directly to the company's site, you'll end up paying the regular filing fee (usually about $20 or so). To make sure you're not going to be hit with that fee, go through the IRS web site every time you log on to your account.

Also, if your taxes are fairly complicated, you might want to shell out the extra cash for a paid service that includes some extra bells and whistles. For example, with TurboTax Deluxe (which is available through its web site for $29.95) you'll get help calculating your deductions with the company's deduction maximizer-something that is not available through its free file program.

Finally, be sure to read all the fine print carefully. Chances are you'll be pitched additional fee-based services (like audit protection or refund-anticipation loans) that you may not need. And if you want to file your state return along with your federal one, prepare to pay up because most of these preparers charge for state returns.

IX. LOOKING AHEAD TO YOUR 2010 TAX SITUATION

WIDE OPEN ROTH IRA CONVERSATION OPPORTUNITY FOR THIS YEAR

THE TAX ADVANTAGES of converting a traditional IRA (including a SEP-IRA or SIMPLE-IRA) into a Roth IRA are well-known. Unlike withdrawals from traditional IRAs, qualifying withdrawals from Roth accounts (generally those taken after you've had at least one Roth IRA open for over five years and reached age 591/2) are completely free of federal income taxes and usually free of state income taxes too.

Also, Roth account owners who've reached age 701/2 don't have to take those taxable minimum required distributions (MRDs) that must be withdrawn from traditional IRAs. You can leave your Roth balance untouched for as long as you live. This makes Roth accounts ideal assets to leave to heirs if you don't expect to need the money yourself.

However, there's always been one big problem for higher-income individuals who would otherwise take advantage of the Roth conversion strategy. You can't convert a traditional IRA into a Roth account in a year when your modified adjusted gross income (MAGI) exceeds $100,000. The good news is the $100,000 MAGI restriction disappeared at the end of 2009. So in 2010, you can convert a traditional IRA into a Roth no matter how high your income.

Another thing: with a 2010 Roth conversion, you can choose for federal income tax purposes to spread the resulting taxable income evenly over 2011 and 2012 and thereby defer the related federal income taxes. However, this may or may not be good idea, depending on your expected tax situation in those years. If it's not a good idea, you can always follow the standard procedure and report all the taxable income from a 2010 conversion on your 2010 Form 1040.

ENJOY ONE-YEAR REPRIEVE FROM ITEMIZED DEDUCTION AND PERSONAL EXEMPTION PHASE-OUT RULES

FOR YEARS, HIGHER-INCOME individuals have had to worry about their itemized deductions being partially phased out. They have also had to worry about their personal exemption

deductions being partially or completely phased out. Thankfully, these phase-out rules have themselves been getting phased out since 2006, as part of the so-called Bush tax cuts. For 2010, the phase-out rules are totally gone. The bad news is it's only a one-year reprieve. The rules are scheduled to reappear in 2011 with sharper teeth when the Bush tax cuts expire. While it's possible our beloved Congress will change direction, show some mercy and delete these stealth tax increases from your future, don't bet the house on it.

THEY'RE BACK: MINIMUM REQUIRED DISTRIBUTIONS FOR SENIOR IRA OWNERS AND INHERITED IRAS

LEGISLATION PASSED IN 2008 suspended the minimum required distribution, or MRD, rules for the 2009 tax year, but the MRD rules are back for 2010. So, if you've recently turned age 701/2, or if you're older than that, here's what you need to know for this year.

After reaching age 701/2, you're subject to the MRD rules which require you to start taking annual withdrawals from traditional IRAs set up in your name, including any simplified employee pension (SEP) accounts and SIMPLE-IRAs. And, of course, you have to pay the related tax hit. (Roth IRAs set up in your name do not have any minimum withdrawal requirements as long as you are alive.) Failure to take your annual MRD means getting socked with a 50% penalty tax based on the difference between the amount you should have withdrawn and what you actually took out-if anything. This is one of the stiffest penalties in the Internal Revenue Code.

Because so many seniors' traditional IRA balances got hammered by the 2008 stock market meltdown, Congress gave folks a break by eliminating the requirement to take MRDs for the 2009 tax year. That was then, but 2010 is now. Here is what you need to know for this year.

IF YOU TURNED 701/2 IN 2009

ORDINARILY, YOU WOULD be required to take your initial MRD for 2009 (the year you turned 701/2) by no later than April 1 of this year. However, you are off the MRD hook for 2009. Therefore, your initial MRD will be for the 2010 tax year, and you must withdraw that amount by Dec. 31, 2010. The amount you must withdraw is calculated by dividing the total of all your traditional IRA balances (including any SEP or SIMPLE-IRA balances) as of Dec. 31, 2009 by a life expectancy divisor based on your age at the end of 2010.

IF YOU TURNED 701/2 BEFORE 2009

YOUR MUST WITHDRAW the MRD for the 2010 tax year by Dec. 31, 2010. The amount you must withdraw is calculated by dividing the total of all your traditional IRA balances (including any SEP or SIMPLE-IRA balances) as of Dec. 31, 2009 by a life expectancy divisor based on your age at the end of 2010.

IF YOU WILL TURN 701/2 IN 2010

YOU MUST TAKE your initial MRD for the 2010 tax year. You can do so this year, or you can postpone it until as late as April 1, 2011. Regardless of when you do it, the amount you must withdraw is calculated by dividing the total of all your traditional IRA balances (including any SEP or SIMPLE-IRA balances) as of Dec. 31, 2009 by a life expectancy divisor based on your age at the end of 2010.

IF YOU INHERITED AN IRA

AFTER YOU INHERIT AN IRA (including a Roth IRA), you must follow a special set of MRD rules for beneficiaries to avoid getting socked with the 50% penalty tax. These rules apply regardless of your age. If you are required to take an MRD in 2010, you must do so by Dec. 31 of this year.

UNCERTAIN TAX RATES ON INVESTMENT INCOME AND GAINS FOR 2011 AND BEYOND

FOR 2010, the existing (favorable) federal income tax rate structure for individuals will apparently be left in place. For 2011 and beyond, I expect the existing rate structure for ordinary income (including short-term capital gains and interest income) to be left in place, except for those in the top two brackets. The top two rates may increase to 36% and 39.6% (up from 33% and 35%) starting in 2011. For 2011 and beyond, I expect the existing federal income tax rate structure for long-term capital gains to be left in place except for those in the top two brackets. For them, the maximum rate on most long-term capital gains may increase to 20% (up from 15%) starting in 2011. It is possible that an 18% maximum rate will apply to most long-term gains from selling assets held for over five years. For individuals in the top two brackets, the maximum rate on qualified dividends may also increase to 20% (up from 15%)

starting in 2011. Many state income tax rates may continue to increase across the board. These predictions are just educated guesses, and political developments could easily make them wrong. Take them for what they are worth.

THE FEDERAL ESTATE TAX IS DEAD: NOW WHAT?

WASHINGTON, WE HAVE a problem. You just let the federal estate tax expire, and citizens are confused about what it means. No wonder. Nobody saw this coming, least of all me. Now that I've recovered from falling off my chair, let me explain how we got here and my common-sense take on what you may need to do (or not do) at this very moment.

THE TAX WAS PROGRAMMED TO DIE THIS YEAR (AND IT DID), BUT THE STORY IS NOT OVER

SINCE 2001, the federal estate tax has always been scheduled to go bye-bye this year. But it was always a two-part story, because the tax is also scheduled to come roaring back with a vengeance in 2011 and beyond. In those years, estates worth as little as $1 million are lined up for a tax whipping. No informed person ever thought these two things would be allowed to happen because, taken together, they make no sense.

So we all sleepily assumed our beloved Congress would step in to continue the relatively generous (by historical standards) $3.5 million federal estate exemption we had last year. Some thought it might even get bumped to $5 million or so.

No such luck! Our Congressional pals did nothing about the estate tax last year, and it could be months before they get around to tackling it this year. By then, the issue may be so contentious that all previous predictions about what might happen (from guys like me) get thrown out the window.

So sum up, we are now wandering around with no federal estate tax on those who happen to die this year and a confiscatory tax looming over those who happen to die later on. This bizarre situation will continue until the law gets changed, which I'm still pretty sure it will. Meanwhile, you want to know what to do today. Here's my advice.

IF YOU ARE MARRIED WITH A JOINT ESTATE WORTH OVER $3.5 MILLION

IF YOU FALL INTO THIS rather well-off category, I hope you already have a tax-saving estate plan in place. If you do, you should probably leave it alone unless you have one of the two problems I'm about to explain.

First, your existing plan may be horribly flawed if it calls for giving as much money as possible (rather than a specific dollar amount) to your kids and/or grandkids without triggering a federal estate tax bill, with the rest then going to your spouse. Last year, this plan would have directed $3.5 million to the kids, which presumably was fine by you. But with the federal estate tax currently missing in action, dying now would result in your spouse getting absolutely nothing. All your assets would go to the younger generations. If this is not what you intend, please run (don't walk) to your estate planning pro and get the problem fixed. I think the common-sense solution is to stipulate that your spouse would get a specific dollar amount or percentage of your estate with the rest going to the youngsters. You may have to retool your plan later when Congress finally does whatever it does. Oh well. Cross that bridge when you come to it.

The second potential problem is much less serious, and you may decide to not even worry about it. Say your current estate plan calls for leaving the specific amount of $3.5 million to your kids and/or grandkids, with the rest then going to your spouse. Last year, this was a good plan. It avoided any federal estate tax hit by taking full advantage of last year's $3.5 million exemption. As of today, however, you can leave as much as you want to the youngsters with no federal estate tax due. So if your existing plan gives your spouse more than he or she really needs, you can change the deal and leave more to the youngsters. Once again, you may very well have to retool your plan yet again when Congress finally takes action. Sorry about that.

IF YOU ARE MARRIED WITH A JOINT ESTATE WORTH LESS THAN $3.5 MILLION

THERE WON'T BE ANY federal estate tax hit if you die today, and there would not have been one if you had died last year. We can only hope the same will be true if you die next year. In any case, you don't need any tax-saving estate plan right now. But if your plan was set up several years ago, I recommend checking in with your estate planning pro anyway just to make sure your house is still in order. You don't need to run. You can walk.

IF YOU ARE SINGLE WITH AN ESTATE WORTH OVER $3.5 MILLION

LAST YEAR, YOU COULDN'T leave over $3.5 million to loved ones without triggering a federal estate tax bill. So your existing plan might still call for your estate to make enough charitable

donations to whittle its net worth down to $3.5 million before giving that amount to your loved ones. Because you can now leave an unlimited amount to loved ones with no federal estate tax due, you might want to make a change. Of course, you may have to revisit your plan after Congress makes its move. That's the world we live in.

IF YOU ARE SINGLE WITH ESTATE WORTH LESS THAN $3.5 MILLION

THERE WON'T BE ANY federal estate tax hit if you die today, and there would not have been one if you had died last year. We can only hope the same will be true if you die next year. You don't need any tax-saving estate plan right now. But if you have a plan that was set up several years ago, it's a very good idea to revisit it.

DON'T FORGET ABOUT STATE ESTATE TAXES

YES, VIRGINIA, IT'S not just the Feds that charge estate taxes. So if you decide to update your plan because of the federal estate tax considerations I've mentioned here, make sure the changes don't unnecessarily increase your exposure to the state tax collector. This is yet another good reason to visit your professional adviser pronto.