



Client Newsletter

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New Tax Changes

— Federal Changes —

There have been a lot of tax changes so far this year. The principal changes affecting our clients are highlighted below, starting with federal changes and followed by state changes. See also the enclosed brochure for more extensive coverage.

Federal Withholding and Safe Harbors



The federal withholding has been decreased. However, the safe harbor rules on page 2 for underpayment of either estimated taxes or withholding have not been suspended for most people. So to avoid penalties, if your withholding has been just about enough to cover your taxes, you may want to consider increasing it.

Federal Home Buyer's Credit



The Home Buyer's Credit is the larger of \$8000 or 10 percent of the purchase price for purchases made through November 30, 2009. It no longer is treated as an interest-free loan but, instead, will have to be repaid if the house is sold within 36 months of purchase or if the taxpayer stops using it as his or

her principal residence. It applies to first-time buyers only, defined as people who had no ownership interest in a principal residence during the three-year period before the purchase of the home to which the credit applies.

Sales Tax on a New Vehicle



Whether one itemizes or not, taxpayers may deduct the sales and excise tax incurred in the purchase of a new motor vehicle, motorcycle, or motor home during 2009. There are limitations, however:

- The deduction for sales taxes is limited to that levied on the first \$49,500 of the sales price.
- The gross vehicle weight (GVW) must not exceed 8500 pounds.
- The credit is phased out for higher income taxpayers. It's phased out for married taxpayers filing jointly with adjusted gross incomes between \$250,000 and \$260,000. It's phased out at half those numbers for single taxpayers.

Unemployment Compensation



Unemployment compensation is taxable for federal income tax

purposes. However, for 2009, the first \$2400 of unemployment compensation is exempt.

Foreign Investment Accounts



Foreign investment accounts, whether or not reported on 1099 forms, are supposed to be indicated on one's Form 1040, Schedule B. In addition, if the total value of such accounts exceeds \$10,000

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at any time during the year, one must also file Form TDF 90-22.1 (Report of Foreign Bank Accounts and Financial Accounts).

Voluntary disclosure available until September 23, 2009.



The IRS is coming down hard on those who haven't filed the required form(s). However, by voluntarily disclosing those omissions before September 23, 2009, taxpayers may escape penalties. Clients with a problem in this area should confer with an attorney. (We can provide a referral if needed.)

Minimum Required Distributions



Minimum required IRA distributions (for those over age 70.5) have been waived for 2009. They're not required this year.

Cash for Clunkers



The President has signed the Consumer Assistance to Recycle and Save Act of 2009. Car dealerships that register for this voluntary program will receive vouchers for qualifying trade-ins on the purchase of new vehicles where the fuel efficiency of the new car exceeds the fuel efficiency of the trade-in by specified amounts. The amount of the vouchers will vary from \$3500 to \$4500, depending on the increase in fuel efficiency, and are to be treated as the downpayment or part of the downpayment on the purchase of the new car. The Act is effective for purchases made between July 1, 2009, and November 1, 2009. This is only a federal program. Under the Act, the voucher is not treated as gross income for federal income tax purposes.

Certain California counties (primarily Santa Clara, San Mateo, Alameda, Contra Costa, Marin, Napa, and San Francisco) have a program of their own via the Bay Area Air Quality Management District. The District will pay \$1000 for any 1989 or older car, pickup truck, or SUV. This is an increase from the earlier rate of \$650. For more information, go to www.baaqmd.gov/vbb.

More Breaks for Higher Education



The American opportunity tax credit is in effect for 2009 and 2010. For those years, most taxpayers who pay tuition and related expenses for post-high school education can claim a tax credit of up to \$2500.

The tax credit will be for 100% of the first \$2000 of higher education expenses and 25% of the next \$2000 of those expenses. Outlays for course materials such as books are included among the costs eligible for the credit.

— California Changes —

New Taxes



The sales tax has been increased by one cent, effective April 1, 2009, through fiscal year 2011-12.

As the result of prior legislation, the Franchise Tax Board has advised the public that 2009 California tax brackets will be increased by 0.025 over what they were last year. So, for example, someone who was in the 9.3% bracket for 2008 will be in the 9.55% bracket for 2009.

The VLF (vehicle license fee) portion of the total paid for auto license plate fees has increased to 1% though June 30, 2014.

Drop in Dependent Credit



The credit for dependents has been reduced from \$309 to \$99, a \$210 drop per dependent. *This will effectively be a tax increase for those who have children.*

Income Ceiling on IRA-to-Roth Conversions

This won't be effective until 2010, but it's being hailed as a current breakthrough. Currently, a taxpayer with an adjusted gross income (not including the amount of the conversion) over \$100,000 may not make a Roth conversion. Effective for 2010, the income limitation is removed.

Taxpayers contemplating a Roth conversion should know and plan for the fact that the previously un-taxed amount in their IRA will be

taxed at the time of the conversion. For 2010 only, the taxable amount will not be taxable for 2010 but, instead, half will be taxed in 2011, and the other half in 2012.

As everyone knows, the law can change between now and then. So for right now, it's simply a public relations gimmick by the government. It remains to be seen whether or not Congress will repeal this provision.

Year 2009 Estimated Tax Rules



The rules for estimated tax payments are often confusing. In addition,

Congress changes them periodically. The general rule is that everyone must pay at least 90% of his or her federal and California income taxes via withholding and/or estimates.

There are two principal safe harbors for 2009. First, if your 2008 adjusted gross income (AGI—the amount on line 37, page 1 of Form 1040) was \$150,000 or less, the safe harbor is to pay an amount equal to your 2008 tax liability (line 61, page 2 for Form 1040). This can be done by any combination of withholding and/or estimated tax payments.

Generally speaking, the estimates must be paid uniformly over the four quarterly due dates. Those dates are April 15, June 15, September 15, and next January 15. If this safe harbor is met, there will be no penalty for underpayment of estimated taxes, irrespective of how much is owed on April 15, 2010. This rule is known as “Exception #1.”

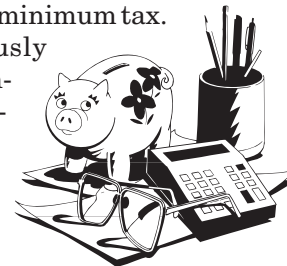
The other exception to the general rule is that if your 2008 AGI exceeded \$150,000, the safe harbor is 110% of your 2008 tax liability.



While the above statements are accurate, there are many nuances, especially if one has a large gain from stock and/

or real estate sales. In addition, prepaying a California estimate may or may not save a lot in federal taxes because of the alternative minimum tax.

One obviously needs a consultation appointment if there are questions on this matter.



If we did an estimate for you based on “Exception #1,” we assumed that your 2009 withholding will be at least as much as your 2008 withholding. So monitor your withholding. If it’s running behind 2008’s figures, contact us about increasing your withholding to keep you in compliance with “Exception #1.”

Wills, Trusts, and Property Titles



This is a reminder that everyone needs to keep his or her will, living trust, joint tenancy designations, beneficiary designations, and property titles up to date.

An attorney is the proper person to write a will and/or living trust and also to give advice regarding property title forms. To have anyone other than an attorney write such documents or give advice in these areas falls into the same category as having golf pros do brain surgery.

If you don’t have an attorney, we can give you the names of several with whom we’ve worked over the years. They all are bright and honest.



Any referrals that we make are just that—referrals; we receive no kickbacks, finder’s fees, or anything else other than freeing ourselves of headaches downstream when those documents have been prepared by amateurs instead of lawyers.

Horror stories abound of people who have been divorced for years, but estate documents still designate their ex-spouses as the beneficiary of their IRAs or as the joint tenant on the real estate, bank accounts, or stock brokerage accounts. Joint tenancy with right of survivorship (JTRWS) will override any other title form, living trust designation, or will. The property will pass to the person(s) designated as being the joint tenant(s) irrespective of any other legal document.

In a marriage, there generally is a tax benefit to the surviving spouse for appreciated property held in the

title form of ‘community property.’ California added a new property form a few years ago of “Community Property with Rights of Survivorship.” This has produced some unintended consequences so, once again, it isn’t the quick-and-dirty answer to all situations.



The bottom line is see an attorney to get your estate planning documents done properly and/or updated.

Suggested Reading

- Kathleen Pender’s column in the *San Francisco Chronicle*
- *Forbes* magazine
- *The Wall Street Journal*
- *Smart Money* magazine

Clearing Up Some Common Tax Misconceptions

The following is a short list of common tax misconceptions.

Buying a Nevada Corporation



A lot of people pay good money to form Nevada corporations, only to learn that they don't save taxes, because a corporation doing business in California has to pay California taxes, no matter where it is formed. Thus a Nevada corporation isn't really a viable tax shelter. For further information, see FTB Publication 689, available at www.ftb.ca.gov.

Vacation Homes



Vacation homes used solely for personal purposes don't qualify for Section 1031 exchanges.

Tax-Free Interest Income



For California residents' state income tax returns, only interest income from bonds issued by the State of California or its local entities is tax-free. For instance, the interest on a New York state bond will be tax-free for federal income tax purposes but taxable for California income tax purposes. The U.S. Supreme Court upheld this in 2008.

If you're looking to buy a tax-free municipal bond fund, be sure to buy one that is totally invested in California governmental entities if your goal is to have the income tax-free for California purposes. There are a few minor exceptions to this rule, but they're beyond the scope of this brief discussion.

Investment Seminars



"Investment seminars" are generally not deductible, in spite of what the promoters say.

Misleading Mailings



Beware of mailings, no matter how official looking, offering fee-based services or documents (e.g., offering to file a Prop. 13 claim or provide copies of a deed). Usually these services can be obtained free or at minimal cost from government agencies.

Refinancing a Rental



Refinancing a rental to get money to buy a personal primary residence doesn't result in deductible interest for the increased loan against the rental.

Rent-Free Use of Property



Rent-free use of vacation homes or other property by a church or other charity does not result in a charitable deduction for the fair

market value of the rental. See the Internal Revenue Code, Section 170(f)(3) for details.

Annuities



Annuities aren't bought; they're sold. Although annuities can be useful in some situations, they're far too often sold to elderly people for whom they're not even remotely appropriate. According to the June 15, 2007, issue of *The Wall Street Journal*, variable annuities have "risks for insurers and a checkered past for U.S. consumers, thanks to unscrupulous sales practices by some brokers and third-party agents."

Direct Personal Charity



There is no deduction for money given directly to a needy person, whether related to you or not.

Contacting the IRS ... and Avoiding Imposters Who May Contact You

The IRS web site www.irs.gov is the official IRS web site and the place to go for IRS publications and forms. You can also check the status of your refund here by clicking on the "Where's My Refund?" link. Phoning the IRS cold turkey usually is a waste of time, so the web site is a good place to start.

Warning: There is only one IRS web site: www.irs.gov. Any emails purporting to be from the IRS, but

coming from other sites or email addresses, no matter how similar, are fraudulent and should be deleted. The IRS doesn't contact people cold-turkey by email. It is virtually always via snail mail.

A common tactic of "phishers," as email frauds are often called, is to send an email saying that you are owed a refund from the IRS or Franchise Tax Board and asking for your social security number. Neither agency operates that way, so the email is probably a scam aimed at stealing your identity.



Beware the Scams Promising a Refund While Stealing Your Identity

Converting a Rental to a Personal Residence (and Vice Versa)

With the new liberalized rules for excluding gain from selling a personal residence, many clients are considering moving into a rental house that they own, living there for two years, then selling it and excluding \$250,000 or \$500,000 of the gain. However, the exclusion is not available on any nonpersonal use of the home after January 31, 2008.

So, for example, if you buy a home in February 2008, rent it out for the first two years, then live in it for the next three years before selling it, 40% of the gain will be attributable to nonqualified use. Thus only 60% of the gain will qualify for the \$250,000 or \$500,000 exclusion.

If a former rental is your now primary personal residence, you must document it as follows:

- Change the address on your driver's license.
- Apply for the homeowners' exemption on the property taxes.
- Change the mailing address with the U.S. Postal Service (to a street address, not a post office box).
- Change your voting registration to the new address.
- File a change of address notice with the IRS. (We have the form and can do that for you.)

Section 1031 Exchanges of Rental, Investment, or Business Real Estate

Section 1031 of the Internal Revenue Code allows for the tax-deferred exchange of rental houses, duplexes, apartment buildings, or commercial buildings for any other type of rental or business real estate, or even vacant land to be held for investment. Farm property also qualifies, as does the building in which a taxpayer conducts his or her business.

This is similar to, but not the same as, the old rules about selling one's home and replacing it with another. The principal difference is that there is no provision for selling the property outright and having two years to find a replacement. A qualifying exchange must be part of an integrated transaction or series of transactions leading from the disposition of one property to the acquisition of another property or properties.

Normally, a second home, vacation home, and one's personal primary residence don't qualify for the Section 1031 exchange. However, they can be made to qualify if converted to full-time rentals before the planned Section 1031 exchange. Although there is no statutory minimum required period given in the Internal Revenue Code, as a practical rule of thumb, the rental period should begin before the year in which the exchange is planned. A quick turnaround (e.g., converting the property in August and exchanging it two months later) might cause an IRS auditor to contest the use of the Section 1031 treatment and reclassify it as a taxable sale.

In order to have a totally tax-deferred exchange, three elements are required: (1) going across or higher in value, (2) going across or higher in indebtedness, and (3) using up all of one's equity.

Home Sale Rules

There is no sale-and-replacement provision anymore. People still phone (thank goodness) and say, "We just sold our home. How long do we have to replace it?" The answer is that they don't have to replace it, and replacing it won't reduce the taxes (if any) that have to be paid on the sale.

The old sale-and-replacement rules were replaced with a \$250,000 exclusion for single people and a \$500,000 one for married people. Although this has been in this client newsletter many times since the law changed in 1997, many people still struggle with it.

A widow or widower may exclude \$500,000 in profit, if otherwise qualified, if the home is sold within two years after the deceased spouse's death. This is new, effective for 2008 and subsequent years. The change applies only for federal income tax purposes; California hasn't conformed to it.

Home improvements. It is important to have a record of the improvements that have been made to the home over the years. The total amount of home improvements increases the cost basis and consequently decreases the profit on sale.

A worksheet of home improvements is available on our web site at www.LWWilliamsca.com. It may also be obtained free of charge by phoning the office administrator, Paula Holcomb, at (408) 736-1566 or by emailing her at Holcomb@LWWilliamsca.com.



Being Prepared for IRS Audits

As reported in the newspapers, the IRS has increased the number of auditors in the San Francisco Bay Area. The following are a few things they're looking for.

Accurate Income Reporting



The auditors are checking the amounts shown as income on a taxpayer's return against the IRS's record of how much has been paid to the taxpayer. The IRS has done this automatically for years and issues notices when there are apparent discrepancies. However, the auditors also now are doing it when a return is audited.

A Business Bank Account



If a taxpayer has a business or owns rental property, IRS auditors are looking for a separate bank account for that activity.

It makes it easier for them to spot personal expenses being claimed as business expenses. However, there's also an advantage to the taxpayer. By paying all business bills through the business account, it reduces or eliminates the possibility of business expenses falling through the cracks and not being claimed.

1099 Forms



IRS auditors are looking to see if 1099 Forms were filed for payments made to non-employee 'independent contractors' for business purposes. IRS isn't concerned about payments made for personal nondeductible expenditures, such as repairs to one's private residence. The emphasis is on expenditures made in the context of taxpayers who own a business or rental property. If the taxpayer can't produce file copies of 1099 Forms that he or she has filed for such independent contractors, then the auditor will

limit the amount of the deduction to \$599, irrespective of how much has been paid.

If you retain an independent contractor for your business or rental, give him or her an IRS Form W-9 right away. The form requires the contractor to give you his or her Social Security number. If the contractor won't cooperate, don't do business with that person. You'll just be looking for trouble.

If the business you're hiring is incorporated, it isn't necessary to file a 1099 form. However, many people think that having a business license is the same as being incorporated. It isn't. If a business is incorporated, it will say 'Inc.' or 'Incorporated' in its name. If it doesn't, it's probably not incorporated.

Home Mortgage Interest



Taxpayers are limited to deducting interest on \$1 million of loans, secured by the residence, incurred to purchase or improve a primary and/or secondary residence. Additionally, taxpayers may deduct the interest on \$100,000 of home equity interest used for any purpose. The latter, though, is a preference item for the alternative minimum tax.

The IRS is auditing returns with high mortgage interest deductions to be certain those limits aren't being exceeded.

Prepaid Audit Plan Available



Our prepaid audit/IRS/FTB/notices plan is being offered again this year. See the enclosed green sheet for details.

IRS and Franchise Tax Board Notices

IRS/FTB Notices Received



Although most notices from the IRS and the Franchise Tax Board are incorrect, never ignore one, no matter how unfounded or irrational it may seem. Most IRS horror stories began when a taxpayer didn't respond to a notice.

If you receive a notice from the IRS or the Franchise Tax Board, fax or mail it to us immediately; do not phone and attempt to read it to us over the phone. Trying to read an involved notice over the phone is a waste of your time.

Unexpected Checks Received

Also notify us of any checks that you receive from IRS or FTB that you weren't expecting, and don't deposit or cash them until you have checked with us. Sometimes they mistakenly send a check for money that had been designated as a prepayment on estimated taxes. If you deposit or cash the check, you'll have to pay interest if they subsequently discover the error and ask that it be returned. However, if you return the check with an explanation, life goes on and there will be no penalties or interest for a late estimated tax payment.

Providing for One's Children

There is not now, nor has there ever been, an income tax deduction or credit for gifts to one's children. But there are things parents can do to provide for their children.

Properly planned, gifts to one's children are a method of transferring wealth to the next generation and/or reducing estate taxes. It's beyond the scope of this brief article to cover all of the possibilities. However, the following are two simple options.

The Gift Tax Exclusion



People often ask, "What about the \$13,000 gift tax exclusion?" The exclusion is exactly what it says it is—an exclusion, not a deduction or credit. Anyone may give \$13,000 per year to an unlimited number of recipients without having to file a gift tax return. However, that has almost nothing to do with income taxes.

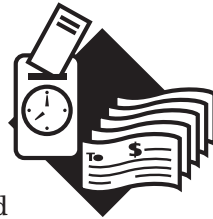
Pay for Work Performed



People who own rental property and/or their own business may pay their children for work

performed at the rental or in the business. That is deductible for the parent as a business expense, just like paying anyone else. It is taxable to the child, but a child is allowed to have up to \$5000 of earned income without having to pay income tax, assuming that the child doesn't have any interest or dividend income to speak of. If the child is under age 18, and the parents' business is not incorporated, the parent/employer isn't required to withhold FICA or SDI taxes, but a W-2 must be filed at the end of the year although it will show only wages subject to withholding. The box for FICA wages will be blank. This exemption from payroll taxes will not work if the business is incorporated, a partnership, or a LLC.

Two new wrinkles are that IRS auditors are now asking for the time and wage records and for the work permits of school-age children who work in the family business for wages. A work permit has to be obtained from the school district when school age children want to become employed for wages. Contact the school district itself for further information.



Claiming Exemptions for Two Working Spouses

The W-4 forms that an employer gives an employee has worksheets for computing the number of withholding exemptions a person should claim. However, these worksheets don't necessarily do a good job of guiding employees whose spouses also have a job.

As a general rule, we recommend that each spouse designate "0 exemptions" and "withhold as a single person" to get the maximum withholding. Anything else usually results in drastically insufficient withholding ... and a nasty surprise at tax time.

IRA Custodian or Advisory Fees

IRA custodian and/or advisory fees are deductible on Schedule A of one's Form 1040, but there are three catches.



First, the fees must be paid via check or cash; if they merely are deducted from the account, they aren't deductible. (This first rule does not apply to non-IRA accounts.)

Second, the fees are miscellaneous itemized deductions, and the total of one's miscellaneous itemized deductions must exceed 2% of one's adjusted gross income to be deductible.

Third, taking an IRA withdrawal to pay the annual fee is not tax-efficient. If the fee is paid from the account (not as a withdrawal), it's tax-neutral. It's not deductible, but neither is it counted as income. Conversely, if the fee is withdrawn, it is counted as taxable income.

Yes, the fee is deductible, but as indicated above, it won't count unless the total of one's miscellaneous itemized deductions exceeds 2% of adjusted gross income. Even then, only the amount in excess of the 2% threshold is deductible. The rest is not.

Additionally, assuming there is a measurable deduction after the 2% threshold, miscellaneous itemized deductions aren't deductible in computing the alternative minimum tax. So someone paying the alternative minimum tax will lose out altogether.



Bottom line, either pay the fees from a non-IRA account, which is the best thing to do, or let the fees be paid directly from the IRA account.

Our Web Site and Newsletters

You can find valuable resources at our web site (www.LWWilliams.com). We post our client newsletter there (although we will continue to mail a paper version to our clients). We'll also be posting tax news items on the web site as they occur, so that people don't have to wait for the client newsletter to get the latest tax information.

The information in our newsletters and on our web site is general in nature; no transaction should be completed without a professional consultation on its ramifications.

If there's a subject you would like to see addressed on the web site or in future issues of the client newsletter, send your idea to Leonard at Williams@LWWilliams.com or mail it to the office.

Thanks for your many kind comments about this newsletter. Suggested topics, jokes, and cartoons are always welcome.

Please pass this newsletter along to a friend or colleague when you have finished, or phone the office for an extra copy.

Speaker Available

Leonard Williams is a well known speaker on almost any tax subject. His most popular tax talk is an estate tax update in lay persons' language.



Alternatively, Leonard has a slide show on his fire engine collection; over the years, groups have found that fascinating.

Laughter Is the Best Medicine and Assorted Words of Wisdom

The only thing about taxes that everyone can agree on is that someone else should pay them.

—Scott Burns, msn.com

In my many years, I have come to a conclusion that one useless man is a shame, two is a law firm, and three or more is Congress.

—John Adams, Second President of the United States

We picked the wrong day for April Fool's Day. I would have chosen April 15.

—Steve Maple

When you do a good deed, get a receipt, in case heaven is like the IRS.

—Bumper Sticker

Finance is the art of passing currency from hand to hand until it disappears.

—Robert Sarnoff

Some will rob you with a six gun, some with a fountain pen.

—Woody Guthrie

Money can't buy happiness, but neither can poverty.

—Leo Rosten

A lot of people mistake a short memory for a clear conscience.

—Doug Larson

Thank you for another successful filing season. The long-term outlook of our firm remains the same. We all plan to continue what we're doing for many years. So your continued referrals are appreciated.



You can't control the wind, but you can adjust your sails.

—Yiddish proverb

The world has achieved brilliance without conscience. Ours is a world of nuclear giants and ethical infants.

—General Omar Bradley

The irony of life is that by the time you're old enough to know your way around, you're not going anywhere.



The economy is so bad ...

I went to buy a toaster oven, and they gave me a bank.

I got a pre-declined credit card in the mail.

Hotwheels and Matchbox cars are now trading higher than GM.

Jury duty is considered a high-paying job.

People in Beverly Hills fired their nannies and learned their children's names.



In today's economic environment, this letter to the bank is very appropriate ...

Dear Sirs:

One of my checks was returned marked "insufficient funds." Does that refer to me or you?