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BUSINESS

TAX TIME

How last year's bad debt, job cuts and investment losses could affect your return

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Filing an income tax return is challenging enough in normal years. This year, it will be a whole new adventure for millions of people because of an economy filled with land mines.

People who have never had to deal with job loss or bad debts or steep investment losses will have to figure out what these issues mean for their taxes. But the down economy also presents good opportunities for some people.

Here's a look at some big issues that more people will have to consider this year:

Unemployment benefits: Several years ago, these weren't taxable, said Cindy Mitchell, tax supervisor at Bober, Markey, Fedorovich & Co. in Akron. Now they are for both federal and state purposes. Many people don't realize the law changed, or else they get unemployment confused with workers' compensation benefits, which are not taxable.

In addition, taxes aren't deducted up front from the unemployment payments, so people should have been setting money aside for the big tax bill or else they could be in for a rude surprise. Benefits are taxed at the same rate as regular income.

Investments that have lost value: Taxpayers can claim capital losses only on investments that were actually sold, said Laura White, tax manager at Cohen & Co. in Cleveland. People should get a 1099-B detailing their losses. They can claim only $3,000 per year but can indefinitely carry forward the losses, White said.

Losses on 401(k)s, IRAs, 529s or other investments that aren't sold are not deductible.

Relatives or friends who have moved in: With millions of people losing their jobs, many are moving in with relatives or friends just to survive financially. If you've had someone move in with you, you may be able to claim the person as a dependent, said certified public accountant Cynthia VerDuin of Hatfield CPA LLC in Beachwood.

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The two big catches: You must have provided more than half of their support for the year, and they may not have had more than $3,300 in taxable income.

"You're going to see this a lot with families who've lost their homes and have moved in with someone," said Terry Fergus, president of FSM Capital Management LLC in Cleveland. It's important that the dependent has undeniably established the new residence, such as by changing their address with the post office, he said.

Foreclosure or forgiven debts: If you've lost your home in foreclosure, you no longer have to claim any forgiven balance as taxable income. Previously, if your home was seized and sold by the bank for less than you owed on it, then the difference counted as taxable income for you.

The Mortgage Forgiveness Debt Relief Act of 2007 now excludes any debt forgiven through foreclosure or a restructured mortgage. This initially was extended through 2009 and has now been extended through 2012, Mitchell said.

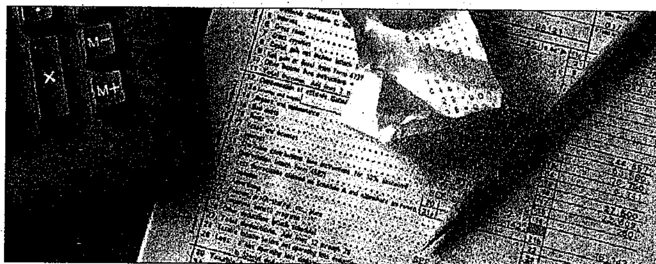
A person's primary residence is the only place taxpayers catch a break on forgiven debt. "Everything else is taxable," she said. So balances forgiven on credit cards or other loans are considered taxable income. The rules can vary in bankruptcy cases, so you should consult your attorney.

The earned income tax credit: This credit is normally associated with low-income households, but it will apply to a lot more families this year if their incomes were way down, White said. To be eligible, the maximum adjusted gross income is $41,646 for a couple with two children filing jointly.

Roth IRA eligibility: Higher-income folks for now are prohibited from contributing to a Roth IRA, but people who have suffered a hit to their income may be eligible for the first time, said Paula DiVencenzo, a certified public accountant with the accounting firm Bober, Markey, Fedorovich. A contribution can be made until April 15.

Under a Roth IRA, taxes are paid on contributions now, and the principal and gains are exempt from taxes once you are 59½ and have had the Roth for five years.

Currently, eligibility starts to phase out at $105,000 for a single filer, Mitchell said, and at $166,000 for a joint filer.



People who still don't qualify have another option, said DiVencenzo. They could put money into a nondeductible IRA now — which has no income limits — and convert it to a Roth starting next year, when conversion eligibility rules relax.

Hardship withdrawals from a retirement plan: While the government allows hardship withdrawals for significant economic woes, such as job loss or a medical emergency, not all plans allow them. Even if yours does, there's no escaping the taxes owed on the withdrawal and the 10 percent penalty for early withdrawal — both of which must be reconciled on your tax return, Fergus said.

The only exception: People who are at least 55 can withdraw money without penalty under specific guidelines.

Again, taxes aren't withheld up front on these withdrawals, Fergus said, but people will have to pay up now.

Getting a rebate from 2008: If your income from 2007 was too high to qualify for the rebates that were sent out last spring, you have another chance. You may be able to claim your rebate retroactively on this year's return if your 2008 income was below the limits, Mitchell said. The thresholds varied according to number of dependents. The rebates start phasing out at $75,000 adjusted gross income for individuals and $150,000 for couples.

Job-hunting expenses: If you lost your job and spent money looking for a new one, those expenses may be deductible, DiVencenzo said. Your job search must have been in the same trade or business, and the expenses must have exceeded 2 percent of your adjusted gross income. Only expenses above the 2 percent level are deductible.

If you're a first-time home buyer: As part of the economic stimulus law passed last year, first-time home buyers can get a maximum credit of $7,500. Single filers making up to $75,000 and joint filers making up to $150,000 are eligible. The credit applies to homes bought from April 9 through July 1.

However, the credit isn't like your normal credit. "It's not free money," White said. It's more like an interest-free loan and must be repaid over 15 years.

But the new economic stimulus bill would eliminate the repayment requirement, extend the time frame to Aug. 31 and raise the credit to $8,000.

Taking required minimum distributions from an IRA: Rules were changed in December. If you're 70½ or older and would normally have had to take a required minimum distribution from your IRA, now you don't have to if you don't need it, Mitchell said.

Taking the distribution would be locking in last year's steep losses on that amount, so keeping it in the IRA gives the investor a chance to build up the money again, she said.

More important in some cases, Fergus said, the calculation for a 2009 distribution is based on the value of the IRA as of Jan. 1, 2008. Because the value at year's end may have been 30 percent to 50 percent less, "this allows them not to deplete their retirement funds" so much at one time, Fergus said.

The retirement savers' credit: This isn't a new credit, but again, with so many people seeing their incomes drop last year, more people will be eligible, White said. The maximum adjusted gross income is $53,000 for married tazpayers filing jointly.

Taxpayers can get credits of various percentages on contributions to retirement accounts; the maximum credit is $1,000 for single filers and $2,000 for joint filers.

Borrowing from a Roth IRA: If you made a withdrawal from a Roth IRA recently, you may be considering repaying it to avoid the 10 percent early withdrawal penalty. But because many investments have lost so much value, VerDuin of Beachwood's Hatfield CPA has found cases where clients were better off paying the 10 percent penalty and taking an itemized deduction on the loss (it must exceed 2 percent of adjusted gross income). Investors have 60 days from the date of withdrawal to repay it.

Leniency by the IRS: In contrast to its reputation, the IRS this year has adopted a kinder, gentler attitude and will be quicker to forgive back taxes and to work out payment plans and settlements for both individuals and small businesses because economic times are tough. The IRS in January said the nation's financial crisis calls for the IRS to be sensitive to taxpayers this year, especially if they have a record of paying their taxes on time but have lost their jobs or been walloped by the housing crisis or medical bills.

"It's amazing," VerDuin said. "The IRS keeps sending out these bulletins just saying, 'Pay your taxes when you can. We still love you.' They've gotten way more lenient."

The key: You must file your return on time or else the IRS will have no mercy. You can work out the details of paying your bill later.

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