November, 2010

YEAR END TAX SAVING STRATEGIES

As the end of the year 2010 approaches, please find some tax-planning ideas and issues to which you should be aware prior to the close of this year.

Watch out for AMT

While many recent tax-law changes have been helpful in reducing your 2010 regular federal income tax bill, they didn't do much to reduce the odds that you'll owe the Alternative Minimum Tax (AMT). Therefore, it's critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are complicated and we still don't know exactly what they will be for 2010, you may want our assistance. We stand ready to help!

With these general principles in mind, let's take a look at some specific tax planning ideas that apply to the vast majority of taxpayers—that is, those in a regular tax situation. Call us if you would like to discuss those that may be appropriate for you or if you want to consider other tax-saving strategies.

Traditional Strategy of Deferring Income Is Dicey This Year

Be careful when considering the strategy of deferring taxable income from this year into next year. The strategy makes sense if you're confident you'll be in the same or lower tax bracket next year, but the tax picture for 2011 is blurry and as of the date of this letter; our fates are still unknown.

The top two rates have widely been expected to increase in 2011 from the current 33% and 35% to 36% and 39.6%, respectively—at least for taxpayers earning $250,000 or more ($200,000 or more if single). Therefore, such taxpayers might want to consider reversing the traditional strategy and accelerating income into 2010 to take advantage of this year's presumably lower rates. If you're in business for yourself and a cash-method taxpayer, you may be able to accelerate taxable income into 2010 by sending out client invoices as soon as feasible so that you will receive payment for them in late 2010. You can also increase taxable income by postponing deductible business expenses such as office supplies and repairs and maintenance until next year. If you're an employee of a family-owned business and it will pay you a bonus for this year, you might want to get it paid in 2010, rather than waiting for 2011.

Higher-income Individuals May Benefit from Accelerating Itemized Deductions into This Year

For 2010, the phase-out rule that previously reduced write-offs for the most popular itemized deduction items (including home mortgage interest, state and local taxes, and charitable donations) is gone. However, the phase-out rule is scheduled to come back with a vengeance in 2011 unless Congress takes action to prevent it, which looks increasingly unlikely. If the phase-out rule comes back as expected, it will wipe out $3 of affected itemized deductions for every $100 of Adjusted Gross Income (AGI) above the applicable threshold. Individuals with very high AGI can see up to 80% of their affected deductions wiped out. For 2011, the AGI threshold will probably be around $170,000, or around $85,000 for married individuals who file separate returns.

Bottom Line: Depending on your AGI, you may get more tax-saving benefit from accelerating into 2010 your state and local tax payments that are due early next year and some charitable donations that you'd normally make in 2011. However, things get a bit tricky if you'll be subject to the AMT this year. Please contact us if you have questions about the advisability of accelerating itemized deductions into this year.

Time Investment Gains and Losses and Consider Being Bold

As you evaluate investments held in your taxable brokerage firm accounts, consider the impact of selling appreciated securities this year instead of next year. The maximum federal income tax rate on long-term capital gains from 2010 sales is 15%. However, that low 15% rate only applies to gains from securities that have been held for at least a year and a day. In 2011, the maximum rate on long-term capital gains is scheduled to increase to 20%. That will happen automatically unless Congress takes action, which looks increasingly unlikely right now.

To the extent you have capital losses from earlier this year or a capital loss carryover from pre-2010 years selling appreciated securities this year will be a tax-free deal because the losses will shelter your gains. Using capital losses to shelter short-term capital gains is especially helpful because short-term gains will be taxed at your regular rate (which could be as high as 35%) if they are left unsheltered.

Consider selling some of your “loser” securities to even generate some carryover losses into future years to shelter capital gains, including high-taxed short-term gains, from other sales this year. If you think your investments that are currently underwater are poised for a comeback, you can buy them back after taking a loss as long as you don’t reacquire them within 30 days before *or* after the sale.

If selling a bunch of losers would cause your capital losses for this year to exceed your capital gains, no problem. You will have a net capital loss for 2010. You can then use that net capital loss to shelter up to $3,000 of this year’s high-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you’re married and file separately). Any excess net capital loss gets carried forward to next year.

Convert Traditional IRA into Roth IRA

If your traditional IRA has dropped in value and you expect to pay higher federal income tax rates in future years, now might be a very good time to consider converting all or part of your traditional IRA balance into a Roth IRA. Here’s why. If you convert, it will trigger a current tax hit on the amount you convert. But, with your traditional IRA balance at a depressed level (and possibly your overall income too), the tax hit will be less. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals after you reach age 59$^1/_2$, will be totally free of any federal taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today’s rates (maybe much higher depending on how things go).

Before this year, there were two big restrictions on the Roth IRA conversion privilege. First, your Modified Adjusted Gross Income (MAGI) could not exceed $100,000. Second, you were completely ineligible if you used married filing separate status. For 2010, both restrictions are eliminated. Now, virtually anyone who owns a traditional IRA can do a Roth IRA conversion.

Of course, conversion is not a no-brainer. You have to be satisfied that paying the upfront conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher tax brackets, which would not be good. However, for 2010 conversions only, you can elect for federal income tax purposes to spread the income triggered by conversions evenly over 2011 and 2012 and thereby defer the related federal income taxes. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth. If the Roth IRA conversion idea intrigues you, please contact us for a full analysis of all the relevant variables.

Ideas for Your Business

Take Advantage of Tax Breaks for Purchasing Equipment, Software, and Certain Real Property. If you have plans to buy a business computer, office furniture, equipment, vehicle, or other tangible business property or to make certain improvements to real property, you might consider doing so before year-end to maximize your 2010 deductions. Here’s why.

- *Bigger Section 179 Deduction.* Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. Thanks to the Small Business Jobs Act passed in late September, for tax years beginning in 2010 and 2011, the maximum Section 179 deduction is a whopping $500,000, as long as the amount of qualifying property placed in service during the year does not exceed $2 million. Furthermore, for the first time, up to $250,000 of some types of real property can qualify, including restaurant buildings and improvements made to interiors of retail and leased nonresidential buildings.

  Note: Watch out if your business already has a tax loss for the year (or is close to it) before considering any Section 179 deduction. You can't claim a Section 179 write-off that would create or increase an overall business tax loss for the year. Please contact us if you think this might be an issue for your operation.

- *50% First-*year *Bonus Depreciation.* Above and beyond the bumped-up Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost (reduced by the Section 179 deduction) of most new (not used) equipment, software, and qualified leasehold improvements placed in service by December 31 of this year.

Claim New Health Insurance Tax Credit for Small Employers. Qualifying small employers can claim a new tax credit that can potentially cover up to 35% of the cost of providing health insurance coverage to employees. A qualifying small employer is one that: (1) has no more than 25 Full-time Equivalent (FTE) workers, (2) pays an average FTE wage of less than $50,000, and (3) has a qualifying healthcare arrangement in place.

A qualifying arrangement is one that requires the employer to—(1) pay at least 50% of the cost of each enrolled employee's coverage, and (2) pay the same percentage for all employees. For tax years beginning in 2010, however, a favorable transition rule allows the credit to be claimed when the employer does not pay the same percentage for each enrolled employee, but instead pays for each enrolled employee an amount equal to at least 50% of the cost of single coverage (even if the employee has more-expensive family or self-plus-one coverage).

The allowable credit is quickly reduced under a complicated two-tiered phase-out rule when the employer has more than 10 FTE employees or an average FTE wage in excess of $25,000. Please contact us if you have questions about this new break.

Social Security Tax Exemption for Wages Paid to New Hires. Wages paid to a qualified new employee between March 19, 2010 and December 31 2010 are exempt from the *employer's* portion of the Social Security tax (the employer portion equals 6.2% of wages up to $106,800). The exemption doesn't apply to the *employee's* portion of the Social Security tax (also 6.2% of wages of up to $106,800). Qualified new employees are full-time or part-time workers who—(1) start work after February 3, 2010 and by no later than December 31, 2010, and (2) were not employed more than 40 hours during the 60-day period ending on the start date. The new worker cannot displace a current employee unless that person quit voluntarily or was discharged for cause. Wages paid to workers who are related to an owner of the employer may be ineligible. Please contact us if you think you might qualify for this tax break.

Tax Credit for Retaining New Hires. Above and beyond the Social Security tax exemption, employers can also claim a new tax credit of up to $1,000 for wages paid to each qualified new employee (defined the same way as for the Social Security tax exemption). However, there are some additional requirements to collect this break. You must keep the worker on the payroll for at least 52 consecutive weeks, and wages during the second 26 weeks must equal at least 80% of wages paid during the first 26 weeks. The credit equals the lesser of (1) 6.2% of qualifying wages paid during the 52-consecutive-week period or (2) $1,000. To claim the maximum $1,000 credit, the worker must be paid at least $16,130 during the 52-week period. Also, the credit is claimed in the tax year that the 52-week period is met for the worker. Therefore, the credit will be claimed on your 2011 return. Still, you have to get the ball rolling by hiring the new employee in 2010.

Ideas for the Office

Maximize Contributions to 401(k) Plans. If you have a 401(k) plan at work, it's just about time to tell your company how much you want to set aside on a tax-free basis for next year. Contribute as much as you can stand, especially if your employer makes matching contributions. You give up "free money" when you fail to participate to the max for the match.

Take Advantage of Flexible Spending Accounts (FSAs). If your company has an FSA, before year-end you must specify how much of your 2011 salary to convert into tax-free contributions to the plan. You can then take tax-free withdrawals next year to reimburse yourself for out-of-pocket medical and dental expenses and qualifying child care costs. Watch out, though, FSAs are "use-it-or-lose-it" accounts—you don't want to set aside more than what you'll likely have in qualifying expenses for the year. And, starting in 2011, over-the-counter drugs (e.g., aspirin and antacids) will no longer qualify for reimbursement by FSAs so you may need to consider that when you determine your 2011 contribution amount.

If you currently have an FSA, make sure you drain it by incurring eligible expenses before the deadline for this year. Otherwise, you'll lose the remaining balance. It's not that hard to drum some things up: new glasses or contacts, dental work you've been putting off, or prescriptions that can be filled early. Also, for 2010, over-the-counter drugs still count.

Make Energy Efficiency Improvements to Your Home

A great way to cut energy costs and save up to $1,500 in federal income taxes this year is to make energy efficiency improvements to your principal residence. Basically, if you install energy efficient insulation, windows, doors, roofs, heat pumps, furnaces, central A/C units, hot water heaters or boilers, or advanced main air circulating fans to your home during 2010, you may be entitled to a tax credit of 30% of the purchase price. However, the maximum total credit you can claim for 2009 and 2010 combined is limited $1,500. Absent Congressional action, the credit won't be available after 2010.