November 5, 2010

----2010 End of the Year Tax Planning ----

Dear Clients and Friends

You may be thinking "Is it that time again – time to try and figure out what this year's tax bill might turn out to be?" or, perhaps, "Tax planning – why do I need to do that?"

Whether you're new to tax planning or you have done it consistently for years, tax planning for 2010 will likely be both important and difficult.

With substantial healthcare legislation enacted and the lapse (albeit temporary) of the estate tax and impending sunset provisions of many of the previous Administration's tax cuts, 2010 stands to be a critical year for changes in tax law.

Despite some efforts to address these issues earlier this year, it appears clear that lawmakers have waited till after the November elections. Now that the elections are over, we have no clearer picture of what will happen. This makes 2010 year-end tax planning particularly challenging and tenuous.

There are other uncertainties to consider, such as the economy. How will my business do in the next year? Will I still have my job next year? While these questions can't be answered by tax planning, the process will help you focus on what is known, consider what is tentative, highlight your options and understand the tax impact of each.

We recognize that not every year-end tax strategy will apply to every reader. As you read through the list below, check those items that you feel might apply to your situation. Then you can easily go back to review and follow up on the more pertinent planning points, particularly should any last-minute legislation be enacted.

This letter certainly does not include every tax planning opportunity that may be available to you. Be sure to involve us. We are the ones keeping up with the latest tax developments and can help you strategize to reduce and/or defer your taxes.

The basics

No one likes to pay taxes any sooner than they have to. So, year-end strategies typically focus on deferring income from this year into future years and accelerating deductions from future years into this year. (Although for 2010 planning, the reverse may be applicable for some.)

Year-end tax planning involves considering two years at the same time – this year and next. If possible, planning may involve the next two to three years, but that is usually difficult to do. Also, tax planning should be a dynamic process, changing as your situation and the tax laws change.

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For more complex situations, planning should be done throughout each year, revisiting specifics at least twice.

Following are some basic principles that can help guide your overall thinking:

- If you expect your tax rate to be higher next year, it might make sense to accelerate income into this year and defer deductions into next year.
- If you think your tax rate might be lower next year, consider deferring income to next year and accelerating deductions into this year.
- If your deductions might be restricted next year, accelerate some into this year.
- If you expect to qualify for the standard deduction in either year, consider shifting qualified expenditures into the year you expect to itemize your deductions.
- Fewer deductions are allowed for alternative minimum tax (AMT). If you expect to pay AMT in one year and not the other, you may want to shift deductions into the non-AMT year.

When evaluating specific items of income or deduction, you need to consider your marginal tax rate – the highest rate at which your last, or marginal, dollar of income will be taxed. However, because there are typically several changes being considered simultaneously, the overall projected tax result is what matters.

Finally, we all need to be reminded that, while the tax impact is a critical component of any financial planning, it is only one piece of the puzzle. It is one cost in light of the overall cost-benefit analysis we should consider. It should not solely drive the financial decisions.

The current unknown

It is helpful to know the specific tax issues that are currently up in the air. Fortunately, several business-related uncertainties were resolved in the Small Business Jobs Act of 2010 that became law on Sept. 27, 2010. We'll discuss those in more detail below. Following are a few of the more significant tax issues still in question.

On Jan. 1, 2011, the graduated individual income tax rates are scheduled to revert back to those we got accustomed to several years ago, with each bracket having a higher rate than now. Under the administration's fiscal year 2011 budget proposals, the lowest four brackets will remain at 10, 15, 25, and 28 percent, but the top two brackets will increase – 33 percent will move to 36 percent, and 35 percent will move to 39.6 percent. In addition, the preferential rates of 0-15 percent afforded certain capital gains and qualified dividends are anticipated to be stretched upward, resulting in a top rate of 20 percent.

While we don't know where the final results will end up, most everyone agrees that tax rates will not be lower in 2011, but hopefully won't rise either for 2011.

This affects not only individual earnings but also those of sole proprietorships and those passed through to individuals by trusts, partnerships and S corporations.

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For 2010, the dreaded phaseout rule that previously reduced write-offs for the most popular itemized deductions (including home mortgage interest, state and local taxes and charitable donations) is gone. We'll talk more about this opportunity later. Current budget proposals include an inflation-adjusted phaseout plan for 2011 and beyond.

By now we've all heard about the lack of federal estate tax in 2010 – and that a fix is needed to prevent the return of higher tax rates and lower exemptions in 2011 and beyond. Most experts expect that the 2009 rules will be reinstated, with an exclusion of $3.5 million and a maximum tax rate of 45 percent.

There are other areas of uncertainty as well, some of which are addressed as we talk about the following planning strategies in greater detail.

INDIVIDUALS

Timing of salaries, bonuses, etc.

It's possible that compensation you earn in 2010 can be paid to you in early 2011. Your employer may even be entitled to its tax deduction in 2010. If you are self-employed and your business operates on the cash method, you can delay sending out bills for 2010 work until late in the year, so payment arrives in 2011, making it taxable in 2011. However, there are constructive receipt rules to be mindful of.

Alternatively, if you are trying to increase 2010 income, you might offer a discount to clients who prepay.

Capital gains and losses

Generally, gains and losses from securities sales are recognized on the trade date, not the settlement date. December trades will be 2010 transactions, even if the settlement date is in January 2011. Sales at a loss can reduce other capital gains, and a net loss of up to $3,000 can be used to offset other income.

Before you pull the trigger on a sale and recognize a gain, check your holding period. Long-term capital gains (held for longer than one year) are eligible for a significantly lower tax rate – generally no more than 15 percent. It's anticipated that the top capital gains tax rate could move up to 20 percent beginning in 2011, so this might be a good time to accelerate a gain into 2010 and save 5 percent.

Also, capital gains can be as low as 0 percent – the same is true of qualified dividends. For those whose marginal tax rate does not exceed 15 percent, the tax rate on these special types of income is reduced to zero. If you are single and your taxable income for 2010 is under $34,000, or you are married filing jointly with taxable income under $68,000, the 0 percent rate applies to you.

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Many people with taxable income below these thresholds do not receive qualified dividends or recognize long-term capital gains that qualify for the 0 percent rate. While the kiddie tax rules prevent your children from qualifying, gifts to others that are in lower tax brackets (e.g., retired parents) might be a good technique. If you gift appreciated stock to someone in the 10 or 15 percent tax brackets, they could sell the investment and qualify for the 0 percent tax rate on the gain. Be sure to discuss such a plan with us first so you do not trigger gift taxes while trying to save on income tax.

When selling to recognize a capital loss, do not run afoul of the wash sale rules. A wash sale occurs if you repurchase substantially identical assets within the 61-day period beginning 30 days prior to your loss sale and ending 30 days after the sale. A wash sale will wipe out any loss you thought you had.

When planning year-end stock sales, be sure to consider any capital loss carry-forward that may be available to you in 2010 – losses incurred in prior years that were not fully utilized.

Installment sales

Selling an asset at a gain and collecting the proceeds in future years may allow you to defer part of the income until the years in which you receive the payments. But be careful – this may also be risky because you would be financing the sale yourself and could be faced with collection challenges.

While the installment sale option has been popular and effective over the years, with capital gains rates at an all-time low in 2010, be sure to consider electing to report the entire gain in 2010. So, while financing a sale might make good financial sense (e.g., while you have someone interested in buying), it may or may not make sense to stretch any resulting gains out into future years that have higher tax rates.

Credit card payments

Paying tax-deductible expenditures, including charitable contributions, with a credit card secures the deduction, even if you do not actually pay the credit card company until the following year. A pledge – or promise – to make the contribution is not good enough. You actually have to make the payment or charge it to your credit card.

Suspended passive activity losses

The most common passive activity is rental real estate, but could also be a trade or business that you do not actively participate in. Losses from passive activities are limited and thus are often carried over (suspended) to future years instead of being available to offset current income.

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If you own a passive activity with a suspended loss, and you do not expect sufficient passive income in 2010 to allow you to deduct the suspended loss, consider disposing of the activity before Dec. 31. Disposal frees up the suspended loss and allows it to be used in the current year.

Charitable contributions

Consider contributing appreciated securities instead of cash. You can deduct the fair market value of long-term capital gain property contributed to charity, even though your basis in that security might be significantly less. Not only do you get a higher deduction, you also avoid taxes on the gain that would have been recognized if you sold it and donated the proceeds. However, if you're determined to get rid of securities that have declined in value since you bought them, don't gift those – sell them first to realize the loss, then gift the proceeds. And remember the annual capital loss limitations.

As of now, contributions made directly from your IRA do not get the preferred treatment they did in 2009 (for those age 70½ or older, allowing no income to be triggered, but also not allowing the charitable deduction). However, there is talk in Congress of retroactively reinstating this provision to Jan. 1, 2010. So you might want to hold off on some of your planned giving until after the November elections, when Congress is scheduled to consider this and other issues.

Tax credits for home improvements

A tax credit for 30 percent of the cost of qualifying home improvements, up to a maximum aggregate credit of $1,500, is available for certain improvements placed in service in 2010. The credit is limited to $1,500 cumulatively – not annually – so if you have claimed the credit previously, the full amount will not be available in 2010. The credit applies to energy-efficient improvements such as insulation, exterior windows and exterior doors, as well as heating and air conditioning systems and water heaters. You will need to complete your purchase before Dec. 31 to qualify for the credit in 2010. There is currently no provision for this credit after 2010.

Tax credits for alternative vehicles

Several different tax credits are available to purchasers of various types of motor vehicles that use fuel-saving or alternative-fuel technologies. The credits vary in amount by the type of credit and type of vehicle. Check with the manufacturer to see what tax credits may be available if you are considering the purchase of a new vehicle. Some of these credits expire after 2010, so this may be the year to make a purchase if you're considering one.

Alternative minimum tax (AMT)

Think of the AMT as a separate tax system that shadows regular income tax – if you don't pay "enough" regular income tax, you might be subject to AMT to increase the total that you pay. An increasing number of middle-income earners, especially retirees, are falling victim to AMT. High itemized deductions (other than charitable contributions), high personal exemptions and large

capital gains are common triggers of AMT. Before implementing any year-end tax strategy, be sure to consider the impact of AMT.

Funding your retirement plans

To qualify for a deduction in 2010, your retirement plan generally must be in place before the end of the year, although some must be set up sooner. Exceptions are IRAs and SEP (simplified employee pension) plans, which can be created and funded by April 15, 2011, or by the extended due date of your return in the case of a SEP. Thus, should you discover next year that you need a few more deductions for 2010, you may be able to get them with an IRA or SEP. You also may qualify for a tax credit for doing so.

Roth IRA conversion

There are several advantages that Roth IRAs have over traditional IRAs, but a conversion from a traditional IRA to a Roth IRA results in taxable income. Even so, there are several reasons that you might want to consider converting part or all of your traditional IRA accounts to Roth IRAs in 2010.

First, there is no longer an income limitation restricting who is eligible to convert. Second, for 2010 only, the resulting taxable income can be split 50-50 between 2011 and 2012. So there will be no impact on 2010 taxable income and you get to spread the income over the two following years – an ideal deferral opportunity. However, remember that tax rates are anticipated to increase in 2011. You can opt out of the deferral and pick up all of the income in 2010. This might be advisable, depending on your specific situation. For example, if you are expecting business or other losses in 2010, income from a Roth conversion could be partially or fully sheltered by these losses, resulting in little or no tax.

Other individual considerations

Following are a few additional items to consider:

- Consider paying anticipated state income taxes before year-end. Just remember that accelerating taxes won't do any good if you're subject to the AMT.
- Ensure that you have basis to claim losses from pass-through entities. Don't just assume that you do, especially if you have claimed losses in previous years.
- Maximize the benefit of the standard deduction – it might make sense to accelerate or defer deductions into one year or the other, allowing you to benefit from the "free" standard deduction one year and itemized deductions the next. This approach is also helpful for deductions subject to an income limitation.
- Consider buying over-the-counter drugs this year. The new healthcare law provides that for purchases after 2010, flex plans and health reimbursement arrangements (HRAs) can no longer reimburse the cost of these items.
- If you have self-employment income and are considering purchasing health insurance, it might make sense to do this before year-end. As long as there is earned income from self-

employed sources, self-employed health insurance is an “above-the-line” deduction (deductible even if you don’t itemize). Also, thanks to the Small Business Jobs Act of 2010, it not only reduces income tax, but also self-employment tax. Alternatively, if you already have health insurance but are considering long-term care insurance, this also qualifies for the deduction.

- If you qualify for making a health savings account (HSA) contribution, consider maximizing your contribution before year-end. The beauty of an HSA is that you do not have to use the funds for medical expenses this year, but the contributions are currently deductible.

Estate and gift taxes

Other than the significant fact that there is currently no estate tax for 2010, there is nothing particularly unique when it comes to general estate and gift tax planning for 2010. We’ve all seen the jokes – the best estate tax planning advice for 2010 is to make sure you die this year.

Estate planning

Joking aside, the key is keeping your estate plan flexible until we know what rules will be in effect. Make sure your will distributes your assets in the appropriate manner. If you have younger children, your will should appoint a guardian in the event of the death of both parents. You certainly do not want the probate court making decisions on your behalf.

With states looking for additional revenue to balance their budgets, state inheritance taxes are receiving increased attention. Be sure your estate plan minimizes inheritance taxes in your state of residence and in any states in which you own property. It is also important to note that there may still be federal information filing requirements related to a death in 2010.

Gift tax

The annual gift tax exclusion for 2010 remained at the 2009 level of $13,000. If you are married, you can gift up to $26,000 per donee by using the gift-splitting rules while avoiding any federal gift tax ramifications. Gifting is a good way to reduce your taxable estate and may be important in a good estate plan. For example, if you and your spouse have two children, with gift-splitting you can give each child $26,000 in late December and another $26,000 in early January. If your children are married and/or you have grandchildren, the opportunity increases exponentially.

BUSINESSES

The Small Business Jobs Act of 2010 was passed in September and provides some significant tax benefits for businesses. It extended the life of expiring provisions we’re familiar with and added some new deductions that we’ve not seen before. These and other year-end business tax planning ideas are detailed below.

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Section 179 deduction

Instead of depreciating an asset over several years, Internal Revenue Code Section 179 allows the expensing of all or a portion of certain qualifying assets in the year placed in service. There are limitations, the most significant of which is the nature of the asset – it must be used in an active trade or business and generally must be personal property (not real property).

For 2010, we now have the highest amount available to expense under Section 179 that we've ever had --$500,000. This amount applies to assets placed in service for years beginning in 2010 and 2011. For total investments of qualifying property exceeding $2 million, there is a dollar-for-dollar reduction of the $500,000 expense available.

A brand new provision is to allow Section 179 expensing of up to $250,000 of qualified real property, which includes qualified leasehold improvements, qualified restaurant property and qualified retail improvements. To qualify, the building must be occupied exclusively by the lessee, it must have been in service for more than three years and the improvements can only be to the interior.

Bonus depreciation

Property that does not qualify for an immediate tax write-off under Section 179 may qualify for an increased first-year depreciation deduction under bonus depreciation rules, which were also just recently extended for one year. This deduction is equal to 50 percent of the cost of qualifying property purchased and placed in service by Dec. 31, 2010.

To qualify for bonus depreciation, the property must be new. Used property does not qualify. In addition, the property must:

- Have an applicable modified accelerated cost recovery system (MACRS) recovery period of 20 years or less
- Be water utility property or certain computer software
- Be qualified leasehold improvement property

Losses from pass-through entities

Economic pressures are causing many historically profitable businesses to experience operating losses. If you are an owner of a pass-through business entity operating as a partnership, LLC, S corporation or trust, and the business incurs a loss in 2010, you need to plan ahead to be sure you can take advantage of that loss on your personal tax return.

If your business activity is "passive" – generally a rental real estate activity or a business in which you do not materially participate – you may not be able to deduct the loss unless you also experience passive income. Even if you are actively involved in the business, your loss may not be

deductible if you do not have "basis." These rules are complicated, and you should consult with your tax professional.

You may be able to take steps before the end of the tax year to invest more in the business or otherwise increase your basis, thus allowing you to deduct the loss this year.

Employee-related benefits

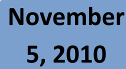
Many of the same tax savings opportunities related to employees continue as in prior years, such as establishing and contributing to a retirement plan. However, a few new ones are now available that we should be mindful of. Be sure you are benefiting from any of the following that you may qualify for:

- **Health insurance tax credit** – Under the 2010 healthcare act, a tax credit is provided for an eligible small employer (ESE) to purchase health insurance for its employees. An ESE is one that pays for at least 50 percent of the premium cost for employees and generally has no more than 25 full-time equivalent employees employed during the year, and whose employees have annual full-time equivalent wages that average no more than $50,000.
- **Payroll tax holiday for new hires** – The Hiring Incentives to Restore Employment (HIRE) Act introduced a payroll tax holiday for wages paid to new hires. It exempts employers from paying the employer share of Social Security taxes on wages paid in 2010 to qualified newly hired workers. These are workers who: (1) begin employment with the employer after Feb. 3, 2010, and before Jan. 1, 2011, (2) were previously unemployed and (3) do not replace other employees of the employer. So, while this provision was available for most of 2010, you might want to make sure you benefited from this provision if you were eligible.

Pay corporate dividends

Traditional C corporations (ones that have not elected S corporation status) face the dreaded "double tax" – profits are taxed at the corporate level and dividends paid out to shareholders are again subject to tax.

However, given the maximum 15 percent tax rate for qualified dividends, many have seen this as an opportunity to pay out accumulated earnings at relatively low rates (compared to the 39.6 percent rates that applied previously). With the likelihood that the tax rate on dividends will increase (to 20 percent or higher), it may be worth accelerating any planned dividends into 2010 to benefit from the lower rate.



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CONCLUSION

As noted earlier, there are many other considerations in tax planning that are not addressed here, but our intent is that you use this as a primer for your year-end planning. Now that the elections are over, there may be some specific post-election tax planning opportunities to take advantage of before the year end. Contact us if you'd like to discuss those.

Starting now can make the process less stressful and leave you some time to take any necessary steps before Jan. 1. However, with significant tax laws scheduled to change before year-end, be sure to schedule time to revisit the facts and projected tax results.

Let's start planning.

Sincerely,

Your friends at Zimmerman & Co CPA