White and Williams LLP

Tax and Estates News Alert, November 2010 www.whiteandwilliams.com

YEAR-END TAX PLANNING

By: Kevin S. Koscil

The following alert highlights the unique opportunities and challenges that affect year-end tax planning as 2010 draws to a close. Year-end planning is a much bigger challenge this year given the major tax issues facing a "lame-duck" Congress, which must decide, among other things, whether to extend the so-called Bush tax cuts. Without Congressional action, individuals will face higher tax rates on their income, including capital gains and dividends. Inaction is a distinct possibility. Further, the estate tax is due to return in 2011 with a vengeance (a 55% top rate and a mere $1 million exemption) and the alternative minimum tax (AMT) has yet to be "patched."

Without new legislation, the 2011 income tax brackets will revert to pre-2001 levels: 15%; 28%; 31%; 36%; and 39.6%. Currently, income in the highest bracket is taxed at 35%. Further, for 2011 the top long-term capital gains rate is set to increase from 15% to 20% and qualifying dividends are set to be taxed at ordinary income rates (they are currently taxed at capital gains rates). While the President has proposed keeping qualifying dividends in line with capital gains, such proposal nonetheless represents an increase in the dividend tax rate. Needless to say, these uncertainties must inform timing decisions.

Despite the uncertainty, this alert offers several observations, suggestions, and strategies aimed at reducing taxes for the 2010 tax year and beyond. Several tax saving opportunities will disappear in the near future so, in many cases, it is necessary to act now.

OPTIONS FOR INDIVIDUALS

- **Take advantage of an anticipated change in your marginal tax rate.** Either accelerate income or deductions depending on the nature of the change. For example, if your marginal tax rate might be lower in 2011 and a bonus payment is coming your way, it may be beneficial to arrange with your employer to defer the payment until 2011. This technique is a staple in terms of tax strategies and, all things being equal, a plan to accelerate deductions and defer income is generally tax-efficient. The analysis takes on a new complexity in 2010, however, due to the legislative uncertainties explained above. Given those uncertainties, it would generally be wise to accelerate capital gains and dividends—and the attendant tax—that would otherwise be realized early in 2011. The decision regarding ordinary income and deductions is a more difficult one.
- **"Bunch" deductions.** You may be able to save taxes this year and next by applying a bunching strategy to "miscellaneous" itemized deductions, medical expenses and other itemized deductions that are subject to a floor. For example, extend your subscriptions to professional journals, pay union or professional dues, enroll in (and pay tuition for) job-related courses, etc. This will allow you to bunch into 2010 miscellaneous itemized deductions, which are subject to a 2%-of-AGI floor (and may be lost if spread over two years).
- Consider using a credit card to prepay expenses that can generate deductions for 2010.
- Pay contested taxes, deducting them this year while continuing to contest them. Note that if you eventually prevail, you may need to recognize income to the extent of the deduction.
- Settle an insurance or damage claim in order to maximize your 2010 casualty loss deduction.
- **Make state and local tax payments by year end.** If you expect to owe state or local income taxes when you file your return next year, consider increasing your withholding for such taxes (or make estimated payments) before year-end to pull the deduction into 2010.

Note: Before implementing a strategy involving the timing of deductions, consider whether a deduction might be worth more next year in light of a potential tax rate increase or fluctuations in your income. Also, be mindful of AMT considerations (see below).

- Remember that an estimated tax payment for 2010 is due by December 31, 2010.
- **Realize losses on stock while substantially preserving your investment position.** One way to accomplish this might be to sell a holding, then buy back the same securities at least 31 days later (repurchasing during the waiting period will trigger "wash sale" rules).

- **Purchase qualified small business stock before year end.** If stock of certain qualifying small businesses is purchased after September 27, 2010 and before January 1, 2011 and is held for more than five years, gain from a subsequent sale will be completely excluded. The exclusion ordinarily applies to only 50% of such gain and was extended to 75% for stock acquired after February 17, 2009 and before September 28, 2010.
- **Utilize homebuyer credits.** If you purchased a home before April 30, 2010 (and closed before September 30, 2010), you may be eligible for a credit worth up to $6,500 (or $8,000 in the case of first-time homebuyers). The credit is subject to limitations based on modified adjusted gross income and on the value of the home.
- **Make energy-saving improvements.** Credits are available for making energy-saving improvements to your home, such as installing energy-saving windows or an energy-efficient furnace. The credit could be worth 30% of the investment but is capped at $1,500. Additional credits are also available for investments in energy generating equipment, such as solar panels.
- **Avoid underpayment penalties.** If to this point you've underpaid federal estimated tax, options may be available to increase withholding and avoid or reduce an underpayment penalty.
- **Take required minimum distributions** from your IRA or 401(k) plan if you have reached age 70 ½ on or before December 31, 2009 to avoid penalties. Penalties were waived for 2009 only; the usual rules apply in 2010. For those turning 70 ½ during 2010, a required minimum distribution must be made by April 15, 2011. Since income tax rates may increase in 2011, it may be beneficial to take the required minimum distribution by year end.
- **Consider a Roth IRA conversion.** The tax due on conversion to a Roth IRA in 2010 may be spread ratably over two years (2011 and 2012) at the option of the taxpayer. In 2010, taxpayers can make Roth IRA conversions regardless of AGI.
- **Make year-end gifts.** Save gift and estate taxes by making excludable gifts before year end. In 2010, taxpayers may make gifts of up to $13,000 each to an unlimited number of individuals. A husband and wife may join together in a gift, thus increasing the limit to $26,000. Unused exclusions cannot be carried to later years. For those considering taxable gifts in the near future (*i.e.* gifts in excess of the annual exclusion amount), the time to act is now. The tax rate on such gifts is currently 35% but will likely jump to 45% or 55% next year.
- **Increase basis.** Partners and S corporation shareholders may need to increase basis in their entity to enable loss deductions for 2010.

OPTIONS FOR BUSINESSES

- **Make business expenditures.** For tax years beginning in 2010, business owners may be able to expense up to $500,000 of the cost of qualifying property placed in service during the year. Within the $500,000 limit, a taxpayer may be able to expense up to $250,000 for certain real property expenditures. This benefit begins to phase out as the cost of qualifying property exceeds $2 million. It may be beneficial to opt out of this expensing method if tax rates increase in 2011 making post-2010 deductions more valuable. This assessment can be made at the time your 2010 return is filed.
- **Utilize first-year bonus depreciation allowance.** Business owners who place new business property in service before the end of 2010 may qualify for 50% bonus first-year depreciation. Without Congressional action, this bonus writeoff generally will not be available next year.
- **Carryback business credits.** New legislation extends the carryback period for eligible small business credits from one to five years. Eligible small business credits are the general business credits for non-publicly-traded entities that meet a modified gross receipts test. Examples include the investment credit, research credit, renewable energy production credit and employer-provided child care credit.
- **Consider deferring cancellation of indebtedness (COD) income resulting from debt restructurings.** Under relatively new provisions, COD income arising in 2010 may be deferred and recognized ratably over five tax years beginning with 2014. This relief will not be available for COD income arising next year. Taxpayers must be careful to avoid transactions that accelerate deferred COD income.
- **Temporary Reduction of S Corporation Built-In Gain Holding Period:** When a C Corporation elects to become an S Corporation, the S Corporation is taxed at 35% (the highest corporate rate) on all gains that are built-in at the time of conversion and recognized within 10 years of the conversion. New legislation essentially reduces this 10 year holding period to 7 years for sales occurring in 2009 or 2010, and to 5 years for sales occurring in 2011.
- **Credits for hiring.** A tax credit against wages paid may be available to employers who hire from groups whose members historically have difficulty obtaining employment. Unemployed veterans and "disconnected youth" hired in 2010 qualify, along with other members of target groups. Further, an employer who hires, before year end, a worker who has been unemployed for at least 60 days will be exempt from paying its 6.2% share of Social Security payroll tax with respect to that employee for the remainder of 2010. If the employee is retained for 52 weeks, the employer may be eligible for a credit of up to $1,000 on its 2011 return.
- **Start an employer pension plan or SEP.** Certain small business taxpayers may claim a credit for expenses incurred in establishing and administering a new retirement plan for employees (50% of the first $1,000 in qualified expenses for each of the first three plan years). If you are self-employed, consider establishing a self-employed retirement plan if you have not already done so.
- **Credit for providing health insurance.** Eligible small employers may take a credit for certain expenditures to provide health insurance coverage for their employees. To be eligible, an

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employer must have fewer than 25 full-time equivalent employees and an average per-employee wage of less than $50,000.

- **Self-employed taxpayers may deduct medical insurance premiums** paid to cover the taxpayer, the taxpayer's spouse, dependents, and children under age 27. This is an above-the-line deduction taken without regard to the 7.5%-of-AGI floor. The deduction can now be taken into account in computing self-employment taxes.

AMT CONSIDERATIONS

Taxpayers should estimate the effect of any year-end planning moves with an eye toward the alternative minimum tax (AMT). Many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include the deduction for state property taxes on your residence, state income taxes, miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as for medical expenses, are calculated in a more restrictive way for AMT purposes. This could affect timing decisions.

Note that without Congressional action in 2010, AMT exemption amounts for individuals will be low and nonrefundable personal credits will not be available as an offset. This would leave millions of taxpayers subject to the AMT where they otherwise would not be. It could also negate many traditionally effective year-end planning techniques. Typically, Congressional action on this issue has been last-minute but many expected to have a "patch" by now.

These are just a few of the techniques that can be used before the end of 2010 to reduce your taxes. Please feel free to contact us should you have any questions or wish to implement a plan that is specifically tailored to your needs.

If you would like to discuss how any of these changes may affect your business or personal income tax situation, or have any other tax or estate planning questions, please contact Kevin Koscil (215.864.6827), Scott Borsack (215.864.7048), or Bill Hussey (215.864.6257).

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