



December 2010

To Our Clients and Friends:

Despite the confusion created by what seems to be never-ending tax law changes, the 2010 federal income tax environment is still quite favorable. This letter presents some planning ideas to consider while there is still time to act before year-end. Some of the ideas may apply to you, some to family members, and others to your business.

### **Income Tax Planning - General Comments**

First of all, while the goal of year-end tax planning is to identify strategies that will allow you to pay the lowest overall tax, you should look at your tax situation for at least a two-year period, with the objective of reducing your tax liability for the two years combined, rather than just for 2010. Also, it's important to remember to focus on achieving your overall financial goals, in as tax efficient manner as possible.

Also, while many recent tax-law changes have been helpful in reducing your regular federal income taxes, they don't do much to reduce the possibility 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.

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. Contact us if you would like to discuss those that may be appropriate for you, or if you want to consider other tax-saving strategies.

### **Time Your Investment Gains and Losses**

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. 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 tax-free, 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.

What if you have some loser securities (currently worth less than you paid for them) that you would like to dump? Biting the bullet and selling them this year would trigger capital losses that you can use 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 (short sale rules).

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.

**Important Point:** Selling enough loser securities to create a big net capital loss that exceeds what you can use this year might turn out to be a pretty good idea. You can carry forward the excess net capital loss to 2011 and beyond, and use it to shelter both short-term gains and long-term gains recognized in those years. This can give you extra investing flexibility in future years, because you won't necessarily have to hold appreciated securities for over a year to get better tax results.

### **Consider Converting Your Traditional IRA into a 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 taxation on the amount you convert, however 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<sup>1/2</sup>, will be totally free of any federal taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA will be taxable, and possibly at higher than today's income tax rates.

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 convert to a Roth IRA.

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 the 2011 and 2012 tax years, and thereby defer the related federal income taxes. You must also make assumptions about future tax rates, how long you will hold the account, 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, in order to maximize your 2010 deductions.

- *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. 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 \$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 one, 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.

*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).

**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 in order to benefit from 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 tax 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, especially if your employer makes matching contributions.

**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.

**Adjust Your Federal Income Tax Withholding.** If it looks like you are going to owe income taxes for 2010, consider bumping up the Federal income taxes withheld from your paychecks now, through the end of the year. When you file your return, you will still have to pay any taxes due, less the amount paid in. However, as long as your total tax payments (estimated payments plus withholdings) equal at least 90% of your 2010 liability or, if smaller, 100% of your 2009 liability (110% if your 2009 adjusted gross income exceeded \$150,000; \$75,000 for married individuals who filed separate returns), underpayment penalties will be minimized, if not eliminated.



## 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 to \$1,500. Absent Congressional action, the credit won't be available after 2010.

## Retirement Plan Distributions for Seniors Age 70<sup>1/2</sup> Plus

The tax laws generally require individuals with retirement accounts to take withdrawals, based on the size of their account and their age, every year, after they reach age 70<sup>1/2</sup>. Failure to take a required withdrawal can result in a penalty of 50% of the amount required, but not withdrawn. A temporary tax law change waived the minimum distribution requirement for 2009 only. This waiver does *not* apply for 2010. So, if you are age 70<sup>1/2</sup> or older, you generally must take your required distribution before the end of the year, in order to avoid the penalty. However, if you turned age 70<sup>1/2</sup> in 2010, you can delay your 2010 required minimum distribution to April of 2011, if you choose.

Just remember that waiting until 2011 will result in two distributions in 2011—the amount required for 2010 plus the amount required for 2011. While deferring income is normally a sound tax strategy, you might think twice before postponing your 2010 distribution to 2011, because bunching income into 2011 might throw you into a higher tax bracket, or have a detrimental impact on your other income or deductions.

## Summary of the New Tax Legislation – Effective January 1, 2011

The President signed the new tax legislation on December 17, 2010. The following is a summary of the major provisions of the new law, which has an effective date of January 1, 2011, and will have an impact on the 2011 and 2012 income tax reporting years.

**Provides a two-year “patch” of the AMT.** The description of this provision by the Joint Tax Committee is: The provision provides that the individual AMT exemption amount for taxable years beginning in 2010 is (1) \$72,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$47,450 in the case of other unmarried individuals; and (3) \$36,225 in the case of married individuals filing separate returns.

The provision provides that the individual AMT exemption amount for taxable years beginning in 2011 is (1) \$74,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$48,450 in the case of other unmarried individuals; and (3) \$37,225 in the case of married individuals filing separate returns.

**Temporarily extends the Bush era tax cuts through 2012.** This means that the current 10-percent, 15-percent, 25-percent, 28-percent, 33-percent and 35-percent individual income tax rates are extended for two more years (through 2012). This has particular impact on withholding rates for wage earners beginning January 1, 2010, since those rates had been scheduled to be increased at that time. The IRS has already provided a Notice containing the 2011 Percentage Method Tables for Income Tax reflecting the changes made by the tax bill. The Notice is available at the following web link: [http://www.irs.gov/pub/newsroom/notice\\_1036.pdf](http://www.irs.gov/pub/newsroom/notice_1036.pdf).

**Extension of the current moratorium on itemized deduction limitations.** Under the provision, the overall limitation on itemized deductions does not apply for two additional years (through 2012). In addition, the personal exemption phase-out does not apply for two additional years (through 2012).

**Educator expenses.** The provision extends the deduction for eligible educator expenses for two years, so that the \$250 “educator expense” deduction is available for the 2010 and 2011 tax years.



**Education incentives.** The current exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts will continue to be available through 2012. In addition, the above-the-line deduction for qualified tuition and related expenses is also extended through the 2012 tax year.

**Dividends and capital gains tax rates.** The regular and minimum tax rates, for qualified dividend income and capital gains in effect before 2011, are extended for two additional years (through 2012). This may have some interest for those doing some end of the year tax planning who were anticipating higher rates in 2011.

**Tuition and education expense tax credits.** The provision extends for two years (through 2012) the temporary modifications to the Hope credit, for taxable years beginning in 2009 and 2010, that are known as the American Opportunity Tax Credit.

**Depreciation deductions.** The provision extends and expands the additional first-year depreciation to equal 100 percent of the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), and provides for a 50 percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011, and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived and transportation property).

**Employment taxes.** The provision reduces the employee social security tax rate by two percentage points to 4.2 percent for one year (2011). Similarly, the provision reduces the social security tax rate under the SECA tax by two percentage points to 10.4 percent, for taxable years of individuals that begin in 2011.

As we said at the beginning, this letter is intended to give you just a few ideas, in order to get you thinking about tax planning by the end of the year. Additionally, we wanted to bring to your attention some of the more important aspects of the new tax legislation, just recently passed into law. Please don't hesitate to contact us if you want to go over any aspect of the content of this newsletter, relative to its application to you and/or your business.

Very truly yours,

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