MCDONALD JACOBS
ACCOUNTANTS & CONSULTANTS

Strength in Numbers

August 1, 2010

To Our Clients and Friends:

Although this year is half over, we've already seen legislation with major tax changes, and more are almost certainly on the way. Despite confusion created by the never-ending changes, the 2010 federal income tax environment is still quite favorable. However, there are upcoming changes for 2011 and beyond. Therefore, tax planning actions taken between now and year-end may be more important than ever. This letter presents some planning ideas to consider this summer while you have time to think. Some of the ideas may apply to you, some to family members, and others to your business.

Traditional Strategy of Deferring Income Is Dicey This Year

Be careful when considering the time-honored strategy of deferring taxable income from this year into next year. The strategy still 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 unclear.

The top two rates are widely expected to increase from the current 33% and 35% to 36% and 39.6%, respectively. Therefore, individuals in the top two brackets might want to consider reversing the traditional strategy and accelerating income into 2010 to take advantage of this year's presumably lower rates.

Many prior tax cutting measures are set to automatically expire at the end of 2010. In the current economic environment, it seems likely that Congress will take no action and allow the prior administration tax breaks, including some lower tax rates, to expire as scheduled. The existing 10%, 15%, 25%, and 28% rate brackets will automatically be replaced by three higher rates: 15%, 28%, and 31%. Therefore, individuals in the existing 10%, 15%, 25%, and 28% rate brackets should also be skeptical about following the traditional strategy of deferring income into next year.

We wish we could give you more definitive advice about the advisability of deferring income (or not), but the uncertainty about future tax rates is what it is. Please check back with us later this year when we may have more clarity about what's going to happen with 2011 tax rates.

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

For 2010, the prior phase-out rule that previously reduced write-offs for many 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 in 2011. If the phase-out rule comes back as expected, it will reduce itemized deductions for taxpayers with higher 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 your January 2011 mortgage interest payment, your state and local tax payments that are due early next year, and some charitable donations. However, things get a bit tricky if you'll be subject to the Alternative Minimum Tax (AMT) this year. Please contact us if you have questions about the advisability of accelerating some 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%. The lower tax rate for qualified dividends will also expire.

To the extent you have capital losses from earlier this year or a capital loss carryover from pre-2010 years (most likely from the 2008 stock market meltdown), 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.

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 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. Remember: It's widely expected that the maximum federal income tax rate on long-term capital gains will be increased to 20% after 2010 (up from the current 15%). Also, the top two federal rates on ordinary income, including short-term capital gains, are widely expected to be increased starting in 2011 to 36% and 39.6% (up from the current 33% and 35%). Contact us if you want help in identifying your best tax-smart options in a world where future tax rates are uncertain, but likely headed higher.

For the Charitably Inclined: Sell Loser Shares and Give Away Cash; Give Away Winner Shares

Say you want to make some gifts to favorite relatives and/or charities (who may really be hurting financially). You can make gifts in conjunction with an overall revamping of your holdings of stocks and equity mutual fund shares held in taxable brokerage firm accounts. Here's how to get the best tax results from your generosity.

Gifts to Relatives. *Don't* give away loser shares (currently worth less than what you paid for them). Instead sell the shares, and take advantage of the resulting capital loss. Then, give the cash sales proceeds to the relative. *Do* give away winner shares to relatives. Most likely, they will pay lower tax rates than you would pay if you sold the same shares. In fact, relatives who are in the 10% or 15% federal income tax brackets will generally pay a 0% federal tax rate on long-term gains from shares that were held for over a year before being sold this year. Hopefully, the same will be true if they sell appreciated shares next year. (For purposes of meeting the more-than-one-year rule for gifted shares, you get to count your ownership period plus the recipient relative's ownership period, however brief.) Even if the shares are held for one year or less before being sold this year, your relative will probably pay a lower tax rate than you would (typically only 10% or 15%). However, beware of one thing before employing this give-away-winner-shares strategy. Gains recognized by a younger relative who is under age 24 may be taxed at his or her parent's higher rates under the so-called Kiddie Tax rules. (Contact us if you're concerned about this issue.)

Gifts to Charities. The strategies for gifts to relatives work equally well for gifts to IRS-approved charities. So, sell loser shares and claim the resulting tax-saving capital loss on your return. Then, give the cash sales proceeds to the charity and claim the resulting charitable donation write-off (assuming you itemize deductions). As you can see, this idea results in a double tax benefit (tax-saving capital loss plus tax-saving charitable donation deduction). With winner shares, give them away to charity instead of giving cash. Here's why. For publicly traded shares that you've owned over a year, your charitable deduction equals the full current market value at the time of the gift. Plus when you give winner shares away, you walk away from the related capital gains tax. So this idea is another double tax-saver (you avoid capital gains tax on the winner shares, and you get a tax-saving charitable donation write-off to boot). Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to the IRS.

Convert Traditional IRA into Roth IRA

Here's the best scenario for this idea: Your traditional IRA is (or was) loaded with equities and took a major beating during the 2008 stock market downturn. So your account is still worth considerably less than it once was. Correspondingly, the tax hit from converting your traditional IRA into a Roth IRA right now would also be a lot less than before. Why? Because a Roth conversion is treated as a taxable liquidation of your traditional IRA followed by a nondeductible contribution to the new Roth IRA. While even the reduced current tax hit from converting is unwelcome, it may be a small price to pay for future tax savings. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals, 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).

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 2010 tax brackets, which would not be good. 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.

Important Point: 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.

Watch out for Alternative Minimum Tax

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 dreaded 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.

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 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. We will send you a letter at year-end to assist in organizing the information needed for us to compute this credit on your behalf.

Take Advantage of Temporary Business Tax Breaks

Several favorable business tax provisions have a limited shelf life that may dictate taking quick action.

Big 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. For tax years beginning in 2010, the maximum Section 179 deduction is a whopping $250,000 (same as last year). For tax years beginning in 2011, the maximum deduction is scheduled to fall off the cliff to only $25,000. (Congress will probably increase the number, but don't bet the house on it.) Various limitations apply to the Section 179 deduction privilege, so please contact us if you want more information.

Longer Carryback Period for Net Operating Losses (NOLs). Legislation passed last year allows businesses to carry back Net Operating Losses (NOLs) generated in tax years beginning in 2009 for up to five years (versus the two-year carryback rule that usually applies). If your business uses a fiscal tax year (say one that began last October), you may still have time to take actions that will create or increase an NOL for the current tax year. That NOL can then be carried back for up to five years to recover taxes paid in those years.

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 your payroll service 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.

Conclusion

As we said at the beginning, this letter is intended to give you just a few ideas to get you thinking about tax planning moves for the rest of this year. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning strategy session. We are at your service!

Very truly yours,

McDonald Jacobs, P.C.