

CPA Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*SM

Planning During Uncertain Times

November 2010



Some of the tax laws that were passed in the early years of this century will expire after 2010. Next year, prior law could take effect again. Alternatively, Congress may pass new tax laws effective in 2011—or even some laws that are retroactive to the beginning of 2010. Therefore, tax planning for year-end 2010 is unusually challenging.

The articles in this issue of the *CPA Client Bulletin* are based on current law, as of this writing. However, Congress may act by year-end, changing current law substantially. Therefore, our office will keep you posted to let you know what changes, if any, have been signed into law and how they might affect your personal tax planning.

Income tax

In 2010, six federal income tax rates exist, ranging from 10% to 35%. Current law calls for five tax rates to be in effect for 2011, from 15% to 39.6%. As you can see, such a change would increase tax obligations for many people. In that case, year-end tax planning might suggest accelerating income into 2010, to pay tax at lower rates, while deferring deductions until 2011, when higher tax rates might make deductions more valuable.

The Obama Administration has proposed keeping 2010 tax rates for most taxpayers; only those with income over \$200,000 (\$250,000 for married couples filing joint returns) would face higher rates. As some lawmakers have pointed out, though, such a limited increase might do little to reduce the federal budget deficit. Therefore, Congress could decide to increase tax rates for people earning \$150,000; \$100,000; or even less. On the other hand, some federal legislators have suggested keeping the tax rates of 2010 in effect for another year to help stimulate the economy.

In addition, many specific income tax breaks expired after 2009. For example, you could deduct sales tax in 2009 but not in 2010. Congress may pass a so-called “extenders” bill that would reinstate those tax breaks for 2010. Such a bill, if

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2010 Tax Return*

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*At least four American
billionaires have died
so far in 2010, during a
period when the federal
estate tax has lapsed.*

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passed, could lead you to change your year-end strategies.

Estate tax

The federal estate tax has not been in effect for deaths occurring in 2010. Some lawmakers have announced their intention of reinstating the estate tax for 2010, but such an effort, if successful, would be controversial, to say the least. The deeper in the year we go before any change in estate tax law happens, the less likely it becomes that the federal estate tax will be retroactively instituted for 2010.

Regardless of how deaths in 2010 are treated, it's highly probable that the federal estate tax will be back in effect for deaths in future years. Under current law, the estate tax exemption in 2011 would be only \$1 million. If that happens, many estates would owe federal tax, based on the value of the decedent's home, investments, life insurance, and so on.

Some senators and representatives have suggested increasing the exemption amount to \$3.5 million, the same as it was in 2009. Others would like to see an even larger exemption, perhaps \$5 million. Lawmakers also are debating the issue of *portability*: the idea of allowing a surviving spouse to use any remaining federal estate tax exemption that was not fully used by the first spouse when he or she died.

Estate tax rates also are on the table. In 2009, the last year this tax was in effect, the top rate was 45%. Under current law, the top rate will be 55%, plus a 5% surtax for very large estates. Some people in Congress favor bringing the rate down to 45%, and others would go even lower. Any revisions in the federal estate tax rules also would affect the gift tax and the generation-skipping transfer tax.

With far-reaching changes in tax law likely to pass in late 2010 or in

2011, feel free to contact our office periodically to keep up with legislative developments. Once the situation has clarified, we can help you accomplish two key goals: determining whether your estate plan needs to be updated and getting timely ideas for year-end income tax savings. ■

Correction

The article "How to Pay an Investment Advisor" in the August 2010 issue of *CPA Client Bulletin* contains an error in example 2. The example states that the investment advisor, Mark, offers a reduced rate of 8% per year. This is incorrect. Because his original rate is 1%, the reduced rate would be .8%. We apologize for any inconvenience or confusion this error may have caused.

Year-End Tax Planning for Investors

For the past two years, investors have experienced extraordinarily tumultuous times. From late 2008 through early 2009, stock markets in the United States and around the world have fallen sharply. The S&P 500 Index, a leading benchmark for the U.S. stock market, lost about half of its value, for example.

As the winter of 2009 came to a close, stocks rebounded. For the remainder of last year and into early 2010, stocks enjoyed one of the strongest recoveries since the 1930s. Investors who held on recouped some of their losses, and those who timed the market successfully had sharp gains.

During the second quarter of 2010, however, stocks dived again. Debt woes in Europe and sluggish employment growth in the United

States discouraged investors. As of this writing, the outlook for the balance of 2010 is uncertain.

The bottom line? Depending on your investment history, you may have a mix of gains and losses in your portfolio, short term or long term. To make savvy trades by year-end, a careful review of your holdings in taxable accounts should be done to see exactly where you stand.

Capital gain concerns

In 2010, most taxpayers owe tax at 15% on long-term capital gains. Certain low-income taxpayers have a 0% tax rate. Under current law, the 0% rate would be eliminated, and the 15% rate would move up to 20%.

The Obama Administration has proposed that the 0% and 15% tax rates be retained; only high-income

taxpayers (those with income over \$200,000, or \$250,000 on a joint return) would owe 20% tax on long-term gains. At present, no one knows how capital gains will be taxed in 2011.

How can you proceed? The following are suggested strategies for minimizing taxes.

Did You Know?

Full retirement age is 66 for people born from 1943 through 1954. For a worker retiring at age 66 in 2010, the maximum monthly benefit is \$2,346.

Source: Social Security Administration



Take losses

If you own securities in your taxable account that are trading at levels below your purchase price, you can sell them before year-end. Such trades will provide capital losses. At year-end, those losses can offset the capital gains tax on any profits you have taken. If you have excess losses for the year, up to \$3,000 can be deducted from your ordinary income. Excess losses can be carried over to future years with no time limit.

Example 1: Jim Bell takes \$11,000 worth of capital gains during 2010 and \$19,000 worth of capital losses. Therefore, he has a net capital loss of \$8,000 for the year. Jim takes a \$3,000 deduction on his 2010 tax return and carries over \$5,000 of losses for use in the future.

If you wish to reinvest in the securities that you sell for a loss, beware of the wash-sale rules. Under these rules, after you sell securities at a loss, you must wait at least 31 days before repurchasing them. The capital loss won't count if you buy them back too soon. If you are concerned about being out of the market for that time period, you are allowed to buy a similar, but not identical, security right away.

Take gains

After taking losses in taxable accounts, go over your holdings for which you have a paper profit. Do you intend to sell them soon, either for investment reasons or to raise

cash? If so, you can sell them in 2010, tax free, up to the amount of your net capital losses for the year.

Example 2: Meg Clark tallies her gains and losses for 2010 in early December. She discovers that she has net capital losses of \$6,000 so far. Meg intends to sell \$30,000 of ABC Mutual Fund shares

in early 2011 to raise money for her daughter's college bills. At current prices, Meg would have a \$5,000 gain on the sale. Meg can sell those shares in 2010, tax free, because her gains would be more than offset by her net capital losses. She'll have a \$1,000 net loss for the year, after taking \$5,000 of tax-free gains, and she can deduct that \$1,000 net capital loss on her 2010 tax return against her ordinary income.

What if Meg also has a \$10,000 paper profit on XYZ Mutual Fund, and she expects to sell those shares in 2011? Should she sell those shares in 2010, too? If she does, the first \$1,000 of gains will be offset by her net capital loss and the other \$9,000 will be taxed; however, Meg will lock in the gain and owe tax at only 15%.

If Meg expects her taxable income in 2011 to be well over \$200,000, taking those gains in 2010 might make sense. Even if her income will be lower, she may want to take gains this year if she fears that tax rates will increase, and she'll owe 20% or more on a sale in 2011.

Yet another tactic: Meg could give some of her XYZ shares to her widowed mother Karen, whom Meg is helping to support. Then Karen could sell those shares in 2010. As long as Karen's taxable income remains under \$34,000 for the year, she will owe 0% tax on long-term capital gains. At year-end, our office can help you make those types of sell, hold, or giveaway decisions. ■

Trusted Advice

Work-Around for Wash Sales

- ❖ The wash sale rules prevent you from taking a capital loss if you immediately repurchase the asset you sold. The wash sale rules won't apply if you wait at least 31 days before repurchasing or if you immediately buy something that's similar but not identical.
- ❖ Another tactic is available if you act before the end of November. You can buy an equivalent amount of the security trading at a loss, wait 31 days, and then sell the original holding.
- ❖ For example, Louise Albert has 100 shares of AlphaBetaGamma Corp., trading far below her original purchase price. She buys another 100 shares in late November 2010.
- ❖ After waiting 31 or more days, Louise can sell her original 100 shares of AlphaBetaGamma at a loss. If she sells by December 31, the capital loss will count for 2010.
- ❖ With this technique, Louise gets her tax loss and never loses the opportunity to profit from a surge in AlphaBetaGamma's stock price.

Beyond the Limits

- ❖ In 2010, single taxpayers with modified adjusted gross income (MAGI) over \$120,000 cannot contribute to a Roth IRA.
- ❖ Married taxpayers who file joint returns with MAGI over \$176,000 cannot contribute to a Roth IRA.
- ❖ No MAGI limits exist for making nondeductible contributions to a traditional IRA. You need earned income, and you must be under age 70½ at the end of the year.
- ❖ Therefore, qualified high-income taxpayers can make nondeductible traditional IRA contributions of \$5,000, or \$6,000 if they're at least age 50.
- ❖ Once the money is in a traditional IRA, it can be converted to a Roth IRA.

Year-End Tax Planning for IRAs

Most years don't require much year-end planning for IRAs. You have until the following April 15 to make "look back" contributions. For example, you can contribute to a traditional IRA or a Roth IRA for 2010 any time until April 15, 2011.

This year, however, is not like most years. As part of your year-end planning, you may want to convert all or part of your traditional IRA to a Roth IRA. Indeed, you might want to make a 2010 traditional IRA contribution before year-end in order to have more money available for a 2010 Roth IRA conversion.

Roth IRA rewards

When you convert a traditional IRA to a Roth IRA, you will owe income tax. Why pay tax that you might be able to defer for many years? Because you can withdraw any or all of the money in your Roth IRA, tax-free, after five years and age 59½. Paying tax now can provide years of tax-free future growth.

What's more, you never have to take required minimum distributions from a Roth IRA. When you pass the age 59½ and 5-year marks, you can withdraw tax-free cash, as needed. If you need little or no cash from your IRA, you can leave the account alone, continuing the tax-free growth for yourself or for your Roth IRA beneficiaries.

Timely tactics

You can get the advantages of a Roth IRA by converting at any time. However, there may be special reasons to convert this year:

Low tax rates. Income tax rates are now scheduled to increase in 2011. By converting in 2010, you can use this year's relatively low tax rates. If your taxable income is generally \$200,000 or more, you might be

particularly interested in a 2010 Roth IRA conversion. The Obama Administration has proposed increasing tax rates only for such high-income taxpayers. (As of 2010, you can convert a traditional IRA to a Roth IRA even if you have a six- or seven-figure income.)

Tax deferral opportunity. Roth IRA conversions in 2010 get a unique tax benefit. You can choose to pay the conversion tax on your 2011 and 2012 tax returns. If you make this choice, you will split evenly the taxable income between those two years.

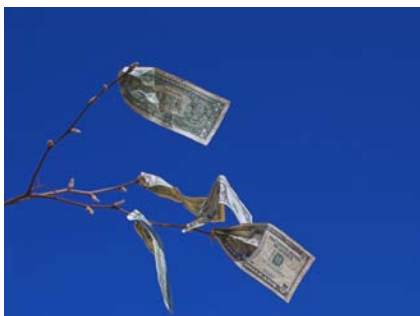
With all Roth IRA conversions, including those in 2010, you can recharacterize (reverse) all or part of the transaction back to a traditional IRA by October 15 of the following year. Therefore, you'll have a chance for savvy tax planning with a late 2010 Roth IRA conversion.

Example 1: Mark Palmer has \$100,000 in his traditional IRA. All of those dollars are pretax from deductible contributions. Therefore, a Roth IRA conversion will be 100% taxable. In December 2010, Mark converts the entire account to a Roth IRA.

In April 2011, Mark reviews his Roth IRA conversion. He is in the 28% tax bracket for 2010; he now learns that the 28% tax bracket was not increased for 2011. Therefore, Mark decides that he will keep his Roth IRA conversion in place and defer the income tax. Mark will report \$50,000 of taxable income from the Roth IRA conversion on his 2011 tax return and the remaining \$50,000 on his 2012 tax return. In his 28% tax bracket, Mark will owe \$14,000 in Roth IRA conversion tax on his 2011 tax return. If tax rates and Mark's income tax bracket remain the same, he will owe another \$14,000 on his 2012 tax return.

Example 2: Assume the same facts as example 1, except that Mark does not want to pay \$28,000 in total tax on a Roth IRA conversion, even with the tax deferral. In his specific financial situation, Mark wants to pay no more than \$20,000 in total tax.

To keep the example simple, assume Mark's Roth IRA is still worth \$100,000 in April 2011. Mark recharacterizes \$30,000 of his Roth IRA to a traditional IRA, leaving him with a \$70,000 conversion. Mark can choose to report \$35,000 of that income in 2011 and the other \$35,000 in 2012. If Mark is in the 28% tax bracket both years, he will pay a total of \$19,600 in Roth IRA conversion tax: $28\% \times \$70,000$.



Example 3: Suppose, however, that current law remains in effect and the 28% tax rate increases to 31% for 2011. In this scenario, Mark decides to pay the tax on his 2010 tax return to use the 28% bracket. He can implement a full \$100,000 conversion and pay \$28,000 in tax. Alternatively, if he decides he'd

rather pay \$19,600 in tax, Mark can recharacterize \$30,000 of his Roth IRA conversion. Then he can report a \$70,000 Roth IRA conversion on his 2010 return and pay \$19,600 in tax, at the 28% rate.

Traditional IRA, too

In 2010, you can contribute up to \$5,000 to a Roth IRA or a traditional IRA (up to \$6,000 if you're 50 or older by year-end). If you usually contribute to a traditional IRA, you might consider making that contribution well before December 31, 2010. That will give you as much as \$6,000 more in your traditional IRA that can be converted to a Roth IRA in 2010. ■

Year-End Estate Tax Planning

As of this writing, current law calls for the federal estate tax to resume for deaths in 2011, after a break for deaths in 2010. Many states also impose tax on estates or estate beneficiaries. Although the outcome of federal legislation might not become clear until late this year or even until 2011, people with a net worth of \$1 million or more may leave their heirs with tax to pay. You might reduce that future tax with astute planning.

Embracing the exclusion

Do you have more wealth than the amount you're likely to need for yourself and perhaps for a surviving spouse? If that's the case, use your annual gift tax exclusion for 2010 before year-end. Once the calendar flips to January, you can use your gift tax exclusion for 2011, but you can't go back and use any leftover exclusion from 2010.

In 2010, the exclusion amount is \$13,000 per recipient, and no limit exists on the number of recipients for which you can use the exclusion.

Thus, married couples effectively have annual exclusions up to \$26,000 per recipient to an unlimited number of recipients this year. (See articles in the September and October 2010 issues of the *CPA Client Bulletin* for tips on which assets make the most tax-effective gifts.)

Gifts in excess of \$13,000 this year will be sheltered from gift tax by a \$1 million lifetime gift tax exemption, per giver. Gifts in excess of the annual exclusion and the lifetime exemption are taxed at 35% in 2010, down from 45% in 2009.

Great GRATs

Grantor retained annuity trusts (GRATs) may help reduce your taxable estate, if you anticipate having a large estate—and a potentially large estate tax obligation. If you act in 2010, you can take advantage of low interest rates, low asset values, and current tax law. The Obama Administration has proposed tightening the rules on GRATs, and the House of Representatives has passed a bill that would restrict

the use of GRATs. You can take advantage of the current GRAT rules by creating a GRAT before any legislation takes effect.

With a GRAT, you create a trust (so you're the grantor) and contribute assets to it. You set the term of the trust and the annuity you'll retain; that's the payout you'll receive during the life of the GRAT. After the trust term, the assets will pass to the trust beneficiaries you've named, perhaps your children.

Example 1: Sheila Simmons transfers stock worth \$500,000 to a GRAT. She sets a trust term of four years and agrees to receive an annuity of \$135,000 a year from the trust. Going by the current IRS interest rate, the present value of receiving \$540,000 over the next four years is \$500,000. Therefore, Sheila has not made a gift and owes no gift tax. This transaction gives Sheila a return on her money of around 3% a year.

In this example, Sheila transfers stock that has lost value in recent years. She thinks the shares will appreciate by more than 3% a year

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over the next four years. If that happens, assets will be left in the trust when the GRAT terminates. Sheila's beneficiaries might receive shares worth \$50,000, \$100,000, or more when the trust terminates, free of any gift tax.

If you create a GRAT, you'll use the "Section 7520 interest rate" published monthly by the IRS, to put a value on the annuity you retain. The lower the interest rate, the greater the chance that the appreciation of the trust assets will result in a transfer of wealth to the trust beneficiaries with little or no gift tax.

Home runs

Qualified personal residence trusts (QPRTs) are similar to GRATs in some ways. You create a QPRT, transfer assets into it, set a trust term, and name trust beneficiaries who eventually will receive the assets from the trust. With a QPRT, however, the asset you transfer must be a house (it can be a principal residence or a vacation home) and instead of receiving a flow of assets from the trust, as you do with a GRAT, you receive the right to use the house during the trust term.



The transfer of the house to the QPRT is treated, for gift tax purposes, as a gift of the remainder interest in the house that the trust beneficiaries will receive at the end of the trust term. The value of the remainder interest is the value of the house at the time of transfer less the value of the right to use the house during the trust term. The value of the right to use the home is determined according to the length of the trust, the grantor's life expectancy, and the Section 7520 interest rate (the applicable federal rate) as determined by the IRS for the month of the transfer.

At the end of the trust term, you are allowed to live in or use the house if you wish. However, you must pay a fair market rent to the new owners—the QPRT beneficiaries. Such payments will move even more assets to your loved ones, free of gift tax.

Example 2: Phil Matthews, age 50, transfers a \$1 million vacation home to a QPRT, setting the trust term at 25 years. Using interest rates in effect at that time, the value of Phil's retained interest is about \$700,000. Thus, Phil has made a gift of \$300,000, which will be amply covered by his \$1 million lifetime gift tax exemption.

Phil can continue to use the vacation home for the next 25 years. Assuming appreciation of less than 3% a year, the home will be worth around \$2 million when the QPRT expires. At that point, the \$2 million home will pass to the trust beneficiaries with no gift or estate tax due. QPRTs might make sense now that real estate values are depressed, if you assume the property will gain value in the future.

With a QPRT, you can enlarge the gift tax break by creating a trust with a long term. However, you must outlive the trust term to get the estate tax exemption. If you die during the QPRT term, the house will go back into your estate. Our office can illustrate how various QPRT terms will result in smaller or greater gift tax obligations. ■

TAX CALENDAR

NOVEMBER 2010

November 1

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2010. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than \$500.

November 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2010. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

DECEMBER 2010

December 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in November if the monthly rule applies.

Corporations. Deposit the fourth installment of estimated income tax for 2010.