2010 Mid-Year Tax Planning Letter

Dear Clients and Friends,

Mid-year tax planning for 2010 may require an understanding of one of the most complicated tax years in recent memory.

The 2010 tax year represents a critical time to ascertain and identify any tax traps while maximizing opportunities for dramatic tax savings. Next year may truly be too late ...

There have been many changes to tax law already this year, and more changes are anticipated. As always, the key is to be able to project your anticipated income levels not only for 2010 – but also for the next two to three years.

Although the typical tax planning wisdom has been to avoid paying any taxes for as long as possible, this strategy may have to be dramatically altered. On the other hand, deductions may be worth a great deal more in a year or two.

Unfortunately, any tax projections can require you to predict a series of unknown future events. But, despite the difficulties involved, you will need to make educated guesses and reasonable assumptions. Remember, no tax strategy is cast in stone until the time for changing strategies has passed. Tax planning is a dynamic process, and the earlier you start, the better.

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

- If you expect your tax rate will be *higher* next year, you may want to accelerate income into this year and defer deductions into next year.
- If you think your tax rate might be *lower* in 2011, consider deferring income to next year and accelerating deductions into this year.

Remember to pay careful attention to your **marginal tax rate** – the highest rate at which your last, or marginal, dollar of income will be taxed.

Overall tax rates are scheduled to rise in 2011. However, if your income in 2011will be substantially lower than in 2010, your marginal tax rate may actually decrease.

Here are a couple of additional guidelines:

- If your deductions might be limited next year, try to accelerate some deductible expenses into this year.
- If you qualify for the standard deduction in either year, consider shifting the itemized deduction into the year you can itemize.

The critical step is to meet with your tax adviser now, during the middle of the 2010 tax year, while there is still plenty of time to consider and implement appropriate planning strategies.

MARGINAL TAX RATES

The biggest factor in your planning is that marginal tax rates are scheduled to increase in 2011, to a top tax rate of 39.6 percent, 4.6 percent higher than the current top rate of 35 percent.

This can be somewhat misleading because the limitations on *both* itemized deductions and personal/dependency exemptions are scheduled to be restored in 2011. They had been eliminated for 2010. And, taxpayers fully subject to the limitations face an effective top marginal tax rate that can, in fact, be 3 to 4 percentage points higher than the stated 39.6 percent rate.

If that were not enough, there is talk that dividends may once again be taxed as ordinary income. This could mean a marginal tax rate on dividends of up to 39.6 percent, up from 15 percent in 2010. This would represent an increase of 164 percent!

For 2013, the top marginal rate for long-term capital gains will climb to 23.8 percent (20 percent plus an additional 3.8 percent Medicare tax).

With scheduled rate increases such as these, it may be tempting to opt out of the installment sale treatment, even though the taxes would be paid sooner. Make sure you consider that an additional Medicare tax of 3.8 percent will apply to unearned income beginning in 2013. As a result, installment gains could be taxed at an effective tax rate in excess of 45 percent (39.6 percent highest marginal rate plus the effect of the phaseout of itemized deductions and exemptions, plus a 3.8 percent Medicare surtax). This is before you even begin including any applicable state or local income taxes!

A solution may be to consider taking an installment note payable over a shorter period – preferably, a three-year term or less for assets disposed of in 2010. As you can see, tax planning is very important.

The highest long-term capital gain rate is increasing from 15 percent to 20 percent in 2011, at least for those taxpayers in the two highest brackets. Also remember, any type of income such as long-term capital gains would be included in adjusted gross income, which then affects the limitations on itemized deductions and exemptions.

The timing of taking a bonus from your profitable company is another critical issue. Once again, W-2 or self-employment income faces a top rate of only 35 percent this year vs. 39.6 percent in 2011.

Starting in 2013, earned income above $200,000 for an unmarried taxpayer ($250,000 on a joint return) will be subject to a new .9 percent Medicare surtax. Thus, the Medicare surtax increases to 2.35 percent vs. the current 1.45 percent rate.

The FICA cap is set at $108,600 for both 2010 and 2011, but with the shortfalls expected for the Social Security system, this cap is projected by the Social Security Administration to rise to $154,000 by 2017!

The good news is that, despite the fact that this Medicare surtax will be applied to most types of earned and unearned income starting in 2013, it will not be imposed on retirement plan distributions, IRA payouts or Social Security benefits. Tax-exempt income, such as municipal bond interest, would also be spared.

Deductions

The curious thing is that the value of deductions will correspondingly increase as these marginal tax rates go up over the next few years. Therefore, it might make a great deal of sense to pay any real estate taxes just after the close of the 2010 tax year, along with fourth-quarter estimated state income taxes.

Too many itemized deductions in one year may cause a trap for the unwary because of the alternative minimum tax (AMT). The key is to find a balance between paying these expenses over the two-year period.

The same will hold true for deductions stemming from depreciable asset acquisitions. However, the exact analysis will depend on your particular cash flow needs.

For instance, the following three criteria might be used in doing this analysis:

1. If your business was experiencing cash flow problems due to losses over the last several years, and asset acquisitions were made during 2009, you would have until the extended due date of the return, or Oct. 15, 2010, to claim 50 percent bonus depreciation on certain eligible property. This write-off could, in turn, serve to create or increase a net operating loss, which could then be carried back three, four or five years to a profitable tax year, to garner a refund and thus assist in cash flow needs. Conversely, it should be noted that a Section 179 deduction would not generate any immediate tax benefit to the extent that the business did not have current trade or business taxable income to cover the deduction amount. This also applies to partners who file Form K-1.
2. If the business, especially a flow-through entity such as a partnership, LLC or S corporation, was finally starting to make money or its losses were starting to diminish in 2010, and it anticipated these profits to grow dramatically over the next several years, future deductions would be even more valuable as individual tax rates increase. A Section 179 immediate expensing election of up to $250,000 might make sense even if there were not enough profits to cover the expensed amount. For example, suppose 2010 was a loss year, but the company was finally able to start reinvesting in plant and equipment. On the other hand, 2011 and 2012 were projected to be significantly more profitable. In such a scenario, it might make sense to take the Section 179 deduction in 2010 and then carry it over to the next year or two and deduct it when the business owner will be facing a 39.6 percent marginal tax rate on the company's profits.
3. If the deductions would be most valuable in later years – 2013 or later, when the top marginal rate could be as much as 43.4 percent before considering the effect of the

phaseout mechanisms at the K-1 owner level – then it might be best to take normal depreciation over a four-, six- or eight-year period, as appropriate.

It should be stressed that bonus depreciation must be claimed on a 2009 tax return filed by Oct. 15, 2010, but Section 179 may be elected or revoked on an amended tax return filed any time within the normal three-year statute of limitations period.

LOSSES

The sad thing about personal losses for individual taxpayers is that they continue to be nondeductible. This includes any loss incurred on the sale of a personal residence or vacation home. Meanwhile, capital losses (both short- and long-term) remain capped at $3,000 per year to the extent that they exceed the total of any capital gains.

One bit of good news continues to be that individuals experiencing any forgiveness of debt in relation to their mortgage on a principal residence need not pick this up as income to the extent that it does not exceed $2 million. Yet, any other "cancellation of debt" income, such as mortgages on second homes or rental properties or credit card debt, remains fully taxable unless the taxpayer is otherwise insolvent or has filed for bankruptcy protection.

Most business investments are done through ownership of a partnership, LLC or S corporation. If someone is merely an investor in this business enterprise and not actively participating, the "passive loss" rules will normally come into play. Basically, investors are not allowed to take such passive losses (e.g., those that have flowed through to investors on a Schedule K-1) to the extent that they exceed any net profits received from such investments or from net rental income. The losses become "suspended" until some future time when profits are realized.

The only other exception results when investors finally dispose of their entire investment in a particular passive activity in a fully taxable transaction. Then, any suspended losses become fully deductible. Therefore, if investors do hold investments in these so-called passive investments, it behooves them to consider disposing of them in 2011 or 2013, when such losses might be much more valuable.

It is common for the owners of a business conducted as a partnership, LLC or S corporation to also own the real estate that is held in a separate LLC in the same percentages and is, in turn, rented to the business.

Furthermore, given the state of the economy over the last several years, rent being paid to the owners of these "real estate" LLCs was probably the last use to which the company's limited cash flow was spent.

As a result, it has not been unusual to see a net rental loss flowing out of the LLC to the owners on their K-1 forms. In such a situation, consideration should be given to elect to treat the ownership of the business and the LLC holding the real estate as one activity. The end result is that the passive loss rules do *not* apply to these particular rental losses, meaning that the owners can freely take the losses as a write-off against their other earned income, as well as their portfolio, such as dividend, interest and capital gain income.

Taxpayers owning real estate used in, or rented to, a trade or business should consider having a cost segregation study done to ascertain whether a much faster write-off can be obtained. Such a study could segregate shorter-life parts of the property from the underlying real estate that normally receives 27.5- or 39-year depreciable life. Not only will a shorter period be required in taking any depreciation deductions, assets might be identified for which a Section 179 immediate expensing election can be made. Or, a 50 percent bonus depreciation deduction might apply, at least for those assets placed into service before 2010.

CREDITS

For tax credits, 30 percent of the cost of any insulation or other energy-saving investments, such as new windows or doors, can be taken on your 2010 return. This is limited to an overall cap of $1,500 for 2009 and 2010 combined. With the popularity of geothermal wells being used to lower energy costs, especially with new construction, this 30 percent credit has no cap whatsoever. In most cases, this is combined with a return on investment period of less than seven years.

The use of the first-time home buyer credit grew dramatically in 2010. The key deadline required was that the contract be signed by April 30, 2010, with the taxpayer taking occupancy by September 30.

For new construction, the same occupancy cutoff of September 30 applied. That deadline also applied to individuals claiming a credit for a new home purchase after owning another principal residence for at least five consecutive years out of the prior eight years.

CONCLUSION

A number of tax provisions expired at the end of 2009 that may be extended at least for the 2010 tax year. The provisions include the sales tax deduction, the $250 educator’s deduction and the deduction for charitable IRA transfers of up to $100,000.

Congress is having trouble figuring out how to pay for its continuation of the current and projected future deficits. Nevertheless, new laws will likely be passed in time for filing of 2010 returns.

Gifts exceeding $13,000 annually to any third party remain taxable. But a credit against such transfer tax remains available for up to $1 million of gifts over one’s lifetime.

The news isn’t so good for the estate tax, which remains in limbo at this point.

However, the consensus by financial professionals is that it will be retroactively reinstated with a top rate of 45 percent and an exemption of $3.5 million per decedent. Talks of lowering the rate or increasing the exemption remain just that – mere discussion points.

Although this letter cannot cover all possibilities, it has outlined numerous tax alerts that should be discussed with your adviser. It is imperative that appointments be made while there is still time to implement recommended strategies.

This is indeed a challenging year to begin planning for your 2010 taxes – and for those in the next few years, given the many changes to tax law. We are ready to help. Please contact us to discuss your individual situation.

Sincerely,

Lori L Moore

Cape Coral Accounting Service, LLC