YEAR-END 2010

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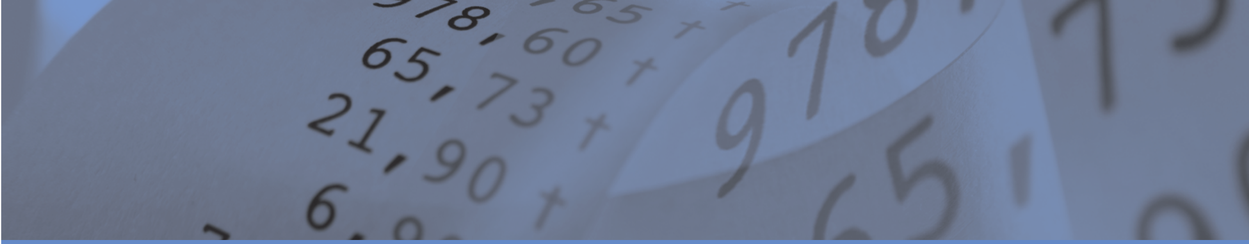

TAX TIPS & news

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The Year-End Challenge: Is Your Tax Deduction List Ready?

As the end of the year approaches, it's a good time to review your potential tax deductions and develop a strategy that maximizes the benefits. Most taxpayers may deduct the higher of two amounts from adjusted gross income when figuring their taxable income. These amounts are either a fixed amount set by law (the "standard deduction") or a listing of the expenses the taxpayer paid during the year that the government allows (known as "itemized deductions").

The basic federal standard deductions for 2010 are: $11,400 for joint filers, $8,400 for head of household, and $5,700 for others. Add-ons to the standard deduction are allowed for taxpayers (and their spouses, if filing jointly) who are blind and/or age 65 or older. In some years, other add-ons – such as a limited amount of real property tax – are also allowed.

It would seem like a simple choice – use the larger of the standard or itemized deductions. However, strategies may be used to maximize the benefits that add complexity. For example:

- **Bunching Strategy –** If your itemized deductions and your standard deduction are about the same, it may be possible to maximize your itemized deductions every other year and take the standard deduction in alternate years. Methods of doing this are discussed below.
- **The Alternative Minimum Tax (AMT) Effect –** If you are subject to the AMT, the standard deduction is not allowed at all, but some itemized deductions are. Therefore, if you are subject to the AMT, you should always itemize your deductions.

Here are some tips on maximizing your itemized deductions:

- **Medical –** Medical deductions for regular tax purposes are deductible only to the extent that they exceed 7.5% of your Adjusted Gross Income (AGI). That percentage increases to 10% for the AMT. Where possible, consider prepaying or deferring medical expenses to match your deduction strategy. In addition to the normal medical deductions, don't overlook the costs of fertility procedures, learning disability expenses, nursing home expenses, pregnancy tests, certain special education, prescribed smoking-cessation programs, certain weight-loss program expenses, and certain impairment-related expenses.

  A child's medical expenses paid for by divorced parents are generally deductible by the parent who pays the expense. You can also deduct medical expenses for an adult "medical dependent." Generally, one who would qualify as your dependent except for gross income limitations.
- **Taxes –** Deductible taxes include real and personal property taxes as well as state and local income taxes. Generally, real property taxes are paid in two or more installments during the year. This gives you the opportunity to "bunch" tax payments by paying an entire year's tax bill plus one or more installments from the prior year all in one tax year.

  If you are paying state estimated taxes, the fourth quarter's payment is due by January 18, 2011 in most states. However, you have the option to pay it before the end of the year and move the deduction into 2010. Keep in mind that taxes are not deductible for AMT purposes.
- **Charitable Contributions –** Charitable contributions are deductible for both the regular tax and the AMT. Because they are discretionary, a taxpayer can choose when to make a payment. For example, you could prepay your 2011 tithes in 2010, thereby doubling up deductions in 2010.

  Don't overlook year-end non-cash contributions of items lying around the house that are never used. As long as they are in good or better condition and are contributed to a charity before the close of the year, the contribution will count as a deduction for 2010 (provided you have proper documentation).
- **Miscellaneous Deductions –** This is a catch-all category that generally includes investment and employee business expenses. These deductions are only allowed to the extent that they exceed 2% of your AGI – but not at all for AMT purposes. Don't overlook potential losses from IRA and variable annuity accounts that have declined in value during the recession. However, utilizing these losses requires special action, so please call for details. Because of the 2% of AGI limitation, certain otherwise-deductible expenses might be handled differently, such as

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The Year-End Challenge: Is Your Tax Deduction List Ready? (Cont'd)

working out a reimbursement plan from your employer for employee business expenses. Doing so may mean reducing your salary, but you will be converting taxable income to non-taxable reimbursement – always a desirable outcome. If your miscellaneous deductions are less than 2% of your AGI, consider paying IRA fees from the IRA account instead of making a separate payment.

If you believe you are a candidate for deduction planning, please call this office for an appointment.

New Roth Opportunities are Knocking on Your Door

2010 is the first year in which taxpayers – including married taxpayers filing separately – are able to convert funds in regular IRAs (including SEP and Simple IRAs) to Roth IRAs, regardless of income level. This can provide a significant opportunity for certain taxpayers.

There are several advantages to a Roth IRA – All future earnings and distributions at retirement generally will be tax-free, and Roth IRAs are not subject to the required minimum distribution rules. Because distributions from Roth IRAs are tax-free (if they are qualified distributions), they may keep a taxpayer from being taxed in a higher tax bracket than would otherwise apply if he were withdrawing taxable distributions. Roth IRAs don't enter into the calculation of tax owed on Social Security payments and have no effect on AGI-based deductions. What's more, the benefits flow through to beneficiaries of inherited Roth IRA accounts, who also can make tax-free withdrawals from such accounts (beneficiaries, however, are subject to the same annual post-death minimum distribution rules that apply to beneficiaries of regular IRAs). 0

Conversion downside – The conversions are taxable, except for previously non-deductible amounts, but they are not subject to the 10% premature distribution tax.

Should you make an IRA-to-Roth IRA conversion? Generally, taxpayers with the following tax profiles should consider making a conversion:

- Those who still have a number of years to go before retirement and time to recoup conversion tax dollars.
- Those in a lower-than-normal tax bracket in the year of conversion.
- Those who anticipate being taxed in a higher bracket in the future.
- Those who can pay the tax on the conversion from funds other than non-taxed retirement funds.

Complicating factor for 2010 conversions – A unique income inclusion rule will apply for IRA-to-Roth-IRA conversions occurring in 2010. Unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010; half of the income resulting from the conversion will be includible in gross income in 2011 and the other half in 2012. This requires some careful planning since it is anticipated that taxes will rise in future years.

Additional items to take into consideration:

- It might be appropriate for you to design your own custom conversion plan over a number of years rather than convert everything at once.
- Where does the money to pay the conversion tax come from? Generally, it must be from separate funds. If it is taken from the IRA being converted, then for individuals under age 59$\frac{1}{2}$, the funds withdrawn to pay the tax will also be subject to the 10% early distribution penalty in addition to being taxed.
- Unlike conversions, annual contributions to Roth IRAs are not allowed for certain higher-income taxpayers. However, that problem could be circumvented by contributing to a non-deductible traditional IRA and then making a conversion to a Roth IRA in a subsequent year.
- If the traditional IRA being converted consists of assets such as stocks and mutual funds that could decline in value after the conversion, it may be appropriate to apply for an automatic six-month extension to file the conversion year's return. By waiting to file until the extended due date (October 15 for most individuals), the taxpayer has an opportunity to compare the account's market value at that time to what it was when the conversion was made. If the value has dropped significantly, the taxpayer may elect to undo the conversion (called a "recharacterization"), provided certain requirements are met, and avoid paying tax on the higher value. After a specified waiting period, a reconversion can be made.

Conversions can be tricky! If you are considering a conversion, please call for an appointment so this office can help you properly analyze your conversion and contribution options.

Maximizing Available Credits. It's All About Strategy!

There are a number of credits that can help reduce your tax bite for 2010. Unlike a deduction (which reduces your taxable income and thus provides a benefit equal only to the deduction amount times your tax rate), a tax credit is a dollar-for-dollar reduction of your tax. For some credits, such as the Earned Income Tax Credit, Child Tax Credit, Child and Dependent Care Credit, and others, there's not much you can do to change the outcome. However, there are some credits, described below, that offer year-end tax planning opportunities.

Maximize Education Credits – If you have a child in college for whom you claim a dependent exemption and you or someone else is paying the tuition for that child, you probably qualify for either the American Opportunity Credit or the Lifetime Learning Credit. The credits begin to phase out for higher-income taxpayers whose modified adjusted gross income is $80,000 or more ($160,000 for married couples filing a joint return).

- **American Opportunity Credit –** Maximum credit is obtained from $4,000 of tuition and qualified expenses that provides a credit up to $2,500 (100% of the first $2,000 and 25% of the balance). Under normal circumstances, education credits are non-refundable; that is, they offset only a taxpayer's tax liability. However, for this credit, up to 40% can be refundable.
- **Lifetime Learning Credit –** Maximum credit is obtained from $10,000 of tuition and qualified expenses that provide a 20% credit up to $2,000.

If you have not already paid the maximum expenses for the year, it may be appropriate for you to prepay certain expenses that apply to the first quarter of 2011. The laws generally allow you to prepay tuition for an academic period that begins during the first three months of the next tax year, and then you can claim the prepaid amount for the current year's credit.

Please contact this office for additional information on this tax strategy or other issues relating to education tax benefits and credits.

Take Advantage of the Home Energy Property Tax Credit – 2010 is the final year to take advantage of the "Home Energy Property Credit" that provides a tax credit for energy-saving improvements made to a taxpayer's principal residence. The credit is limited to $1,500 (30% of up to $5,000 of qualified expenditures) for improvements made in 2009 and 2010. So, if you claimed this credit in 2009, the most you can claim for energy-property improvements for 2010 is the $1,500 maximum less any amount claimed in 2009.

Qualified improvements (those certified by the manufacturer to qualify for this credit), the use of which must originate with the taxpayer, must have a reasonable expected life of at least five years, and include:

- Energy-Efficient Exterior Windows and Skylights,
- Energy-Efficient Exterior Doors,
- Energy-Efficient Metal Roofs with appropriate pigmented coatings,
- Energy-Efficient Asphalt Roofing with appropriate cooling granules,
- Energy-Efficient Heating Systems,
- Energy-Efficient Air Conditioning Systems and
- Insulation Materials or Systems designed to reduce heat loss or gain.

Credit is not allowed for onsite preparation, assembly, or installation of the component. It is a non-refundable personal credit; thus, the credit can be used only to bring your tax (including the alternative minimum tax) down to zero. Any excess is not refundable and cannot be carried over to a subsequent year.

Pick a Hybrid or Lean-Burn Vehicle – If you are planning to purchase a new automobile before the end of the year, it might be appropriate to purchase either a hybrid or lean-burn vehicle. Credits for these types of vehicles range from $900 to $2,350. However, this credit has phased out for most manufacturers and is currently available only on qualified vehicles manufactured by General Motors, Chrysler, Nissan, Mazda, BMW, and Mercedes for hybrid vehicles, and by Volkswagen, Audi, and Mercedes for qualifying lean-burn vehicles.

This credit is a non-refundable personal credit, which means it can reduce your tax only to zero, and any balance is lost. However, if the vehicle is used partially for business, the portion of the credit attributable to business use becomes a general business credit, and any amount not used in 2010 carries back one year and forward for 20 years until used up.

If you have questions about how any of these credits will impact your specific circumstances or would like to schedule a year-end planning appointment, please call this office.

Stay Compliant! Rental Owners Hit with New 2011 Reporting Requirement.

If you are a rental owner and make payments of $600 or more during 2011 to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income, the 2010 Small Business Jobs Act says that you are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. To do so, you must obtain the payee's name, SSN, and contact information before making a payment. The IRS provides Form W-9 for that purpose.

There is a "Catch-22" you need to watch out for. Suppose you call a plumber and pay him $400 for a service call at your rental property and don't bother to have him complete and sign a W-9 since the amount is under $600. Then, later in the year, you need him again and pay another $400 for the second service call at the rental, and again fail to obtain the completed W-9. Now, you have a 1099 filing requirement but do not have the information needed to file the information returns in 2012. If the plumber can't be found, you are left holding the bag. Moral of this story: Always collect a completed W-9 from the payee before paying him!

What happens if you don't meet your filing obligation? Well, there are monetary penalties! As part of the 2010 Small Business Act, the penalties are doubled for information returns required to be filed after 2010. So, if you are 30 days late filing the information return with the IRS or furnishing a copy to the payee, you are subject to a $30 per-payee penalty. If returns are more than 30 days late but filed by August 1, the penalty per payee is $60; if filed after August 1, the penalty jumps to $100 per payee.

The penalties can be substantial, and you are cautioned to establish a procedure for obtaining W-9s from your service providers before the beginning of 2011. **Note:** Payments to incorporated businesses and those made for the purchase of merchandise are not included in these requirements until 2012.

Please call this office if you need assistance.

Nov. 2010 - Apr. 2011

Tax Calendar

November-December 2010:

It's time for 2010 year-end and 2011 tax planning. This is highly recommended if you have substantial increases in income or fewer deductions. Please call for an appointment.

December 31, 2010:

- This is the last day to pay deductible expenses for the 2010 return. This doesn't apply to IRA, SEP or Keogh contributions, all of which can be made after December 31, 2010.
- This is the last day to set up a Keogh Retirement Account if you plan to make a 2010 contribution.

January 18, 2011:

The fourth quarter 2010 federal individual estimated tax payment is due unless the 2010 return is filed by February 1, 2011 and the entire balance due is paid with the return. **Caution:** Some states may have different filing dates for state estimated payments. Note that the normal due date would be January 15, but because it falls on a weekend and with January 17 being a Federal holiday, the due date is January 18, 2011.

January 31, 2011:

This is the deadline for businesses to provide 1099s and W-2s to those people they paid during 2010. If you are a business owner or rental property owner and you paid $600 or more for the services of individuals (other than employees) during the year, you will need to provide 1099s to those workers by January 31, 2011. "Services" can mean everything from labor and professional fees to rents on property. In addition, in order to avoid a penalty, copies of 1099s need to be sent to the IRS by February 28, 2011. This firm can prepare these documents for you.

February 28, 2011:

This is the deadline for filing (sending) 1099s and W-2s to the government.

April 18, 2011:

- This is the deadline for individuals to file a 2010 federal income tax return or request an extension of time to file.
- The first installment of the 2011 federal individual estimated tax payment is due. **Caution:** Some states may have different filing dates for state estimated payments.
- The first installment of the 2011 defined benefit pension plan contributions is due.

TAX TIPS & news

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

Since You **Asked...**

You Asked: My wife and I are getting a divorce. As part of the property settlement, she will keep the home. What are the possible tax consequences that may arise?

Answer: When property is divided up in a divorce, there are no immediate tax consequences. Therefore, the transfer of your interest in the home to your spouse will not result in a taxable gain or loss to either you or your spouse. However, let's say that she assumes the home at the community basis. Generally, community basis is what was jointly paid for the home plus the cost of improvements that were made. Thus, she would be responsible for reporting any gain in excess of the community basis when, and if, she sells the home. If she qualifies, she can exclude the first $250,000 of gain; any part of the gain in excess of the exclusion will be taxable to her. As part of your divorce tax strategy, and assuming you qualify for the home gain exclusion, you might want to consider selling the home jointly. This will convert the asset to cash, which can then be divided up as part of the settlement. By doing so, you will have a combined $500,000 home gain exclusion and will only be taxed on the amount, if any, in excess of this larger exclusion amount.

You Asked: I would like to make an IRA contribution for 2010 after I receive my refund from the 2010 tax year. Is that possible?

Answer: Maybe! A deduction may be claimed before the contribution is actually made to the IRA if the taxpayer does in fact make the IRA contribution before the due date, without filing an extension, for the return. Thus, if you were making an IRA contribution for 2010, you would have until April 15, 2011 to make the contribution, even if you filed your return before that date. However, the IRS places the responsibility for making the timely deposit on the taxpayer, so make sure that you file your return early. Otherwise, you may not receive your refund in time, and that is not considered a valid excuse for not making a timely deposit. It is possible to have the IRS directly deposit your refund (or part of it) to your already-established IRA by filing Form 8888 with your return. You'll need to notify the IRA trustee or custodian ahead of time which year the deposit is for. Even with this direct deposit method, the deposit needs to be made by the return due date – and it is your responsibility to verify that it was timely deposited – for it to count as a contribution for the year of the return being filed.