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In 2010, Summer Vacation Should Include Midyear Tax Planning

By Vincent M. Hannigan

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Summer is here and the time is right for thinking about the beach, baseball, barbecues and tax planning. Yes, tax planning. Not likely at the top of your to-do list, but it should be. "I can wait until the end of the year," you convince yourself, however, year-end may be too late. We have all heard taxes will likely rise beginning in 2011, which makes it a challenging time to begin planning for 2010 and beyond. However, the 2010 federal income tax environment is still quite favorable, which makes tax planning in 2010 even more critical.

In 2001 and 2003, Congress enacted several tax cuts for investors, small business owners and families. Absent congressional action, these cuts will all expire on Jan. 1, 2011. The expiring tax cuts presumed to have the greatest impact on most taxpayers, include the following:

- **Personal income tax rate increase.** The top and bottom rates will rise from 35 percent to 39.6 percent and 10 percent to 15 percent, with 3 percent increases at all brackets in between. Additionally, the limitations on itemized deductions and personal and dependency exemptions will be restored in 2011 — they were eliminated in 2010 — resulting in an effective top marginal tax rate of approximately 43 percent for some high-income taxpayers.
- **Capital gain and dividend rate increases.** The long-term capital gain rate will rise from 15 percent to 20 percent while the tax rate on qualified dividends will rise from 15 percent to each individual taxpayer's marginal tax rate. In 2013, these rates will climb even further with the new 3.8 percent Medicare tax on unearned investment income.
- **The return of the "marriage penalty."** The "marriage penalty" results from our progressive tax rate structure and affects families with two working spouses. Married taxpayers with similar earnings will incur a greater joint tax liability when filing a joint return than if they were single filing separate tax returns. Numerous tax acts have mitigated this penalty by adjusting the tax brackets for joint filers, however, this adjustment will expire after 2010.
- **More disappearing tax breaks.** Other breaks that will be reduced after 2010 include the reduction of the child tax credit from $1,000 to $500, reduction of the standard deduction for married couples, cuts to the dependent care and adoption credits and the return of the estate tax.

These are only a few of the more critical tax increases absent legislative action. There are many others. However, planning with respect to these expected increases alone can result in some very favorable tax savings for 2010 and beyond. To counter the ominous threat of tax increases, what follows are a number of tax planning ideas to consider for tax year 2010.

Reversing Conventional Strategies

The strategy of deferring income until the following year is typically the number one tax planning strategy where tax rates and income will remain the same from one year to the next. Not this year? It seems prudent for taxpayers who are confident that they will be in the same or lower tax bracket in 2011 to defer income and accelerate deductions. Keep in mind that maintaining the same tax bracket from 2010 to 2011 is especially difficult given the looming tax rate increase.

A taxpayer's projected income would have to be much lower to ensure inclusion in the same tax bracket for both years. Because the top two tax rates will likely increase from the current 33 percent and 35 percent to 36 percent and 39.6 percent, respectively, individuals in these brackets or otherwise confident that they will be in a higher tax bracket should seriously consider abandoning conventional wisdom and accelerate income into 2010 to profit from this year's probable lower rates.

There is the possibility that the four lower brackets will remain the same. For that to happen, however, Congress must take action. If Congress does not act, the four lowest rates will automatically be replaced by three higher rates — 15 percent, 28 percent and 31 percent — in 2011. Therefore, individuals in all tax brackets should contemplate accelerating income into 2010.

Another Reversal?

You would think that one strategy reversal would lead to another. In a "normal" year, we would recommend deferring income and accelerating deductions. Well, as we now know, this is not a "normal" year. Consistent with the counterintuitive theme, deferring deductions until 2011, when tax rates are higher and a taxpayer would generate more bang for his buck, seems likes a good idea. Not so fast.

The good news is that, for 2010, the phase-out rule that previously reduced itemized deductions — including home mortgage interest, state and local taxes and charitable donations — is eliminated. However, the bad news is the phase-out rule is scheduled to return with a vengeance in 2011 unless Congress takes action to prevent it, which looks increasingly unlikely. If the phase-out rule returns as expected, it will wipe out $3 of affected itemized deductions for every $100 of Adjusted Gross Income (AGI) above the applicable threshold. Thus, for example, individuals with very high AGI can see up to 80 percent of their affected deductions wiped out.

The way it works is an individual whose AGI exceeds a threshold amount must reduce the amount of allowable itemized deductions by a reduction equal to the lesser of: (1) 3 percent of the excess over the threshold amount; or (2) 80 percent of allowable deductions. Assuming a 2011 threshold amount of $170,000 for married taxpayers, AGI of $500,000 and itemized deduction of $80,000, the taxpayers will lose $9,900 of itemized deductions (($500,000 - $170,000) x 3%). The loss of $9,900 of deductions will increase the income tax by about $4,000 at the highest marginal tax rate.

Although dependent upon AGI, a cash-basis taxpayer may generate more tax-savings from accelerating the following payments into 2010: January 2011 mortgage interest payments; state and local tax payments due in early 2011; and charitable donations.

However, things get a bit tricky for taxpayers subject to the Alternative Minimum Tax in 2010. The pesky AMT is discussed further below.

Carefully Time Investment Gains and Losses

As noted above, the maximum rate on long-term capital gains will increase to 20 percent in 2011 unless Congress takes action, which looks increasingly unlikely. Therefore, taxpayers should consider selling appreciated securities this year instead of next.

Taxpayers who have already sustained current year capital losses or with capital loss carryovers from prior years can sell appreciated securities tax-free to the extent the losses shelter the gains. Taxpayers who are so inclined may immediately buy back the just-sold stock, essentially acquiring a tax-free step up in the cost basis of the stock. The wash sale rules — which disallow losses where a purchase of the same stock was made within a 30-day period before or after the loss sale — do not apply to securities sold at a gain. The strategy of selling and buying back the same stock helps shelter future gains in the stock by increasing basis.

Taxpayers with loser investment positions may want to bite the bullet this year in order to shelter current year capital gains, particularly high-taxed short-term gains. Losses exceeding current year gains, are carried forward to 2011 — after a deduction of $3,000 against ordinary income — to offset future gains that could be taxed at rates as high as 39.6 percent. This approach provides future investing flexibility as taxpayers with capital loss carryovers can sell appreciated securities held less than a year and still achieve favorable tax results.

For the Charitable-Minded

Prior to 2010, individuals could roll over up to $100,000 from an individual retirement account (IRA) directly to a qualifying charity without recognizing the assets transferred to the qualifying charity as income. However, as of 2010, this is no longer an option for taxpayers at this time. However, direct gifting of stock to qualified charities remains one of the best tax savings strategies available.

Charitable gifting should be done in conjunction with an overall stock portfolio review. Loser stocks should not be gifted as taxpayers will lose out on a double tax benefit. A taxpayer should instead gift the proceeds from the sale of the loser stock, claiming both the capital loss and charitable deduction.

With appreciated securities the stock should be gifted directly instead of giving cash. The charitable deduction is equal to the full fair market value at the time of the gift assuming the stock was held for more than one year. In addition, by gifting "winner" shares, the related capital gains tax is avoided. Yet another double tax-saving opportunity.

Converting a Traditional IRA to a Roth IRA

As we discussed in a previous tax topics column, beginning in 2010, taxpayers with modified adjusted gross income (MAGI) in excess of $100,000 are permitted to convert a traditional IRA to a Roth IRA. Previously, only individuals with MAGI of $100,000 or less could initiate the conversion. Upon conversion, the IRA is taxable as if the account were distributed in its entirety to the account holder. The income tax burden is often the primary impediment to IRA conversions.

To ease the tax bite, taxpayers may opt to defer the payment of income taxes from the Roth IRA conversion over two years, specifically 2011 and 2012. This option is only available for 2010 conversions and is only prudent if your tax bracket does not increase between years 2011 and 2012. Additionally, taxpayers who have reached the age of mandatory distribution requirements, 70 and a half, must still take a taxable distribution in the year of conversion. Although the $100,000 income limit has been eliminated for conversions, the Roth IRA annual contribution limits still apply. Contributions to a Roth IRA are phased out for single and joint taxpayers with MAGI in excess of $120,000 and $177,000, respectively.

The question of whether to convert to a Roth IRA centers on the assessment of whether it is more advantageous to pay tax now by converting, or to defer the tax by maintaining a traditional IRA or other tax deferred retirement plan. Each course of action has advantages and disadvantages and the final decision will depend upon each individual's unique set of circumstances with additional weight given to factors considered to be most important. (See the article titled "To Convert or Not To Convert: Advantages and Pitfalls of Roth IRA Conversions," authored by my colleagues Steven Packer and Michael Bartosik.)

Electing to pay the tax in full in 2010, rather than spread over 2011 and 2012, makes sense for taxpayers who strongly believe the highest tax rates will increase to the pre-2001 levels of 39.6 percent. We believe there is a good chance this will happen.

Energy-Efficient Improvements

The Recovery Act raised the energy credit limits for qualified improvements placed in service in 2009 and 2010. The law provides for a credit of 30 percent of the cost, up to $1,500, for qualified improvements placed in service in 2009 and 2010. Improvements include adding insulation, energy efficient windows and doors, and energy efficient heating and air conditioning systems to a principal residence. For taxpayers considering energy efficient home improvements, 2010 is the last year to take advantage of the tax benefits.

Beware of the Alternative Minimum Tax Ambush

About 4 million taxpayers paid the AMT in 2009. AMT is calculated using a different set of rules than those used for regular income tax. Under AMT rules, some deductions allowed for regular tax are disallowed or limited. Each year Congress comes to the rescue of more than 20 million taxpayers by extending a "patch" that increases the AMT exemption amount. For 2009 the AMT exemption amounts were $46,700 and $70,950 for single and joint taxpayers, respectively. Without the patch, the exemption amounts would have reverted to the 1986 exemption amounts of $33,750 and $45,000 for single and joint taxpayers, respectively.

To date, there is no "patch" in place for 2010 and the future of the AMT is uncertain. If Congress fails to come to the rescue again, more than 30 million taxpayers could be subject to the dreaded AMT, according to public reports. The Taxpayer Certainty and Relief Act of 2009, introduced in the Senate on March 26, 2009, proposes permanently adopting the 2009 exemption amount and indexing it for inflation for 2010 and beyond. The House has passed a budget resolution that includes a three-year patch of the AMT for 2010, 2011 and 2012 at a projected cost of $214 billion. There is still substantial uncertainty about the number of years involved in an AMT patch for 2010 and beyond. Stay tuned.

In light of the AMT rules, it goes without saying that a critical evaluation of all tax planning strategies is necessary before any one plan is implemented.

Some Breaks for Businesses

- **Consider Equipment Purchases.** The new Hiring Incentives to Restore Employment (HIRE) Act increased the Section 179 deduction to $250,000 for 2010. Before the change, the limit was $134,000 and absent congressional action, the deduction will drop drastically to $25,000 in 2011. Additionally, the Section 179 deduction applies to the full cost of the equipment even if loans were used to make the purchases.
- **Credits for New Hires.** For 2010 only, employers who hire previously unemployed workers are exempt from the employer's portion of the Social Security tax with respect employees hired after Feb. 3, 2010. The exemption

applies to wages paid between March 19, 2010 and Dec. 31, 2010. New workers cannot displace a current employee unless the employee left voluntarily or was dismissed for cause.

In addition to the Social Security exemption, for each qualified employee retained for at least a year whose wages did not significantly decrease in the second half of the year, businesses may claim a new hire retention credit of up to $1,000 per worker. The worker must stay on the payroll for 52 consecutive weeks and his pay in the second 26 weeks must be at least 80 percent of the pay in the first 26 weeks.

- **Health Care Tax Credit.** An eligible small employer (ESE) is entitled to a tax credit of up to 35 percent for the cost of health insurance provided to its employees. An ESE is an employer who employs no more than 25 full-time employees with annual wages averaging no more than $50,000. The full credit amount is only available to employers with 10 or fewer full-time employees with average annual wages of less than $25,000. The employer is entitled to an ordinary and necessary business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an eligible employer pays 100 percent of the cost of its employees' health insurance coverage and receives a credit of 35 percent, the employer can claim a deduction for the other 65 percent of the premium cost.

These are but a few of the midyear tax planning strategies you and your clients may wish to consider as you plan for 2010 tax compliance and contemplate transactions for 2010 and beyond. Every tax situation is unique and there are many moving parts. Therefore, it is advisable to consult with a qualified tax professional when considering tax planning and compliance matters.

Vincent M. Hannigan, a senior manager in the tax accounting group of Duane Morris, has more than 20 years of experience in many facets of federal, state and local income taxation, with particular emphasis on income tax compliance and planning for individuals, estates, trusts and nonprofits. He also has considerable experience in litigation consulting services, including civil tax controversies, damage measurement and preparation of special purpose reports.

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