

# CPA Client

# Advances in Tax Planning

Year-End Tax Planning Strategies *from your* Trusted Business Advisor<sup>SM</sup>

## Prepare for Change

## Planning During Uncertain Times



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

The articles in this tax planning letter are based on current law as of this writing. However, Congress may act by year-end, changing current law substantially. Our office will keep you posted on what changes, if any, have been signed into law and how they may 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 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

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## Basis Builders

*Sales commissions paid when trading securities can be added to your purchase price and subtracted from your selling price, reducing your taxable gain or increasing your loss.*

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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, you can contact our office periodically to keep up with legislative developments. Once the situation has become clear, 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. ■

## Higher Taxes Are Likely, But Perhaps Not for Everyone

**M**any of the tax cuts passed during the George W. Bush administration are due to expire after 2010. Although some of them may be extended to future years, high income taxpayers may face higher rates starting in 2011. If you will be affected by higher tax rates, some planning can help you trim your tax bill.

### Now and then

As mentioned in the article "Planning During Uncertain Times" in this issue, the six rates for federal income tax under current law are 10%, 15%, 25%, 28%, 33%, and 35%. As your income increases, higher rates apply to your taxable income.

Special rates apply to long-term capital gains (profits on assets held for more than one year) and qualified dividends (most dividends received by investors). The maximum tax on both types of income is now 15%, although some long-term gains on collectibles such as works of art and rare coins are taxed at 28%. A 25% rate may also apply to any previously-taken depreciations on the sale of long-term

assets. Taxpayers in the 10% and 15% tax brackets owe 0% tax on most long-term gains and qualified dividends.

If Congress does not pass legislation this year, many people will face higher tax rates on ordinary income, qualified dividends, and long-term capital gains received in 2011. President Obama's budget proposal calls for increasing the 33% tax rate to 36% and the top federal income tax rate from 35% to 39.6%.

Under the President's proposal, these higher rates would affect single taxpayers with taxable income of more than \$200,000 "less the standard deduction and one personal exemption, indexed for inflation." The exact number under this formula probably would be around \$190,000. Similarly, the higher tax rates would affect married couples filing joint returns if their taxable income were higher than approximately \$230,000.

These numbers are for *taxable income*. Therefore, it's possible that even if your gross income were \$200,000 or more (\$250,000 or more on a joint

return), you'd still only be in the third highest federal tax bracket—28%—under this proposal.

The Obama administration suggests a similar approach to qualified dividends and long-term capital gains. Most taxpayers would continue to pay tax at 15% or 0%; however, those taxpayers with incomes in the proposed 36% or 39.6% tax brackets would owe 20% on qualified dividends and long-term capital gains.

### Forecasting the future

Congress might not pass any tax law at all this year. And if it does pass a law, the new rules may not follow the



administration's proposal. However, many observers believe that Congress will pass a tax increase to reduce the projected federal budget deficit. Such a tax increase probably will fall largely on high income families and individuals.

If you are likely to be affected, some broad principles can assist you in your tax planning. For example, beginning next year, you probably will owe more tax on all types of income. Therefore, you may want to increase your use of tax-advantaged vehicles, including employer sponsored retirement plans, tax-exempt municipal bonds, and 529

college savings plans. Our office can help you weigh the tax consequences of various choices for savings and investments.

You also may want to consider converting some or all of your traditional IRAs to Roth IRAs. You can pay tax on the conversion at 2010 rates. Five years after opening the account or at age 59½, which ever comes later, all withdrawals from your Roth IRA will be tax free, even if tax rates are much higher by then.

Assuming some variation of President Obama's plan becomes

law, the gap between high income taxpayers and other taxpayers will increase in future years. This will make income shifting strategies more valuable. If you plan to sell appreciated assets, for example, you might first transfer them to your parents if they are in a lower tax bracket. They may be able to sell those assets and owe less tax than you would owe on a sale. If passage is likely, our office can go over the details with you and develop suitable strategies. ■

## A Future Tax May Hit Unearned Income

**A**lthough major provisions of the new health insurance legislation such as mandatory coverage and premium assistance won't take effect until 2014, you may be affected by significant tax increases before then. One of these tax increases is a 3.8% tax (described as a Medicare contribution) on some taxpayers' unearned income, starting in 2013.

### Two thresholds

This 3.8% tax will affect taxpayers whose modified adjusted gross income (MAGI) exceeds certain amounts. MAGI, for this purpose, will be the adjusted gross income (AGI) you report on the bottom of page 1 of IRS Form 1040 or Form 1040A (on line 4 of Form 1040EZ), plus any foreign earned income you exclude in calculating AGI. If your MAGI is no more than \$200,000 as a single filer, or no more than \$250,000 on a joint return, you will not be subject to this 3.8% tax. (These two MAGI thresholds will not be indexed for inflation.) If your MAGI is over the relevant threshold, you'll probably

owe the 3.8% tax. Here's how to calculate your obligation:

1. Determine your *net investment income*. For a given calendar year, add up your taxable interest, dividends, capital gains, rents, royalties, ordinary income and capital gains from passive activities (such as rental real estate activities) or financial instrument or commodities trading businesses, and taxable payouts from annuities. Then subtract any deductions allocated to that income, such as interest on margin loans.
2. Determine the extent to which your MAGI exceeds the relevant threshold.
3. You will owe 3.8% tax on the lower number, (1) or (2).

### Do the math

Some examples will illustrate the previous calculation.

**Example 1:** John Jones, a single filer, has MAGI of \$220,000 in 2013. His net investment income is \$50,000. John's MAGI is over the \$200,000 threshold by \$20,000. Here, John's MAGI threshold overage of \$20,000 is less than

## Trusted Advice

### Taxing Estates and Trusts

- In 2013, the new 3.8% tax on unearned income also will apply to estates and trusts.
- In 2010, estate and trust income over \$11,200 is taxed at the highest income tax rate, which is 35%.
- By 2013, the 3.8% surtax may also apply to estate and trust income over approximately \$12,000.
- Under current law, the top income tax rate in 2013 will be 39.6%. If a trust has \$13,000 of taxable income that year, all from investment income, and the 39.6% tax rate starts at \$12,000, this trust would owe a total of 43.4% (39.6% plus 3.8%) on \$1,000 of investment income.

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John's net investment income of \$50,000. Thus, John will owe a 3.8% tax on \$20,000, \$760.

**Example 2:** Amelia and Bart Dugan have MAGI of \$310,000 in 2013. Their net investment income is \$50,000, the same as John Jones. However, the Dugans are \$60,000 over the \$250,000 threshold for their joint MAGI. The Dugans' investment income of \$50,000 is less than their income threshold overage of \$60,000. Therefore, the Dugans will owe the 3.8% tax on all \$50,000 of their net investment income, \$1,900.

### Tax trimming tactics

Two ways exist for high income taxpayers to avoid or reduce their exposure to this 3.8% tax. First, you can trim your net investment income. You might invest in tax-exempt municipal bonds or no dividend growth stocks, for example. The less investment income you have, the lower your potential tax obligation.

Second, you can minimize your MAGI. Tax deductible contributions to retirement plans, for example, may be able to hold your MAGI below or modestly above the relevant threshold and reduce the amount you'll owe under this 3.8% tax.

As mentioned, this tax won't be effective until 2013. Therefore, you have more than two years to arrange tax reduction strategies. In 2010, though, you might consider a Roth IRA conversion as a means of reducing the amount of this 3.8% tax you'll owe in the future.

With a Roth IRA, distributions are completely tax free after five years and after age 59½. Depending on your age, you might be able to take tax-free Roth IRA distributions as early as 2015 if you convert in 2010. (If you previously had a Roth IRA, the conversion starts a new five-year clock so you will have to wait those five years until investment earnings from the converted dollars can come out tax

free.) Tax-free Roth IRA distributions are not considered investment income and will not boost your MAGI. Therefore, they will not trigger the 3.8% tax in 2013 and later years.

Converting to a Roth IRA does trigger income tax. If you convert in 2010, you'll pay tax at today's rates, no higher than 35%. That may be better than taking taxable distributions or converting in the future when you may owe higher income tax rates and when distributions or conversions might raise your MAGI and thus cause a 3.8% surtax as well.

What's more, you'll get the greatest advantage from a Roth IRA conversion if you pay the resulting tax from non-IRA funds. If you draw down your taxable investments to pay the tax, you may have less investment income in the future and thus owe a smaller amount of the new 3.8% tax. Our office will be able to help you begin planning for the coming tax on unearned income. ■

## High Earners Face a New Tax

In 2013, when a new tax on unearned income takes effect, some workers also will face a new tax on their earned income. This will be a payroll tax on individuals with earned income over \$200,000. Married couples with earned income over \$250,000 also will be affected.

Under current law, employees see a Medicare tax of 1.45% taken from each paycheck. Employers pay a matching 1.45% for a total of 2.9%. This payroll tax applies to all earnings, with no ceiling.

As of 2013, employees also will pay a 0.9% Medicare tax on earnings over the threshold amounts. Employers will not have to pay this additional tax.

**Example 1:** Paula Franklin earns \$305,000 in 2013. Her Medicare tax will be 1.45% of her first \$250,000 in

earnings and 2.35% (1.45% + 0.9%) of her remaining \$55,000 of earnings. Her employer's contribution remains at 1.45% of Paula's \$305,000 in total earnings.

This 0.9% tax, like the 3.8% tax on some unearned income, has a marriage penalty that may affect dual income couples.

**Example 2:** Steve Matthews and Lynn Baxter are not married in 2013. They each earn \$190,000 a year. Neither owes the 0.9% extra Medicare tax. Steve and Lynn get married in 2014 and file a joint tax return for that year. Assuming they have the same earned income, Steve and Lynn combine for \$380,000 in earnings, \$130,000 over the limit. At a 0.9% rate, they'll owe \$1,170 in extra tax in 2014.



Some taxpayers, such as S corporation shareholders, attempt to minimize earned income in order to reduce payroll taxes. Cash might flow through to S corporation shareholders as profits rather than wages. Such efforts may become more appealing when payroll taxes increase in 2013. If you think you might benefit from such a strategy, our office can help you set acceptable levels of compensation. ■

# Maximize Your Tax Savings

## Save Tax by Filling Up Your Bracket

As the third quarter of 2010 comes to a close, you probably have a good idea of your income for the year. By matching your projected income with federal tax brackets, you may be able to make some tax saving moves. The 2010 tax rates are listed subsequently. These rates are for

	Single Filers	Joint Filers
10%, up to	\$ 8,375	\$ 16,750
15%, up to	34,000	68,000
25%, up to	82,400	137,300
28%, up to	171,850	209,250
33%, up to	373,650	373,650
35%, over	373,650	373,650

taxable income, after you have taken your deductions:

If you will be in the 10%, 15%, or 25% brackets this year, consider filling up these relatively low brackets. Even if you are in a higher bracket, you can suggest some of these strategies to a lower income child, parent, or other loved one.

### Take traditional IRA distributions

If you are at least age 59½, you generally can tap your traditional IRA without owing the 10% early withdrawal penalty. By filling up your tax bracket, you might receive some needed funds at an attractive tax rate.

**Example 1:** Ralph and Bonnie Clark are both 60 years old. They have taken early retirement but can't begin to collect Social Security benefits before age 62. For 2010, they project their taxable income at \$50,000. The Clarks will be able to take up to \$18,000 from one or both of their traditional IRAs by year-end.

They will owe tax on these withdrawals at only 15%, as long as their taxable income remains no higher than \$68,000.

As mentioned, this strategy might not work well if you are under age 59½ because of the 10% early withdrawal penalty. However, several exceptions to the penalty exist, such as withdrawals to pay for qualified higher education costs.

**Example 2:** Harry and Sarah Watson are both 50 years old. For 2010, they project their taxable income at \$50,000. In 2010, they spend \$15,000 on college costs for their son, Jake. The Watsons can withdraw up to \$15,000 from their traditional IRAs and owe tax at only 15%; they will not owe the 10% penalty because of the exception for higher education costs.

### Partial Roth IRA conversions

Regardless of whether you can withdraw money from your traditional IRA, penalty free, you can convert it to a Roth IRA. That's the case no matter how old you are or how much income you have. Converting a traditional IRA to a Roth IRA will generate income tax, but you can tailor a conversion to fill up a tax bracket.

**Example 3:** Nora Greene is 35 years old and single. She has \$50,000 in her IRA, all from pretax contributions. Nora estimates her taxable income for 2010 at \$70,000. She can convert up to \$12,400 of her traditional IRA to a Roth IRA



in 2010 and remain in the 25% tax bracket. This way, Nora will owe only an additional \$3,100 on the conversion (25% of \$12,400) if she executes it this year. Nora fears she or her beneficiaries eventually may owe tax at higher rates on future withdrawals from her traditional IRA.

Nora decides to implement this plan. By the time she reaches age 59½, she can withdraw that entire amount from her Roth IRA, plus any investment earnings, tax free. Nora anticipates that she'll be in a much higher tax bracket by the time she retires and is ready to tap her Roth IRA.

By converting in 2010, Nora is able to choose between two tax efficient strategies. Next year, she can decide to pay the tax on her 2010 return at today's relatively low rates. Alternatively, Nora can opt to evenly divide the taxable income from the Roth IRA conversion between her 2011 and 2012 tax returns, which would defer complete payment of the tax due until 2013.

If you are interested in such tax effective strategies, our office can help you estimate your taxable income for 2010 and suggest ways to fill up lower brackets. ■

# Year-End Tax Planning for IRAs

**T**hrough 2009, you could convert a traditional IRA to a Roth IRA only if your modified adjusted gross income (MAGI) for the year was no greater than \$100,000 on a single or joint tax return. The \$100,000 cap came off in January 2010. Under current law, this change is permanent. Therefore, high income taxpayers can convert traditional IRAs to Roth IRAs in 2010, 2011, 2012, and so on. For taxpayers who would like to convert their traditional IRA to a Roth IRA, year-end 2010 presents multiple opportunities.

**Example 1:** Wendy Ames has \$200,000 in her traditional IRA that contains only pretax dollars. Wendy would like to invest in a Roth IRA because these accounts may permit tax-free withdrawals in the future, and Roth IRA owners don't have to take required distributions. Also, if she wishes, Wendy can leave her Roth IRA intact for her beneficiaries, who will have to take scheduled distributions but will owe no tax as long as the account is at least five years old.

## Crafting a conversion

If Wendy is debating whether to convert her traditional IRA to a Roth IRA in 2010 or wait until 2011 or later, a 2010 conversion offers several advantages:

- 1. Lower taxes.** Although Wendy will owe tax on the amount she converts, in this example, her traditional IRA has a much lower value now than it did in 2007 because of stock market declines. Therefore, a Roth IRA conversion now would generate a lower tax obligation than it would have created three years ago.
- 2. Lower tax rates.** A 2010 conversion also will lock in this year's income tax rates, which might be higher in the future.

## 3. Faster tax-free withdrawals.

Roth IRA withdrawals are tax free after five years and after age 59½. By converting in late 2010, Wendy will start the five year clock for tax-free withdrawals at January 1, 2010.

## 4. Future flexibility.

Taxpayers who convert to a Roth IRA in 2010 have a unique choice. In this example, Wendy can report the taxable income from her 2010 Roth IRA conversion on her 2010 tax return. Or she can take advantage of a special rule for 2010 conversions and report half of the income on her 2011 tax return and the remaining half on her 2012 return, thus obtaining a period of tax deferral.

## 5. Surtax relief.

Starting in 2013, some high-income taxpayers will owe a 3.8% surtax on investment income. If Wendy converts her traditional IRA to a Roth IRA, she will not have to make required minimum distributions in the future, and she may reduce her taxable portfolio to pay the income tax on her Roth IRA conversion. Consequently, Wendy might have lower gross income and lower taxable investment income in future years, which could reduce her exposure to the 3.8% surtax. Wendy can gain this advantage with a Roth IRA conversion in 2011 or 2012 as well, but a 2010 conversion also will provide the other advantages on this list.

## Taking action

Some taxpayers may choose to convert by year-end 2010 because they will have a chance to reverse their conversion. All Roth IRA conversions can be recharacterized by October 15 of the following year (October 17 in 2011); the account would revert to a traditional IRA, and the taxpayer

would receive a refund of any tax paid on the conversion.

**Example 2:** Tim Bradley decides to convert his \$100,000 traditional IRA to a Roth IRA in late 2010 to take advantage of a low IRA balance and today's relatively low tax rates. He pays the tax on \$100,000 of income on his 2011 tax return. In October 2011, Tim sees that his Roth IRA is worth \$125,000. He decides to leave his Roth IRA in place, with \$25,000 of tax-free growth in the account.

**Example 3:** Assume the same facts as in example 2, except that Tim's Roth IRA has declined to \$80,000 by October 2011. He recharacterizes the account to a traditional IRA and files an amended tax return for a refund. After waiting at least 31 days, Tim can reconvert this traditional IRA to a Roth IRA. If the account value has not changed materially in the interim, Tim will owe less tax on this Roth IRA conversion than he owed on his 2010 conversion.

## Being prepared

Taxpayers who are considering a Roth IRA conversion in the last quarter of 2010 should take the following steps:

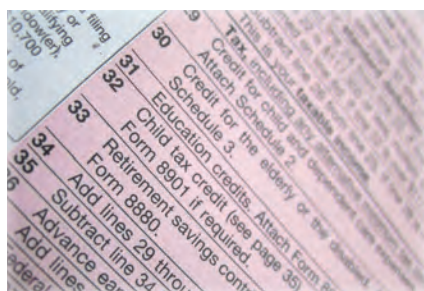
- ▶ First, evaluate the benefits of converting your traditional IRA to a Roth IRA. If you are concerned that upper income individuals and couples will pay much higher taxes in the future, you may want to convert your tax-deferred traditional IRA to a tax-free Roth IRA.
- ▶ Second, if you would like to have a Roth IRA, decide how much you are willing to convert. If you do a partial conversion, you will reduce your tax obligation.
- ▶ Finally, if you decide to convert your traditional IRA to a Roth

IRA and you have determined how much you'd like to convert, notify the custodian of your traditional IRA in advance. There may be a rush to convert to Roth IRAs at the end of 2010 as many

taxpayers seek to take advantage of the benefits mentioned previously. By notifying your IRA custodian in advance about your plans, you may be able to get your paperwork ready for a Roth IRA conversion

in late 2010. If you or a loved one face a similar decision, our office can help you make an IRA plan that's appropriate for your specific circumstances. ■

## Year-End Tax Planning for Itemized Deductions



When you fill out your tax return for 2010, you'll have to choose whether to itemize deductions or claim a standard deduction. If you itemize, you'll deduct certain amounts you spent this year on charitable donations, mortgage interest, and so on.

You may, instead, claim a standard deduction. For 2010, the standard deduction is \$11,400 for married couples filing a joint return; \$5,700 for singles and married individuals filing separately; and \$8,400 for heads of household. Taxpayers who are over age 65 receive an additional standard deduction: \$1,400 for single taxpayers and \$1,100 apiece for married taxpayers in 2010. Similar deductions are available to the blind. If you qualify on both counts, you'll get two deductions.

### Possible tax break

For 2010, you may need to consider another possibility when you decide whether to itemize or take the standard deduction. In previous years, homeowners could deduct up to \$500 of property tax paid, in addition to their standard deduction (married couples could deduct up to \$1,000). This tax break expired after

2009, but Congress is considering a bill to extend it into 2010, as of this writing. Regardless of how Congress acts on this issue, if you itemize deductions instead of taking the standard deduction, you generally can deduct all the property tax you pay.

### Making the choice

As year-end nears, you can determine whether you will be better off itemizing or taking the standard deduction this year. If you think you'll take the standard deduction, you may want to defer itemized deductions until 2011, when you might get a tax benefit.

**Example 1:** Wallace and Diane Franklin are both 66 years old. They own their home without a mortgage and pay \$2,000 per year in property tax. The Franklins expect to pay around \$4,000 in state income tax this year. They have not had significant unreimbursed medical expenses. So far this year, they have not made substantial charitable contributions.

Standard deduction for all couples filing jointly	\$11,400
Additional deduction for married people 65 and older	2,200
Special property tax deduction (if available)	1,000
<b>Total</b>	<b>\$14,600</b>

If the Franklins decide to take the standard deduction, their total will be either \$13,600 or \$14,600, depending on whether the real

estate property tax break has been extended.

If the Franklins decide to itemize, their deductions would include only \$4,000 in state income tax and \$2,000 in property tax—\$6,000 total. Thus, in this example, they would be much better off taking the standard deduction. Therefore, the Franklins probably should delay their usual year-end charitable contributions until January 2011 because they might save tax in 2011 by itemizing deductions. In contrast, taxpayers whose itemized deductions clearly will top the standard deduction amount generally should incur itemized deductions, such as charitable contributions, in 2010. Some taxpayers who owe the alternative minimum tax (AMT) will save tax by itemizing, even if their standard deduction exceeds their itemized deductions. Our office can help you decide.

### Healthier deductions

You can take steps to increase your deductions for 2010, if you decide to itemize rather than take the standard deduction. For instance, you can figure out whether you are likely to deduct medical costs this year. You can deduct such costs only to the extent they exceed 7.5% of your adjusted gross income (AGI).

**Example 2:** Melody Neale expects her AGI this year to be around \$100,000. Thus, she'll be able to deduct healthcare expenses over \$7,500: 7.5% of \$100,000. When Melody tallies her medical outlays for the year, she finds she already

has spent \$10,000, so she is over the threshold. She can go to the dentist, get doctors' checkups, buy prescription eyeglasses, and so on before December 31 and pay those bills with tax-deductible dollars.

On the other hand, suppose Melody's healthcare expenses are only \$4,000 for the year, through November. She can decide to postpone all elective medical procedures until 2011, when they might lead to tax deductions.

### Make the most of miscellany

You should approach miscellaneous itemized deductions in the same manner. Such deductions include outlays for tax preparation, unreimbursed employee business expenses, investment expenses, Roth IRA losses, and 529 college savings plan losses. You add up all of those items and take deductions to the extent they exceed 2% of your AGI.

**Example 3:** Gary Roberts expects his AGI this year to be around \$150,000. Therefore, he'll be able to deduct miscellaneous itemized deductions over \$3,000: 2% of

\$150,000. As of early December, Gary finds that his miscellaneous deductions for 2010 are already at \$4,000; thus, further expenses will be deductible. Before year-end, he can pay for investment publications and software with tax-deductible dollars. If Gary closes out his sole Roth IRA and sole 529 account for losses this year, those losses also will be deductible on his 2010 tax return.

On the other hand, if Gary has only a few hundred dollars in miscellaneous costs in 2010, he may decide to incur additional miscellaneous costs in 2011, when they might be more valuable.

### Adjusting for the AMT

Your strategies for itemized deductions will be different if you are subject to the AMT. Increasingly, moderate and upper income taxpayers owe the AMT in addition to regular tax; our office can tell you if you will pay the AMT this year. Taxpayers who are subject to the AMT can deduct medical costs only to the extent those costs exceed 10% of AGI, rather than 7.5% of AGI.

Therefore, your decision on whether to incur elective medical bills by year-end will be based on whether they'll be greater than 10% of your AGI, not 7.5%.

If you are subject to the AMT, you won't be able to take miscellaneous itemized deductions, no matter how much you spend. Therefore, if you will owe the AMT this year, you shouldn't close out Roth IRAs or 529 college savings plans at a loss because you won't get any tax benefit. Instead, wait until next year to see if those tax-favored accounts recover—or if you'll escape the AMT in 2011 and perhaps be able to deduct miscellaneous expenses.

Just as you can't take miscellaneous itemized deductions for AMT purposes, you also can't deduct state and local tax payments. Taxpayers who itemize deductions may decide to prepay in 2010 any property tax or state and local income tax due in early 2011 to get a current deduction. However, if you will owe the AMT in 2010, you might as well wait until those tax payments are due in early 2011 because you might be able to deduct them on your 2011 return. ■

## Tax Strategies for Unmarried Couples

Typically, married couples pay lower taxes if they file joint returns rather than filing separately. However, if a couple is living together but not married, the two taxpayers can't file jointly. Nevertheless, there are ways for unmarried cohabitants to reduce the household's income tax bill.

### Determining the deductions

The higher your tax bracket, the more tax you'll save from a deduction that reduces your income.

**Example:** Alice Johnson expects to have around \$200,000 in taxable income this year, which will put her

in a 33% federal tax bracket. She lives with Richard Smith, who expects to have taxable income of \$50,000, which will put him in the 25% tax bracket.

This couple decides to contribute \$1,000 to their favorite charity. If Alice writes the check, she'll reduce her taxable income by \$1,000 and save \$330 in tax, at a 33% rate. If Richard writes a \$1,000 check, he'll save only \$250. Therefore, it makes sense for Alice to make the couple's charitable donations.

Similarly, if this couple uses a mortgage to buy a home, Alice should write the checks to take the deduction

at her tax rate. If they take out the mortgage loan together, it is a good idea for Alice to contact the lender to make sure that her Social Security number is on the report of mortgage interest that it files with the IRS.

### Alternative solutions

In keeping with the previous example, in most cases Alice should also pay the real estate property tax to get the deduction in her higher tax bracket. However, Alice may find herself subject to the alternative minimum tax (AMT). Many moderate income and high income taxpayers owe the AMT if they use certain tax credits

and deductions. Taxpayers who are subject to the AMT are allowed no federal tax deductions for state or local tax payments. As long as Richard is a coowner of the house and not subject to the AMT, he can pay the property tax bills and take deductions to cut his federal income tax.

Richard also should pay for items that qualify as miscellaneous itemized deductions, such as investment publications and tax preparation software. Miscellaneous deductions only save tax to the extent that they exceed 2% of your adjusted gross income, and Richard is more likely to clear that hurdle than Alice.



### Capital idea

For some unmarried couples, income differences may be even greater than they are for Alice and Richard. One partner may earn income while the

other stays home to manage the household. In such situations, the high bracket partner might transfer appreciated assets to the low bracket partner before an intended sale. As long as the low bracket partner has taxable income of no more than \$34,000 (in 2010), any gains on assets with a holding period longer than one year will not be taxed.

Transfers of assets between unmarried partners may have gift and estate tax consequences. Our office can help with those issues as well as other tax matters that may arise for unmarried couples. ■

## Plan for Your Healthcare

# How the New Health Insurance Laws Will Affect You Now

**P**resident Obama has signed into law the Patient Protection and Affordable Care Act of 2010 along with the Health Care and Education Tax Credits Reconciliation Act of 2010. These two new laws will dramatically change health insurance in the United States.

Together, the new legislation includes more than 2,000 pages and many provisions. The most prominent features of the new laws may be the requirement for individuals to purchase health insurance and federal subsidies to help some people with low or moderate income pay for the required coverage. Those provisions won't be effective until 2014, however.

Provisions of the new legislation that are effective immediately or later this year generally place restrictions on health insurers. Insurance companies

- ❖ won't be able to limit lifetime payouts to specific policyholders.

- ❖ must comply with annual payout limits, which will be described by federal regulations.
- ❖ won't be allowed to drop policyholders; however, they will be able to cease coverage for individuals who commit fraud or intentional misrepresentation.
- ❖ must cover preventive services such as checkups without copays, coinsurance, or deductibles.
- ❖ can't exclude children from coverage because of pre-existing medical conditions.
- ❖ must allow children to remain on their parents' policies until they reach age 26.

Additionally, two programs will be established in 2010 and remain in effect through 2013. One of these programs enables adults with pre-existing medical conditions to obtain health insurance in a high risk pool. The other will assist companies in maintaining health coverage for former employees between ages

55 and 65, until they qualify for Medicare.

Also, the federal government will pay a \$250 rebate in 2010 to Medicare beneficiaries who reach the so-called "donut hole" for the year. Many Medicare enrollees buy a Part D plan to provide coverage for prescription drugs. After they spend \$2,830 for prescription drugs under the plan (in 2010), these seniors must pay full price until they reach \$4,550 in outlays and insurance coverage resumes. This coverage gap is the donut hole. Other provisions in the new legislation will completely close the donut hole by 2020.

### New tax credit

One provision effective for 2010 is a tax credit for small companies that provide health insurance to employees.

*Which companies qualify?* To get the full tax credit, a company must have 10 or fewer employees and the average annual wage must be less

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than \$25,000. Partial credits are available to companies with as many as 25 employees and average wages up to \$50,000.

*What are the credits worth?* The maximum credit is 35% of premiums paid. The calculation is far from simple, though. Only nonelective employer contributions count as premiums paid. That is, contributions made to a salary reduction arrangement under a cafeteria plan don't count. The nonelective contributions must then be compared to the average health insurance premium for the small group market

in the company's state. The smaller number will be used as the base for determining the tax credit.

**Example:** ABC Corp. has 8 full time employees and a total payroll of \$190,000 per year (an average of \$23,750 per employee per year). The company pays \$20,000 a year for employee health insurance, a number that is smaller than the state average for small groups. Therefore, the company qualifies for a tax credit of \$7,000 in 2010, 35% of \$20,000.

In calculating the tax credit, premiums paid to cover some employees don't count. This group includes

seasonal workers, self employed individuals, shareholders who own 2% or more of an S corporation, and owners of 5% or more of a small business. Premiums paid to cover this group's dependents or other household members won't count either. Our office can help you determine whether your business qualifies for this tax credit and make the required calculation.

As previously mentioned, these tax credits will be offered from 2010 through 2013. Starting in 2014, a new program will take effect, offering tax credits of up to 50% of premiums paid. ■

## The Coming Cost of Health Insurance



**S**ome provisions of the two new health insurance laws passed by Congress and signed by President Obama take effect in 2010, as mentioned in the article "How the New Health Insurance Laws Will Affect You Now" in this issue. Generally, however, the new legislation will phase in over the next decade. In 2014, one of the major provisions of the new legislation will take effect: most people will be required to have health insurance.

Three primary ways to fulfill this requirement would be enrollment in Medicare or Medicaid, coverage by an employer-sponsored health plan, or purchase of any health insurance plan or policy marketed to individuals as long as the plan primarily covers medical benefits. You can't comply with this future legislative requirement, however, by buying long-term care insurance.

### Paying the penalty

What if 2014 arrives and you have no health insurance? You'll have to pay a penalty on your federal income tax return. This penalty will be the greater of (1) a flat dollar amount or (2) a percentage of the excess of your household income over the threshold amount of income required for filing a return for your filing status, both of which will be phased in over the course of three years. In 2014, the flat dollar amount will be \$95 per adult and the income percentage will be 1%. In 2015, the penalty increases to \$325 per adult for the flat dollar amount and 2% for the income percentage amount. By 2016, the penalty will be fully phased in with a flat dollar amount of \$695 per adult and an income percentage of 2.5%. In subsequent years, the \$695 number will be indexed for inflation while the income percentage will remain at 2.5%. Each year, the flat dollar amount for uninsured minors will be one-half the adult fine. The flat dollar amount per family is capped at three times the adult fine for the year.

**Example 1:** In 2014, Jim Smith decides not to carry any health insurance for himself, his wife, and his

two young children. His household income less his filing threshold amount for the year is \$50,000.

The Smiths' flat dollar penalty amount is \$285 for two adults and two minors ( $[\$95 \times 2] + [\$47.50 \times 2]$ ) in 2014. Their income percentage amount is \$500: 1% of his 2014 income. Because the income-based penalty is greater, they would owe a tax penalty of \$500 in 2014 for not having health insurance.

**Example 2:** Assume the Smiths do not buy health insurance in 2016, and their income remains the same. Their tax penalty would be the greater of (1) a flat dollar amount of \$2,085, for two adults at \$695 per adult and an additional \$695 for the two minors combined; or (2) \$1,250, which is 2.5% of \$50,000. Thus, the Smiths would owe a tax penalty of \$2,085 in 2016.

### Month by month

The tax penalty for not buying health insurance will be applied on a monthly basis. Suppose the Smiths decide to buy family coverage halfway through 2016. As explained in example 2, their full year tax penalty would have been \$2,085; however, because the Smiths have insurance

for half the year, they will owe half the full year tax penalty, \$1,042.50.

### Weighing the tradeoff

Some people might decide not to buy health insurance and pay the tax penalty instead. Such choices may be especially common in 2014 and 2015 while the tax penalties are being phased in, but some people may opt for going without health insurance in 2016 and beyond.

For example, a family with \$100,000 in household income subject to the penalty probably would owe a \$2,500 penalty in 2016. Assuming that the family is in good health and doctor visits are rare, their annual healthcare costs, including the tax penalty, might be much less than the cost of buying health insurance. If they do get sick or injured, they can buy health insurance then. As of 2014, legislation prohibits insurance

companies from denying applicants because of pre-existing conditions.

When this provision of the new legislation takes effect, you can decide whether to buy coverage or pay the penalty. Your choice probably will depend on your family's health and the prevailing rates of health insurance premiums. Looking ahead, our office will be able to go over the numbers with you so that you can make an informed decision. ■

## Tax Credits May Help Pay for Health Insurance

**S**tarting in 2014, the law will require most individuals and families in the United States to have health insurance. To help low and middle income consumers purchase the required coverage, the federal government will provide premium assistance tax credits. These tax credits are refundable. This means if someone qualifies for tax credits that exceed his or her tax obligation, the federal government will send the excess to the insurance company providing the coverage, as explained in example 1.

### Who gets the tax credits?

These tax credits will be provided to individuals and families with household income up to 400% of the federal poverty level (FPL) who purchase a qualified health plan on an insurance exchange. Currently, the FPL in the 48 contiguous states and D.C. (the continental United States) is annual income up to about \$11,000 for an individual and \$22,000 for a family of four (the FPL is higher for residents of Alaska and Hawaii). Therefore, if this portion of the new law were to take effect today, tax credits would be provided to individuals in the continental United States with income up to approximately \$44,000 and to families with income up to \$88,000. Those numbers may be higher in 2014.

### How large will the credits be?

Premium assistance tax credits will drop as income increases. Using today's FPL, a family of four in the continental United States with income of approximately \$29,000 or less (about \$14,500 for individuals) would get the maximum tax credit. A family with income of approximately \$66,000 to \$88,000 (\$33,000 to \$44,000 for individuals) would get the smallest tax credit.

To determine the credit amount, a certain percentage of household income will be deemed to go toward health insurance. The percentage increases with income, from 2% to 9.5%, under the new legislation. If the price of a standard policy exceeds that amount, tax credits will make up the difference.

**Example 1:** Ellie and Greg Larsen are married with two young children, living in Ohio. In 2014, their household income is \$40,000, which is 150% of the FPL that year. Under the new laws, the Larsens are expected to spend 4% of their income on health insurance, \$1,600, in 2014.

A standard policy for a family of four where the Larsens live costs \$1,000 a month. That's \$12,000 a year. Therefore, they would receive a \$10,400 tax credit: the assumed

\$12,000 cost of coverage minus the \$1,600 the Larsens are expected to spend. If the Larsens end up owing only \$2,400 in federal income tax, that tax would be completely offset by the \$10,400 credit and the excess \$8,000 would be paid to the Larsens' health insurance company.

Families with income of 300% to 400% of the FPL will go through a similar calculation, except that they will be expected to pay 9.5% of their income on health insurance. A family with income of \$80,000, for example, would be expected to spend \$7,600 on health insurance. If a standard policy costs \$12,000 a year, this family would get a \$4,400 tax credit.

### Complicating factor

Premium assistance tax credits certainly will reduce tax obligations for many people. At the same time, they may increase effective marginal tax rates for recipients of the credits. As income increases, credits may decline.

**Example 2:** In the previous example, the Larsens have income of \$40,000 and a tax credit of \$10,400. Suppose their younger child starts school full time, so Ellie (who has been a homemaker) has an opportunity to go back to work at a salary of \$60,000. This additional income might remove their eligibility

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## Trusted Advice

### Health Savings Accounts: Still Viable

- To have a health savings account (HSA), you must have high deductible health insurance. With a high deductible, your premiums may be relatively low.
- With qualifying health insurance, you can make a tax deductible contribution to an HSA. You can make a one-time contribution or multiple contributions over the course of a year, up to the HSA limit.
- In 2010, the maximum HSA contribution is \$3,050 for an individual and \$6,150 for a family plan. The family contribution can be divided between spouses.
- If you're 55 or older, the maximum contributions in 2010 are \$4,050 for an individual and \$7,150 for a family.
- Investment earnings inside the HSA aren't taxed.
- HSA withdrawals are tax free if the money is spent on healthcare.
- The new health insurance legislation prohibits tax-free withdrawals to pay for over-the-counter drugs, starting in 2011. This mandate applies to HSAs as well as to flexible spending arrangements (FSAs).
- Also in 2011, the penalty tax on nonmedical deductions from HSAs increases from 10% to 20%.

for the tax credit. Not only would Ellie's earned income be subject to income tax, it would cost them a \$10,400 tax credit, an effective tax of more than 17% on her new income, in addition to regular income tax.

For many people, such calculations may affect decisions on whether to

go back to work, take extra freelance assignments, work overtime, and so on. Even if your income is over the threshold for such tax credits, your adult children and grandchildren may have to include premium assistance calculations in their plans. ■

## Additional Tax Provisions

Several other provisions of the new health insurance legislation have tax implications. They include the following:

- ▶ **Employer coverage.** Businesses with 50 or more full time employees must offer health insurance plans. If they don't, they'll owe a tax. To calculate the tax, the company will subtract 30 from its number of full time employees, then multiply the difference by \$2,000 a year. Effective date: 2014.
- ▶ **Cadillac plans.** This phrase applies to expensive employer provided health plans with extremely generous benefits. The new legislation deems a plan that costs more than \$10,200 a year (for individuals) or \$27,500 a year (for family coverage) a high cost plan and imposes a 40% tax on costs above those amounts. The employer, the plan administrator, or the insurer will owe the tax, depending on the type of plan. Effective date: 2018.

Congress inserted this provision to limit the growth of lavish group health insurance benefits. Such benefits are tax free to employees. Lawmakers hope that employers will pay cash compensation instead—compensation that is subject to income tax.

- ▶ **Income tax deductions.** Taxpayers who itemize deductions on their income tax returns can deduct medical expenses that exceed 7.5% of their adjusted gross income (AGI). That threshold will rise to

10% of AGI. Effective date: 2013 (The threshold remains 7.5% in the years 2013 through 2016 for taxpayers who are age 65 and older or reach age 65 before the end of the tax year.)

- ▶ **IRA distributions.** Taxpayers who take money from their IRAs before age 59½ generally owe a 10% penalty in addition to regular income tax. There are several exceptions to this penalty, including amounts spent on medical care that exceed 7.5% of AGI.

**Example:** Ashley Grant, age 55, has AGI of \$100,000 and spends \$12,000 this year on unreimbursed medical expenses. Her 7.5% threshold is \$7,500 so the excess is \$4,500. Thus, Ashley can take up to \$4,500 from her IRA this year without owing the 10% penalty.

Under the new legislation, the threshold will rise to 10% of AGI. For Ashley, that would be \$10,000 (10% of her \$100,000 AGI) so her penalty-free IRA withdrawals would be reduced to \$2,000. Effective date: 2013.

**Flex plans.** Many employers offer cafeteria plans, also known as flexible spending arrangements (FSAs). These plans allow employees to pay certain expenses, including healthcare costs, with pretax dollars. At many companies, employees can contribute up to \$5,000 of compensation to healthcare FSAs. The new laws will limit annual healthcare FSA contributions to \$2,500. Effective date: 2013. ■

## Plan for Your Business

# You and Your Company Can Avoid the Disguised Dividend Tax Trap

If you are the owner or part owner of a C corporation, you might think that your compensation plan is relatively straightforward. You pay yourself a salary to cover your living expenses during the year. At year-end, if your company has made money, you pay yourself a bonus. Your company deducts the salary and bonus so it winds up with little or no net income and pays little or no corporate income tax.

In such a scenario, you might be in for a shock. The IRS could say that your compensation is unreasonable. Part of your compensation may be recast as a dividend, subject to both corporate and personal income taxes.

**Example:** Grace Moran owns 100% of ABC, a C corporation. She pays herself a salary of \$10,000 a month, or \$120,000 a year. In December 2010, Grace pays herself a \$300,000 bonus. ABC reports no taxable income for 2010, and Grace pays personal income tax on her total income of \$420,000.

The IRS examines ABC's corporate return and decides that Grace's \$120,000 salary is reasonable compensation for her efforts. The other \$300,000 is classified as a dividend, bringing ABC's corporate income up to \$300,000 for the year. Counting state and federal taxes, ABC owes about \$100,000 in corporate income tax. Grace, meanwhile, also has to pay personal income tax on both the \$300,000 dividend and her \$120,000 salary.

### Sidestepping the snare

With careful planning, your C corporation can avoid this tax trap. Possible strategies include



- ❖ **creating a formal compensation plan.** Your corporate minutes can explain the plan and report its adoption. Such a plan might call for owner-executives to receive a salary plus a bonus that's determined by financial goals, such as revenues, profits, and market share. If you worked for years with little compensation, helping your company to grow, your minutes might state that some of your compensation is a makeup for prior sacrifice.
- ❖ **using external comparisons.** Your compensation plan might refer to an industry study indicating that executives at other companies in your field are paid amounts comparable to those you are likely to receive. You might get such data from an industry association.
- ❖ **paying some corporate income tax.** In the previous example, Grace could pay herself a \$200,000 or \$250,000 bonus, rather than a \$300,000 bonus. That would leave some money in the company subject to corporate income tax. On the first \$75,000 of corporate income, your company will pay only 15% or 25% in federal corporate income tax.
- ❖ **paying some dividends.** Taking some profits as double-taxed

## Trusted Advice

### Bonuses That Look Like Dividends

- A closely held C corporation should avoid pro rata bonuses that look like dividends.
- Suppose Ann Walker owns 70% of XYZ Corporation, and Brad Taylor owns 30%. XYZ has net income of \$250,000 in 2010.
- The coowners decide to leave \$50,000 in the company. Of the remaining \$200,000, XYZ pays a \$140,000 (70%) bonus to Ann and a \$60,000 (30%) bonus to Brad.
- The IRS could say that these "bonuses" look like a division of corporate profits. The bonuses might be recast as dividends, subject to both personal and corporate income tax.
- C corporations should adopt a performance-based plan for distributing executive bonuses.

dividends can indicate you are not "zeroing out" corporate income to avoid tax.

- ❖ **making an S corporation election.** Your company must meet several criteria (for example, it can have only one class of stock). But, if your company meets these criteria and makes the election, it will be an S corporation and, therefore, will not be subject to corporate income tax. ■

# Tax Breaks for Business Driving

The IRS has announced optional standard mileage rates for tax deductions in 2010. The rates are 50 cents per mile for business driving, 16.5 cents per mile for medical or moving, and 14 cents per mile for charitable volunteer work.

**Example:** Elly Morgan drives her own car 7,000 miles for business in 2010. She also drives 500 miles for medical purposes, such as driving to doctors' appointments. In addition, Elly drives a total of 600 miles to a local charity where she volunteers.

Elly may be able to deduct \$3,500 for business mileage: 50 cents times 7,000 miles. She also may be able to deduct \$82.50 for her medical miles (500 times 16.5 cents) and \$84 for her charitable driving (600 times 14 cents).

## For the record

Taxpayers such as Elly who drive a car for business purposes have two ways to support their deductions in case of an IRS challenge. The first is the actual expense method. With this technique, you must tally all of your car-related expenses for the year. They include gas, oil, repairs, tires, insurance, registration fees, licenses, and depreciation (or lease payments).

You also must keep a log to determine how much of that driving is related to business. (Driving to and from work doesn't count as business mileage.) If Elly's log shows that she

drives her car 10,000 miles a year, including 7,000 business miles, then 70% of all of her auto-related costs are tax deductible.

The second way to support a deduction for business driving is the standard mileage rate method described previously. Many people prefer this method because they don't have to do as much record keeping. All Elly needs to do is log the total number of business miles she drives, then multiply that number by the standard rate, which is 50 cents per mile in 2010.

With either method, you can add business-related tolls and parking to your deductible expenses for the year.

If you don't mind keeping extensive records of your auto expenses, you might find that the actual expense method provides a larger tax deduction than the standard mileage rate method. However, you may not be allowed to choose between methods in a given year.

**For a car that you own,** you can use the standard mileage rate method only if you use it the first year the car is available for business use. Then you can use either method in subsequent years.

**For a car that you lease,** you can use the standard mileage rate method only if you use it for the entire time you lease the car.

## Deduction requirements

You will find it relatively easy to deduct business driving expenses if you report business income on Schedule C of your tax return as a sole proprietor. That Schedule has a line for car and truck expenses.

If you are an employee, you will have to clear some hurdles to deduct any driving costs. You can deduct only unreimbursed employee business expenses. Therefore, if your employer fully reimburses you for your business driving, you can't take any deduction. If your employer provides partial or no reimbursement, you can report your unreimbursed driving expenses as a miscellaneous itemized deduction. (If your employer reimburses employees at a rate higher than the 2010 standard mileage rate, the excess over 50¢ per mile will be additional income to you, subject to income and payroll taxes.)

Other miscellaneous deductions include investment-related expenses and tax preparation fees. If the total of your miscellaneous deductions exceeds 2% of your adjusted gross income, the excess is tax deductible. However, you can't take any miscellaneous deductions (including unreimbursed employee driving expenses) if you owe the alternative minimum tax.

You should also keep a log to substantiate deductions for qualified medical, moving, and volunteer driving. ■

## Plan for Your Estate

### Win the Giveaway Game

So far in 2010, the federal estate tax is not in effect. However, the federal gift tax is still in place. You are allowed to give up to \$13,000 worth of assets to each of any number of recipients. If you make larger gifts, you'll have to file a gift tax return.

Gifts over the \$13,000 limit also may eat into a future estate tax exemption. (Direct payments of someone else's medical bills or school tuition won't count towards those gift tax limits.) In 2010, the gift tax rate is 35%, down from 45% in 2009.

If you decide to make gifts, cash gifts are best. They're simple to value and pose no tax traps. If you give away cash you're holding in a bank account or a money market fund, you'll give away the future income tax obligation on the interest

income. When you make gifts to a lower-income recipient such as a grandchild or an elderly parent, you'll probably lower the family's overall income tax bill.

### Strategies for securities

If it's not practical to give cash, you can give away stocks, bonds, fund shares, or other securities. However, you should not give away assets trading at a loss. Instead, sell them first to take a capital loss; such losses can offset capital gains and provide deductions

of up to \$3,000 a year. After taking your loss, you can give away the cash from the sale.

When you give away highly appreciated securities, your holding period and your basis (your cost, for tax purposes) is transferred along with the asset.

**Example:** Miriam Goodwin holds shares of stock valued at \$20,000, with a basis of \$6,000. She gives \$10,000 worth of the stock to her grandson Ned and \$10,000 worth to her granddaughter Rachel. Each of

the grandchildren has \$3,000 of basis in his or her shares.

If either of her grandchildren sells the shares, he or she would have a \$7,000 long-term capital gain. This way, Miriam avoids the tax and her grandchildren may owe less tax on the sale. At least through 2010, some taxpayers have a 0% tax rate on dividends and long-term capital gains. Single filers with up to \$34,000 in taxable income and couples filing jointly with income up to \$68,000 can use the 0% rate. ■

## New Tax Breaks Make Long-Term Care Packages More Appealing

If you'll need to go into a nursing home some day or hire a caregiver in your own home, you'll probably have to pay substantial amounts. Long-term care (LTC) insurance policies are available, but many people are reluctant to buy this coverage.

Fortunately, several provisions of the Pension Protection Act of 2006 just took effect in 2010; they can make it more practical to obtain LTC insurance by combining it with life insurance or an annuity.

### Use it or lose it

Depending on the level of coverage you select and how old you are when you buy an LTC insurance policy, you might pay more than \$2,000 a year. Married couples could pay over \$4,000 to cover both spouses. That's a considerable expense for many people, especially retirees who are living on a fixed income.

Moreover, you'll pay those thousands of dollars without a guarantee that you'll get any benefits from your LTC insurance. Some seniors use little to none of their long-term care benefits during their lifetimes. Paying steep premiums

for an LTC insurance policy you'll never use is less than desirable. You may wish to look for another type of coverage.

### Combination coverage

As an alternative to a "straight" LTC policy, you can obtain LTC coverage as an addition to your life insurance policy. That way you'll know that at least someone will benefit from the premiums you pay.

**Example 1:** Steve Clark buys a \$500,000 insurance policy on his life, payable to his two children. He chooses to add an LTC rider to this policy. If Steve needs care, the policy will pay a benefit to help him with the cost. However, such payments probably will reduce the death benefit that Steve's children eventually will receive.

If Steve never needs long-term care, his children will receive the life insurance policy's full death benefit when he dies. Therefore, the premiums that Steve pays for this policy eventually will generate a payout.

You also can buy a deferred annuity with an LTC rider. A deferred annuity is an investment that can earn income

## Trusted Advice

### Long-Term Care Qualifications

- The new tax benefits for long-term care (LTC) insurance are available only if the policy is "tax-qualified."
- To be tax-qualified, a policy must pay benefits only when a licensed health care practitioner asserts that at least two activities of daily living (ADLs) can't be performed without substantial assistance.
- ADLs include eating, bathing, dressing, getting in and out of beds and chairs, and using the bathroom.
- For people who can perform their ADLs, an LTC policy may be tax-qualified if it pays benefits in cases of severe cognitive impairment.
- The conditions requiring care must be expected to last for at least 90 days.
- Most LTC insurance policies now sold are tax-qualified.

but delays income tax until you withdraw money.

**Example 2:** Janette Rogers invests \$100,000 in a deferred annuity and selects an LTC rider. As is the case with all deferred annuities, any earnings on that \$100,000 will not be taxed until Janette takes money from the annuity. The LTC rider will pay Janette a benefit if she needs care; however, such payments will reduce the amount of money available to Janette as an annuity.

If Janette does not need long-term care, she will be able to tap the full amount of the deferred annuity for living expenses. Depending on the choices Janette makes with her deferred annuity, her beneficiaries may receive a benefit upon her death. By choosing an annuity/LTC insurance combination product, Janette gets LTC coverage along with the assurance that her premiums ultimately will deliver a financial benefit.

### Delayed gratification

Life insurance/LTC insurance and annuity/LTC insurance combination products have been around for a while. They were enhanced by several of the

recently effective tax provisions of the Pension Protection Act of 2006.

- ▶ *Annuities with LTC riders are explicitly recognized in the tax code.* Previously, the tax benefits of life insurance/LTC policies were spelled out but annuity/LTC combinations didn't garner the same recognition. The new law makes it clear that annuities with LTC riders can make tax free payments for coverage under the LTC rider.
- ▶ *Internal cash transfers can be tax free.* In many of these combination products, you pay a premium for the life insurance policy or the annuity, and then the company makes a bookkeeping entry that pays for LTC coverage. Under prior law, you might have been taxed as though money had been withdrawn from the life insurance policy or annuity. The new law removes the tax on such phantom income.
- ▶ *LTC insurance joins the 1035 club.* For many years, Section 1035 of the tax code has allowed consumers to make tax-free exchanges of life insurance policies and annuities. Now, LTC insurance policies also are on the list.

**Example 3:** Phil Allen owns a deferred annuity that he no longer needs. Phil can exchange this annuity for an LTC insurance policy. To effect the exchange, Phil can apply for an LTC insurance policy. Once the LTC insurance company approves Phil's application, he can transfer his annuity to the LTC insurer, which will surrender the annuity and use the money it receives to fund the LTC insurance policy. Phil won't owe tax on any earnings accumulated within the deferred annuity.

The new law allows an exchange into an LTC insurance combination product or a policy that provides only LTC insurance. Either way, you're using money that you've already spent to buy LTC coverage.

All LTC insurance products can be complex. Combining them with life insurance or annuities may make them even more difficult to understand. If you are interested in LTC coverage, working with an experienced insurance agent is a good idea. Our office can help clarify the costs and possible benefits of a particular policy while reviewing the impact of the new tax provisions. ■

## Plan for Your Investments

### Year-End Tax Planning for Investors



**F**or 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 or 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.

### 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 a repurchase or immediately buying 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.

*continued on page 18*

## Looking backward

As mentioned previously, you can deduct up to \$3,000 worth of net capital losses on your tax return and carry forward excess losses to future years. Therefore, you should check your 2009 tax return to see if you're carrying forward any unused capital losses. You'll find that information on

Schedule D of Form 1040. If you have such losses from the 2008 bear market or prior years, you can take gains to soak them up without paying any taxes out of pocket.

**Example 3:** Louis Ward has \$20,000 worth of loss carry-forwards from previous years. He hasn't taken any capital gains or losses this year.

If Louis generates \$17,000 in net capital gains by the end of 2010, his loss carry-forwards will offset the tax on those gains. He can deduct the remaining \$3,000 of net loss against his 2010 ordinary income, reducing his existing taxable income for the year and his resulting tax obligation. ■

## Year-End Tax Planning for Mutual Funds

If you invest in mutual funds, proceed cautiously at year-end. At this time of year, funds may distribute any net capital gains for 2010 to their shareholders. These distributions are taxable to investors (unless the fund is held in a tax-favored retirement account), and the share price typically drops to reflect the distribution.

**Example 1:** Caitlin Carter invests \$10,000 in Mutual Fund ABC in early December 2010. She acquires 500 shares at \$20 apiece. One week later, ABC makes a \$2-per-share capital gain distribution, and the share price drops to \$18. Caitlin owes tax on a \$1,000 capital gain distribution (\$2 per share  $\times$  500 shares)—even though the distribution is essentially a return

of her own money. Therefore, if you are going to invest in a mutual fund between now and December 31, 2010, you may be better off waiting until after any distribution. You might be able to avoid this tax trap and buy at the post distribution reduced trading price. Check the fund's website for information about capital gain distributions; if the fund won't distribute capital gains because of bear market losses, you can buy at a time of your choosing.

If you are thinking of selling mutual fund shares, on the other hand, you may decide to advance your plans if you learn that your fund will make a capital gain distribution.

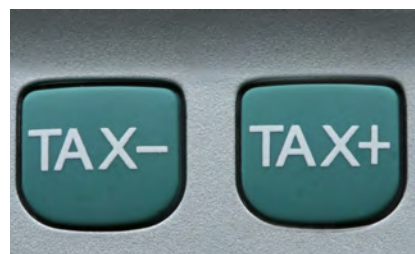
**Example 2:** Steve Davis invested \$10,000 in Mutual Fund XYZ many years ago. He now owns 700

shares of the fund, trading at \$25, for a total of \$17,500. Steve wishes to take his gains in 2010 while the maximum tax rate on long-term gains is 15%. On the XYZ website, Steve sees that a \$3 per share distribution is planned for December 15, 2010. The fund estimates that \$2.50 per share of that distribution will be in the form of short-term capital gains from last winter's rally. Thus, if Steve holds onto his shares, he will receive a distribution of \$2,100 ( $\$3 \times 700$  shares), most of which will be taxed in his 28% ordinary income tax bracket as short-term capital gains.

Instead, Steve sells before XYZ's distribution. With a \$10,000 cost basis and a \$17,500 selling price, Steve will have a \$7,500 long-term gain, all of which will be taxed at only 15%. ■

## Taxes on Bonds Bought at a Premium or a Discount

The taxation of bond interest is relatively straightforward. Assuming the bonds are held in a taxable account, the interest on corporate bonds is generally subject to all income taxes: federal, state (if applicable), and local (if applicable). Treasury issues pay interest that's subject to federal income tax but not state or local tax. Most municipal bonds pay interest that's exempt from federal income tax. If you buy a bond issued in your home state, you probably will avoid all tax on the interest income.



### Plus or minus

You may have a more difficult time figuring capital gain or loss on a bond, however. Bonds are issued at so-called par value (for example, \$1,000 per bond). Then prices

fluctuate as interest rates move up or down. Therefore, when you buy a bond, you may be buying at a premium or a discount to par.

**Example 1:** Corporation ABC issued bonds at a \$1,000 par value. The interest rate was 5%, or \$50 per year, per \$1,000 bond. Since then, interest rates on similar issues have moved up to 6%. Therefore, investors are less interested in ABC's bonds; they'll pay less for a bond with a below-market yield. To attract investors, ABC's bonds

sell for \$940, in this hypothetical example. Investors can buy the bond at a discount to par value.

**Example 2:** Municipality XYZ issued bonds at \$1,000 par value. The interest rate was 4%, or \$40 per year, per \$1,000 bond. Since then, interest rates on similar issues have moved down to 3%. Therefore, investors are more interested in XYZ's bonds. They'll pay more for a bond with an above-market yield. To reflect the increased demand from investors, XYZ's bonds sell for \$1,060, in this hypothetical example. Investors must pay a premium over par value to buy these bonds.

### Paying a premium

Today, most bonds have low effective interest rates, reflecting a low-yield environment. If you buy a bond issued years ago, chances are that you're paying a premium.

**Example 3:** Sue Walker buys \$10,000 worth of Municipality XYZ's tax-exempt bonds for \$10,600. The bonds mature in six years. Each year, Sue's basis in the bonds drops. The actual calculation is complicated and will be done by Sue's broker. To simplify this example, assume that Sue's bonds are amortized (decline in basis) by \$100 per year. She gets no tax benefit for the amortization of her municipal bonds.

After two years, Sue's basis in the bonds will drop by \$200, from \$10,600 to \$10,400. If Sue sells those bonds then for \$10,500, she will have a \$100 long-term capital gain; if Sue sells them for \$10,100, she will have a \$300 long-term capital loss.

The rules on buying a taxable bond at a premium are different.

**Example 4:** Sue Walker buys \$10,000 worth of Corporation UVW's taxable bonds for \$10,600. These bonds mature in six years. With taxable bonds, you can choose whether to amortize the premium you've paid. If Sue chooses to amortize, she will recognize a partial loss each year, offsetting taxable interest income.

If you do not amortize a premium you've paid, the premium will be included in your basis, so you'll have a larger capital loss when you sell or redeem your bonds (or a smaller taxable gain if interest rates fall and you sell at a profit). You typically should make the election to amortize if you've bought taxable bonds at a premium because you'll get more tax savings.

### Dealing with discounts

If interest rates rise from today's low levels, recently-issued bonds will lose value, and you'll be able to buy them at a discount. Bonds trading at a discount due to interest rate fluctuations are called *market discount bonds*. Regardless of whether you buy a taxable or tax-exempt bond at a discount, you'll owe tax at maturity, unless you elect to report the accrued market discount in your income annually.

**Example 5:** Jim Miller buys \$10,000 worth of bonds for \$9,400. They mature in 2016, and Jim collects \$10,000. He will have \$600 of ordinary income, taxed at the same rate as he would pay on investment interest. That's true for tax-exempt or taxable bonds.

Suppose, though, that Jim sells his bonds before maturity. He may have a capital gain or a loss, depending on how much of Jim's \$600 discount has been accrued (reduced). Halfway to the maturity date, \$300 of Jim's \$600 discount will have accrued so his basis in the bonds will have increased from the \$9,400 purchase price to \$9,700. Then, Jim would have a \$100 gain on a sale for \$9,800 and a \$100 loss on a sale for \$9,600. That gain or loss would be in addition to the \$300 of ordinary income Jim would recognize from the accrual of the discount.

Note that the rule illustrated in this example may not apply to a bond purchased before May 1, 1993. Tax-exempt bonds purchased before this date are not subject to the market discount rules; therefore, the accrued market discount on them will be treated as capital gain. The treatment of taxable bonds purchased before May 1, 1993, varies according to the bond's issue date. Bonds issued after July 18, 1984, are subject to the market discount rules. Taxable bonds purchased before that date are not.

As mentioned previously, investors who buy bonds at a discount have the option of recognizing the accrued income each year. The basis of the bonds is increased by the amount of market discount that you include in income each year, thus reducing the tax on sale or redemption of the bonds. Our office can help you determine if recognizing accrued income at the end of each year will be advantageous. ■