Midyear Tax Planning Letter

Mid-year planning this year may be one of the most critical overviews we have done in recent memory. As always, the key is to be able to project your anticipated income levels not only for 2010, but also for the next two to three years. Even though the normal incentive is to avoid paying any taxes for as long as possible, this strategy may have to be dramatically altered. On the other hand, deductions may be worth a great deal more a year or two out into the future.

Any tax projections can both require and challenge you to predict a series of unknown future events. You will need to make educated guesses and reasonable assumptions. Remember, tax planning is a dynamic process, and the earlier that it is started, the better.

Before going into the detailed planning tips which are set out below, here are some basic principles that can help guide your overall thinking:

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

Remember, the question is about your *marginal* tax rate. That is, the highest rate at which your last (marginal) dollar of income will be taxed. Even though overall tax rates will rise in 2011, if your income will be substantially lower in 2011 than in 2010, your marginal tax rate may actually decrease.

Here are a couple of additional guidelines:

- If you think your deductions might be restricted next year, accelerate some deductible expenses into this year.
- If you could qualify for the standard deduction in either year, consider shifting qualified expenditures into the year you expect to itemize your deductions.

It's important for you to make an appointment to meet with us now, during the middle of the 2010 tax year while there is still plenty of time to consider and implement appropriate tax planning strategies.

Marginal tax rates to increase. The biggest factor is that the marginal tax rates are scheduled to increase in 2011 to a top rate of 39.6 percent over the current top rate of 35 percent. But, that is misleading insomuch as the full benefit of *both* itemized deductions and personal/dependency exemptions will be capped at certain income levels in 2011. Taxpayers fully subject to this face an effective top marginal tax rate which could be three to four percentage points higher than the stated 39.6 percent rate.

Tax increase on dividends. If that were not enough, there is talk of allowing dividends to, once again, be taxed at the same rates as other ordinary income such as interest, rents and wages. Currently, qualified dividend income is taxed at a maximum rate of 15 percent. If dividends were to be subject to the top marginal rate of 39.6 percent, this would represent an increase of 164 percent!

Even if the 2011 tax rate on dividends were to remain at the same level as the tax rate on long-term capital gains, the tax rate increase on dividends would still be 33 percent, increasing from 15 percent to 20 percent for taxpayers finding themselves in the top two marginal tax brackets, namely, 36 percent and 39.6 percent.

Increase in long-term capital gains tax. The news gets worse, however. In 2013, the top marginal tax rate for long-term capital gains will climb to 23.8 percent for high income earners when a 3.8 percent Medicare tax will be added to the tax on capital gains. With scheduled rate increases such as these, any business owners considering the possible liquidation of their companies should probably opt for sooner rather than later.

Increase in Medicare surtax. Another critical issue may involve whether or not to take that bonus in 2010 versus next year (assuming that your company is finally starting to swing back into making money), or defer that compensation to 2013 or later. W-2 and self-employment income only faces a top rate of 35 percent this year versus 39.6 percent in 2011. And, starting in 2013, any earned income above $200,000 for an unmarried taxpayer ($250,000 on a joint return) will also be subject to a new .9% Medicare surtax, increasing the Medicare tax from 1.45 percent to 2.35 percent. Furthermore, the FICA cap is set at $108,600 for both 2010 and 2011, but with the shortfalls projected for the Social Security system, this cap is slated to rise to $154,000 by 2017!

The good news is, despite the fact that this Medicare surtax will be applied to most types of earned and unearned income starting in 2013, the tax will *not* be imposed upon retirement plan distributions, IRA payouts or Social Security benefits. Tax-exempt income, such as municipal bond interest, would also be spared. If you are otherwise required to take a minimum distribution out of a retirement plan or an IRA, you might want to consider taking some additional amounts in 2010 versus 2011 in light of these scheduled rate increases.

Timing on deductions is critical. The curious thing is that the value of deductions will correspondingly increase as these marginal tax rates go up over the next few years. Therefore, it might make a great deal of sense to pay any real estate taxes along with fourth-quarter estimated state income taxes just after the close of the 2010 tax year. However, if too many of these deduction dollars are paid in 2011 rather than 2010, the prospect of falling into an alternative minimum tax (AMT) trap can arise. The key is to find that balance between paying these expenses over the two-year period.

Strategy for expensing depreciable assets. The same will hold true for deductions stemming from depreciable asset acquisitions. However, the exact analysis will depend on your particular cash flow needs. The following three criteria might be used in doing this analysis:

1. If your business was experiencing cash flow problems (probably due to losses over the last several years) and your purchased assets during 2009, your would have up until October 15, 2010, the extended due date of the return, to claim 50 percent bonus depreciation. Only tangible real or personal property with a useful life of 20 years or less is eligible. This write-off could serve to create or increase a net operating loss which could then be carried back three, four or five years (to a profitable tax year) to garner a refund and help your cash flow needs. Conversely, deducting and expensing the asset's cost in this manner would *not* generate any immediate tax benefit to the extent that the business, or the K-1 business owner, did *not* have current business taxable income (profits) to cover the deduction amount.

2. If the business, especially a flow-through entity such as a partnership/LLC or an S corporation, was finally starting to make money and anticipated these profits to grow dramatically over the next several years, this could mean that future deductions would be even more valuable as individual tax rates increase. If that were the case, immediately expensing an asset's cost might make sense, even if there were not at least $250,000 of current profits to cover the expensed amount. For example, suppose 2010 was still a loss year, but the company was finally able to start reinvesting in plant and equipment. Also suppose that 2011 and 2012 were projected to be significantly more profitable. In such a scenario, it might make a lot of sense to elect to expense and deduct the asset's cost in 2010 and then carry it over to the next year or two when the owners were facing a 39.6 percent marginal tax rate on their company's profits.

3. If the deductions would be most valuable in later years, such as 2013 or later when the top marginal rate can be as much as 43. 4 percent, then opting to take normal depreciation over a four, six or eight-year period might be the best bet.

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

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

Strategies for owning real estate used in a business. With regard to our business investments, most of these are done through ownership of either a partnership/LLC or an S corporation. If we are merely an investor in this business enterprise, the "passive loss" rules are normally going to come into play. We are not allowed to take such passive losses (which have flowed through to us on a Schedule K-1) to the extent that they exceed any net profits received from such investments, or net rental income. The only other exception is when we finally dispose of our *entire* investment in a particular passive activity in a *fully taxable* transaction. Therefore, if we do hold investments in these so-called passive investments, it behooves us to consider disposing them in 2011 or 2013, when the value of such losses might be much more valuable.

While speaking of passive activities, it is very common for the owners of a business conducted as either a partnership/LLC or an S corporation to also own the real estate. The real estate is typically held in a separate LLC in the same percentages and is rented to these businesses. Furthermore, given the state of the economy over the last several years, rent being paid to the owners of these "real estate" LLCs was probably the last use to which the company's limited cash flow was put. As a result, it has not been unusual to see a net rental loss flowing out of the LLC to the owners on their K-1s. In such a situation, consideration should be given to elect to treat the ownership of the business as one activity with the LLC holding the real estate. The end result is that the passive loss rules do *not* apply to these particular rental losses, meaning that the owners can freely take them as a write-off against their W-2 and self-employment income, as well as their dividend, interest and capital gains income.

Taxpayers owning real estate used in or rented to a trade or business should consider having a "cost segregation" study done. This type of study will assess whether a much faster write-off can be done instead of the normal 27.5 or 39-year periods normally reserved for depreciable real estate. Not only will a shorter timeframe be required in taking any depreciation deductions, assets might be identified where you could elect to immediately expense a portion of their cost, or claim a 50% bonus depreciation deduction - at least for those assets placed into service before 2010.

Tax credits on energy saving investments. As far as any tax credits, taxpayers should be reminded that 30% of the cost of any insulation or other energy saving investments, such as new windows or doors, can be taken on their 2010 return, but limited to an overall cap of $1,500 for 2009 and 2010 combined.

Stipulations of first-time home buyer's credit. The use of the first-time home buyer's credit grew dramatically in 2010, but the key deadline, which has expired, is that the contract for purchase must have been signed by April 30th with the taxpayer taking occupancy by June 30th. The same occupancy cut-off of June 30th applies for new construction, as well as for those individuals claiming a credit for a new home purchase after owning another principal residence for at least five consecutive years out of the prior eight years.

Extension of provisions in 2010. Finally, there are a number of tax provisions that expired at the end of 2009 that will most certainly be extended for the 2010 tax year. Examples of these tax provisions include

the sales tax deduction, $250 educator's deduction, as well as charitable IRA transfers to a charity of up to $100,000. The trouble Congress is having is how to pay for their continuation in light of the current and projected future deficits. Nevertheless, they will be passed in time for filing our 2010 returns.

Gifts exceeding $13,000 annually to any third party remain taxable, but a credit against such transfer tax remains available for up to $1 million of gifts over one's lifetime. The news isn't so good for estate tax, which remains in limbo at this time. The consensus is that it will be retroactively reinstated with a top rate of 45% and an exemption of $3.5 million per decedent. Talks of lowering the rate or increasing the exemption remain just that – mere discussion points. The trick is how to pay for any tax cuts while simultaneously addressing the deficit and paying for the Health Care Act provisions. These provisions include a tax credit for small business owners helping to fund employee health insurance, as well as being able to cover children under age 27 through company medical reimbursement or employee cafeteria plans.

Hopefully, this letter outlined numerous tax alerts, which I would be happy to discuss further with you. But, I highly recommend that you schedule an appointment with me as soon as possible, while there is still time to implement recommended strategies. The 2010 tax year truly represents one of the most critical times in recent memory to identify any tax traps and maximize opportunities for dramatic tax savings. Next year may truly be too late….

To schedule your appointment with Joe Laciak, please call Lori Beier, Executive Assistant, at 219-864-7000, or email lbeier@laciak.com.