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2010 Yearend Tax Planning Alert
October 28, 2010

EXECUTIVE SUMMARY

Currently, the tax outlook for 2011 is murky. Your taxes may go up or they may stay the same. If they go up, they may go up on all types of income or on only selected types of income. Certain deductions and credits may expire, or they may be extended. We may not know what the outlook is for 2011 - or for 2010 with respect to some items - until late December 2010. Some traditional tax planning strategies may not work in 2010.

Some strategies may have to be executed at the very end of the year to be certain that they mesh with 2011 tax laws that will not be settled before then. So, planning now is very important in order to be ready to act late in the year. Even then, Congress may not decide on 2011 taxes (and some 2010 provisions) until 2011. In that case, you'll have to place your bets at yearend - or fold your tax planning cards - with respect to those strategies.

In this Yearend Tax Planning Alert, we cover a number of ideas, but not all possible tax planning moves. Many of the topics are complex. By necessity, we review strategies and tactics summarily. If you have questions or want to review your alternatives, please contact your Huselton, Morgan & Maultsby, P.C. ("HM&M") tax adviser.

EXPANDED ANALYSIS

As the tax return filing season ends on October 15, HM&M tax professionals usually begin in earnest yearend tax planning with our clients. This year is different because the Federal tax law is in an unprecedented state of flux. In this Alert, we explain why this is the case. We also focus on some yearend moves that make sense no matter what happens to tax law. Finally, we examine alternatives that need to be considered in light of possible tax law changes and readied soon for possible action as the year draws to a close.

Some of us at HM&M began our careers in taxes almost 40 years ago. None of us has ever seen such an uncertain short-term outlook with regard to Federal taxation. This complete lack of certainty complicates and necessarily defers until late in the year some planning moves, if they can be made at all. Many normal tax planning strategies may not be effective.

Why? If Congress doesn't act, about 140 tax breaks enacted in 2001 and 2003 (popularly known as the "Bush Tax Cuts"), along with some other beneficial tax provisions, expired at the end of 2009 or will expire at the end of 2010. Thus, with no action by Congress, among other changes:

Income taxes will rise for almost everyone in 2011;
Many more taxpayers will pay the alternative minimum tax ("AMT") in 2010; and
The estate tax will come back into existence in 2011 under pre-2001 law - with a 55% top rate and a \$1 million estate and gift tax lifetime exemption equivalent.

What is Congress currently doing about this? Nothing at the moment. Congress adjourned and legislators went home to campaign. They will not return to Washington until November 15. Taking into account other pressing legislative matters, they may not address taxes until December - or later.

What will Congress do about taxes? Of course, the results of the upcoming November elections will influence significantly tax policy. However, most observers posit three possible scenarios as starting points.

Do nothing and let all the tax breaks expire, raising taxes on everyone during a fragile economic recovery (the "Do Nothing" scenario).

Extend the Bush Tax Cuts and other tax breaks for everyone, either temporarily or permanently, which most Republicans and some Democrats favor (the "Republican alternative").

Extend the Bush Tax Cuts and other tax breaks for everyone but the "rich," either temporarily or permanently.

The Obama administration proposes this plan and, generally, seeks to minimize the benefits for single filers with over \$200,000 of income and married joint filers with over \$250,000 of income.

(This is the "Obama plan" generally set forth in the administration's 2011 budget proposal.)

There is a fourth sub-scenario. If a post-election lame duck Congress gets into another tussle about overall tax policy and economic stimulus, there may be short-term relief enacted in the form of specific provisions such as extension of the AMT patch and extension of education tax incentives for 2010 and 2011.

Then the rest of the tax provisions will be settled in a bare-knuckled legislative brawl.

The "smart money" seems to be betting that the Do Nothing scenario will not be the ultimate solution, although it may be the law as 2011 begins and last for a period of time while both sides of the aisle posture and blame the other for the malaise exacerbated by increased taxes.

After that, opinions diverge, but many commentators expect a temporary compromise landing somewhere between Republican alternative and the Obama plan.

However, remember that the "smart money" was betting about this time of the year in 2009 that Congress would never let the estate tax lapse in 2010.

Adding to the confusion are short-term tax stimuli enacted as part of the HIRE Act of 2010 and the Small Business Jobs Act of 2010 enacted in September.

Some of these stimuli are effective for a period of only a little over three months and end on December 31, 2010. Fast action is required to benefit from some of the tax breaks.

Further clouding the tax picture is the possibility of retroactive enactment for 2010 of the estate tax and the generation-skipping tax and increasing the gift tax rate from 35% to 45% or 55%. However, as the year draws to a close, this seems to be less likely. Indeed, a number of Congressional candidates are pledging to repeal the estate tax (again).

Finally, tax increases for some people loom in 2013, at which time higher income wage earners and self-employed persons face an additional 0.9 percentage health insurance tax and some investment income may attract an additional 3.8 percentage points of Medicare contribution tax.

Despite all the changes and all the uncertainty, there is one thing of which we are pretty certain: tax rates may go up or tax rates may stay the same, but tax rates won't be going down.

So, acting in such a dynamic environment, what can one do? We recommend the following:

Get the facts. Run the numbers based on current law for 2010 and 2011 (the Do Nothing scenario). Assess in broad terms the effect on your situation of the Obama plan and the Republican alternative. Assess where you have flexibility in your timing of recognizing income or incurring deductions in 2010, 2011 or later years. Assess your ability to make wealth transfers in 2010. Consider and execute tax planning strategies and tactics that work well in 2010, regardless of whether taxes remain the same or increase in the future. Gather information that may be needed to effect tax moves later in this year, if it becomes clear to you that your tax rates will increase in 2011. Then, watchfully wait to see if you can act before 2011.

Get the Facts and Run the Numbers

1. HM&M can help you get started.

2. We need to get into the details with you about how your 2010 income tax projection is different from 2009.

3. Then we review any tax attribute carryovers (such as capital loss carryovers, net operating loss carryovers, and charitable contribution carryovers) into 2010.

4. What does your 2011 income tax projection look like compared to the 2010 projection?

5. If you have a material interest in a business - How is that business doing?
Is it hiring? Is it spending money on capital equipment?

(As you will see below, the answers to these questions could affect the business' taxes in 2010.)

6. What is your estate plan? Do you have the ability to make significant wealth transfers or contributions now?

7. Do you have appreciated property that might be contributed to a charity?

Strategies and Tactics for 2010 to Consider Now

This list is not exhaustive. For the most part, this group of planning considerations is suitable and/or recommended for 2010, whether or not the tax rates stay the same in 2011 or increase in 2011.

Personal Investment Considerations

Buy Drugs! Beginning January 1, 2011, unless prescribed or insulin, the cost of the over-the-counter ("OTC") medicines cannot be reimbursed from flexible spending arrangements ("FSA") and other tax-advantaged reimbursement medical reimbursement arrangements. If you have not used all your FSA account in 2010, stock up on OTC medicines before yearend.

Get your IRAs in order. Conduct an IRA "checkup" to see that all is proper. If applicable, be sure to take your required minimum distributions (RMDs) in 2010, but wait a while if you can. You may want to delay your RMD until later in 2010, in case Congress extends the ability to make charitable contributions directly from an IRA. Such contributions count toward your RMD. There may be a "workaround" if you need to make your charitable contributions earlier.

Consider a conversion to a Roth IRA. 2010 is the first year that there is no adjusted gross income limit for persons wanting to convert a traditional IRA to a Roth IRA. While not for everyone, a conversion may be an excellent way to increase after-tax returns and to create a legacy asset for your heirs.

Also, a conversion may help achieve "tax diversification" in your investment portfolio. Learn more about Roth Conversions from our white paper at:

http://r20.rs6.net/tn.jsp?llr=itng8xcab&et=1103841470165&s=975&e=001Z0DfYQpyF4z4pVTvm6pnB2wliNjoZXyHfdTNF-jfJrweaVFmjYNpqoMwQ51087s9-cOVU1dj-PCkwa7MKB7760Gt9LHUQTDye3cZUCigsfkTuS0_iFtUlvjG3lsLXn3LRXeXM0ZB21dhPnkmBcw52xWrRceQIEOX
www.hmpc.com/documents/alerts/Roth_White_Paper.pdf

Seek benefits from any expiring tax attributes. For example, an expiring charitable contribution deduction carryover could bring down a Roth conversion tax to a maximum 17.5% rate. Assess how you might mitigate or exploit your AMT position. Again, a Roth conversion strategy provides an example. If you are always "deep into" AMT, you could convert as much of your traditional IRA as is taxable at the AMT tax rate of 28%.

The ability to recharacterize a Roth conversion up until October 15 of the following year allows you to "claw back" the amount that would tip over into the 35% tax rate. You could follow this strategy year after year. Review your withholding and estimated tax status. Increase your withholding to avoid or mitigate underpayment penalties. Withholding is deemed to occur pro rata throughout the year, even if withheld from a yearend bonus.

See how the one-year absence in 2010 of the "Pease reduction" for itemized deductions affects your taxes. When restored in 2011, for some high income taxpayers the Pease reduction can decrease itemized deductions by 80 percent. You may want to take advantage of this one-year opportunity by increasing your itemized deductions, subject to determining the effect of possible additional AMT application.

Review your investments to see if you have appreciated property owned for more than a year that you can contribute to charities. While there are special limitations for deductions of contributions of appreciated property, you can get a deduction up to the full value of the property and you don't have to recognize income tax on the appreciation.

Hold off on capital loss harvesting until later in the year, if you can. As discussed below, you may want to recognize net long-term capital gain in 2010.

Buy "qualified small business stock" before 2011, hold it for five years and sell it for a gain.

The gain can be tax-free. If you have a taxable estate as determined under 2009 or pre-2001 estate tax rules (simply referred to hereinafter as a "taxable estate"), be sure to use your annual gift tax exclusions to the maximum extent - \$13,000 per recipient - \$26,000 from a husband and wife. Form a family limited partnership ("FLP") and gift interests to your family. Usually, if

properly constructed, you can take discounts on the gifts of the limited partnership interests, compared to the proportionate value of the underlying properties.

The Democrat-controlled Congress is going after many kinds of these arrangements, but hasn't outlawed them yet. If Congress continues to try to limit the application of this strategy, any new rules most likely would be prospectively applied.

Set up a short-term zeroed-out grantor retained annuity trust ("GRAT"). Do you have property that you think will appreciate markedly and want to transfer that appreciation to your children (or grandchildren) tax free? Then, you need to investigate this strategy for immediate implementation. It, too, is being targeted by the current Congress. If any changes are made, they will probably be prospectively applied.

Business Considerations

Review your 2010 and 2011 capital spending plan in light of the expanded Section 179 expensing provision. Many small businesses will be able to deduct currently all of their equipment placed in service in 2010 and 2011.

Gauge the effect on your taxes and your capital spending plan of the extension of 50% bonus depreciation for 2010 only.

Buy new business vehicles in 2010. Enhanced depreciation on new vehicle purchases is scheduled to end in 2010.

Small businesses may be entitled to a health insurance tax credit for 2010. Be sure you have the information to claim it.

An eligible small employer with no more than 25 full-time equivalent employees can receive a tax credit if it offers health insurance to its employees as part of their compensation and contributes at least half the total premium cost. Substantial owners of businesses and their families are not treated as employees for purposes of this credit. The credit is not available for domestic employees of sole proprietors.

Wage limit qualifications exist. The credit is available for 2010-2014. After 2014, the credit is available for an additional two-year period to certain small employers who purchase employee insurance through a state insurance exchange. You may be entitled to a social security tax exemption for new hires in 2010 and a tax credit for retaining those new hires. To help stimulate the hiring of workers by the private sector, not-for-profit organizations, and public higher education institutions, the HIRE Act of 2010 exempts any of such employers that hires a worker who had been unemployed for at least 60 days from having to pay the employer's 6.2% share of the Social Security payroll tax on that employee for the remainder of 2010. The employee must be hired after February 3, 2010. The tax liability is forgiven for taxes on wages paid in any period starting after March 18, 2010. The HIRE Act also provides a credit of \$1,000 for employers who retain such employees for at least 52 weeks. Various limitations on claiming the credit exist.

If Your Taxes Will Be Going Up in 2011

In "normal times," a general income tax planning strategy involves accelerating deductions or deferring income. If rates on all income stay the same in 2011 as they are in 2010, and the other Bush Tax Cuts are extended, this income tax planning strategy continues to work.

If rates rise on all or selected forms of income and some or all of the other Bush Tax Cuts are not renewed, then this general tax planning strategy begins to lose its efficacy. The effects of specific tax planning strategies and tactics can be subtle and must be carefully analyzed.

If Congress decides in 2010 to increase your income taxes in 2011, then you should consider now and be ready to execute before the end of the year one or more of the following strategies.

Personal and Investment Considerations

If you have the ability to accelerate a bonus from early 2011 to 2010, do so. Be sure that you are not running afoul of the deferred compensation rules under Section 409A.

Recognize net long-term capital gains in 2010. Consider not harvesting losses to offset 2010 long-term capital gains. The tax rates on long-term capital gains are scheduled to go from a maximum of 15% (0% to the extent the gain would otherwise be taxed at a rate below 25% if it were ordinary income), to 20% (18% for assets held more than five years).

Consider recognizing income in 2010 from the exercise of non-qualified stock options, rather than in a later year. Top rates are scheduled to rise from 35% to 39.6% next year (and possibly as high as an effective 43.3% rate in 2013 and thereafter).

Consider deferring itemized deductions into 2011, such as charitable contributions, property tax payments, mortgage payments and miscellaneous itemized deductions. On the other hand, you might consider accelerating itemized deductions into 2010. You must assess your itemized deduction strategies while also considering their effects on your AMT liabilities for both years.

Also, if you have a very high income, you must consider the merits of offsetting higher 2011 tax rates relative to the merits of getting a deduction in 2010 when the itemized deduct phase-out, the "Pease reduction," is repealed. (It reappears in 2011 in full force.)

If you have a taxable estate and you don't need it all to live on, and you have used your estate and gift tax unified credit, consider big gifts in 2010. Under the 2010 transfer tax laws, gifts are taxed 35%, which is a rate less than what they were taxed in 2009 (45%) or what they are scheduled to be taxed at in 2011 (55%). However, are you concerned that "normal" estate and gift tax laws (a) could be reinstated retroactively for 2010 or (b) could be permanently repealed by a new Congress (and thus you paid 35% tax on the transfers unnecessarily)?

If you are married, some estate planners suggest that you might work with an attorney to give gifts to a QTIP trust for your spouse, who could disclaim those gifts if your concerns did not come to pass.

If you are giving gifts, you might be generous to your grandchildren.

Barring a retroactive change, there is no generation skipping transfer tax for 2010.

Business Considerations

Good news. Generally speaking, C corporations do not have the same tax rate change challenges to yearend planning except for one important item. Their tax rates don't change in 2011.

However, tax rates are scheduled to go from a maximum of 15% on "qualified dividends" to a maximum of 39.6% (and 43.4% in 2013 and later years). News reports have discussed how privately held C corporations have borrowed money to pay for extraordinary dividend distributions prior to 2010 in order to take advantage.

If you have a C corporation, you might consider dividend payments in 2010.

If you have an S corporation that was once a C corporation, you might consider large distributions in 2010 to empty the accumulated earnings and profits from its C corporation days in order to take advantage of the 15% tax rate on qualified dividends. This can be a complicated strategy and requires some serious number crunching. Some cash basis businesses can accelerate billings and/or delay paying expenses to pay tax at a lower rate in 2010. In some limited cases, there may be the opportunity to effect a change in accounting method to defer expenses to 2011, where they will offset income taxed at a higher rate. If you have purchased real estate for use in your business or for rental in recent years, you may be able to be able to effect a cost segregation strategy that could bunch prior year "missed" deductions into the year of the cost segregation implementation.

Bunching deductions in a higher-tax-rate year is beneficial.

